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COMPANY SECURITY INTERESTS

A consultative report

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This consultative report, completed on 13 August 2004, is circulated for comment and criticism only. It does not represent the final views of the Law Commission.

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THE LAW COMMISSION

COMPANY SECURITY INTERESTS

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Executive Summary

Introduction

1.1 This consultative report and draft regulations set out a scheme for the registration and priority of mortgages and other forms of security created by companies. It also makes general recommendations on the law that applies to security created by unincorporated businesses.

1.2 The consultative report is detailed and complex. This is necessary. Many of the responses to our first consultation paper on this topic (CP No 164, Registration of Security Interests: Company Charges andProperty other than Land (2002)) expressed great interest in the scheme but said that it was not possible to evaluate all its aspects properly without seeing the detail. Much of the report is intended for the specialist reader.

1.3 This summary deals only with the general issues at stake: the difficulties with the current law that make reform necessary, the broad outline of our proposals for reform, and the advantages, as we perceive them, of the scheme that we provisionally recommend.

Background

1.4 Companies, like other businesses, are often dependent on credit. They obtain credit from a number of sources – for example, from lenders such as banks, from suppliers of goods who are prepared to deliver on credit terms and from financiers who are prepared to advance money against the company's future income.

1.5 Any creditor faces the risk that the debtor will be unable to repay. A lender will often insist that the loan be secured by a mortgage or charge over the company's assets, so that if the company becomes insolvent the creditor may take the assets charged and sell them to pay off the debt. Secured lending is of great importance to small and medium-size enterprises, which may not have a sufficient credit-rating to be able to borrow on an unsecured basis at reasonable rates. It is of enormous importance in the financial sector, and it is frequently used by large companies to protect themselves when they are

involved in projects through ‘single purpose vehicles’ that they set up for the project.

1.6 The protection of the secured creditor may be at the expense of other, unsecured creditors. The security could also affect other people who deal with the company: they might buy the asset, or themselves take security over it, without knowing about the rights of the secured creditor. For these reasons it has long been the law that most mortgages and charges over a company’s property have to be publicised by registration on the Companies Register. (There is a separate register for unincorporated businesses.) There are also rules on the ‘priority’ of charges against other secured creditors and those who buy the property that has been charged. These depend on a complex set of factors. One is whether the charge was ‘fixed’ or ‘floating’. A company that has given a fixed charge over an asset cannot dispose of the asset without getting the chargee’s agreement. A floating charge allows the company greater freedom to continue business as usual, but for the lender is a weak form of security.

1.7 The current law provides that details of most company charges have to be registered at Companies House within 21 days. If this is not done and the company goes into liquidation, the charge will be invalid; in effect, the lender will become just another unsecured creditor. The charge will also be void against other creditors, which means that it will lose priority to later charges, providing these are properly registered. The Companies Act 1985 sets out a fixed list of the types of charge that are registrable. Charges that are not on the list do not have to be registered, and can be effective against third parties even though there is no way of finding out about them.

Difficulties with the present law

1.8 The current system is open to a number of criticisms. For instance:

- the registration process is unnecessarily cumbersome and expensive for what it achieves. It is paper-based; for each registrable charge a form stating particulars of the charge, and the original charge document, must be sent to Companies House. Registration after 21 days requires a court order;

- in theory Companies House will check the particulars submitted against the document. In practice this cannot always be done. As a result the Registrar may certify that a charge is properly registered although the particulars on the Register are not accurate;
- the list of what charges are registrable is arbitrary. A fixed charge over shares, for example, is not registrable, but a fixed charge over the dividends that those shares produce is registrable (as a charge over book debts);
- charges over certain types of property, such as land, may have to be registered twice: at Companies House and at the Land Registry. This seems unnecessary and can give rise to complications that are needless;
- the rules that determine priority of competing charges or other interests over the same assets are complex, unclear and in some cases unsuited to the needs of modern methods of business finance;
- recent EC legislation on taking security over 'financial collateral' (investment property such as shares, and bank accounts), because it refers to concepts such as 'control' that have not hitherto been found in our law, has left the law in a somewhat uncertain state. It is not clear what amounts to 'control';
- for unincorporated businesses there is a separate and quite different scheme. This scheme restricts secured lending to unincorporated businesses in ways that seem unnecessary, both because it imposes restrictions on the types of charge that may be taken and because the registration process is so complex and risky that few lenders are willing to use it.

1.9 In addition to these criticisms of the system that applies to mortgages and charges used by companies and other businesses, the current law is open to a more fundamental criticism. It determines whether a transaction amounts to a 'security' on the basis of legal form, rather than looking at function. There are many transactions which fulfil the same purpose as a charge, namely of securing an obligation, but which are not treated by the law as creating security. For example, when a company obtains goods on credit, the supplier may 'retain' ownership of the goods (by using a conditional sale, hire purchase agreement or finance lease) so that, if the company defaults, it may repossess the goods to satisfy the debt due to it. Equally a financier may

advance money to the company as against its future income, but rather than take a charge over the company's 'receivables' it may simply 'buy' them.

1.10 The differences between the way the law treats charges and the way it treats these 'quasi-security' transactions, as they are often called, causes difficulties:

- none of the 'quasi-security' transactions has to be registered. Although there are some voluntary schemes of registration, it may be difficult for other creditors or buyers dealing with a company to find out which goods on a company's premises belong to it, and which still belong to the supplier under a conditional sale, hire-purchase agreement or finance lease. It is also hard to find out which of a company's 'receivables' have been sold. Nonetheless the 'quasi-security interest' will frequently be effective against anyone who buys the relevant assets or takes another security interest over it;
- if the company defaults on its loan, the remedies of the creditor and the rights of the debtor company are quite different to those under a mortgage or charge. This makes the law unduly complex. It leads to results that seem inappropriate and which the courts have on occasion struggled to avoid.

Our proposals

1.11 We suggest replacing the current registration scheme set out in the Companies Act 1985 with a more comprehensive legislative scheme. At a later stage the scheme could be extended to unincorporated businesses.

1.12 This legislation on charges would:

- introduce a wholly electronic registration system ('notice-filing'), so that both registration ('filing') and searching can be done via the internet or, for regular users, via direct computer links. This will make it cheaper and faster to register and to search, and will reduce the cost of maintaining the registration system;
- eliminate the need to register twice for land and other property for which there is a specialist mortgage register. There would be no requirement to file at Companies House;

- remove the 21-day time limit for registration and any need for a court order for 'late' registration;
- enable filing in advance of the actual transaction, and a single filing to be made for a series of transactions between the same parties;
- in practice, remove the distinction between the 'fixed' and the 'floating' charge, whilst retaining the commercial advantages of the latter;
- set out clear and rational rules on priority, broadly preserving the existing balance between competing security interests but linking priority to readily-determined facts such as the date of registration and whether the creditor financed the company's purchase of the asset in question;
- set out clear and rational rules on when a person who buys property from a company will be bound by, or take free of, any security interest over it, so that the buyer knows when it needs to search the register.

1.13 In a separate Part dealing with financial collateral, the consultative report provisionally recommends the adoption of rules that reflect the particular needs of the financial markets:

- filing would not be needed where 'control' was taken of the financial asset;
- 'control' would be defined in a way that fits with commercial good practice;
- the priority rules would be clarified and would give priority to secured parties who have taken 'control' of financial collateral.

1.14 The consultative report provisionally recommends that the scheme should be extended to quasi-securities, and deal with the question of the remedies available on default. It should:

- provide for filing of sales of receivables;
- subject to the views of consultees when they have had the chance to evaluate the scheme in detail, cover conditional sales, hire-purchase agreements and finance leases; and
- set out in legislative form a statement of rights and remedies in the case of the company defaulting on its obligations.

The advantages

1.15 We think our proposals would bring advantages:

- To companies:

- they will be no longer be legally responsible for registering charges: filing would be up to the secured party;
- the lower costs of the scheme to the lender, and its greater certainty and reliability, should make it easier to obtain secured credit and reduce its cost.

- To the secured lender who uses the current registration system:
  - filing would be simple, using only readily available information, and not requiring legal expertise. There would be no need to prepare special documentation for sending to the registry, or to send the charge document;
  - there would be no fixed time limit on filing and no need for court proceedings for 'late' registration;
  - the filing could be made, provided the other party agrees, before the security agreement is finalised; and one filing could cover a series of future transactions;
  - searching will be fast and cheap;
  - charges will appear on the register the moment a filing has been made. Periods of 'invisibility' after a charge has been created but before it has been registered would be largely eliminated;
  - the rules of priority would be clearer and suited to modern financing methods. Once the secured party had filed, it could be confident that its security would have priority, as against any other secured party, as from the date of filing, save in those specific cases in which the scheme provides otherwise. The same would apply as against someone who has bought the assets charged from the company;
  - it will have a new form of security that has all the advantages of the floating charge but with fewer disadvantages.
- To those who take security over financial collateral:
  - the uncertainty surrounding the notion of 'control' will be removed in a way that will encourage good commercial practice;
  - there will be clear rules of priority over financial collateral.
- To receivables financiers. 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. Once they have filed they will ensure their own priority, without having to notify account debtors who owe the receivables.

- To finance companies. If the scheme is extended to cover conditional sales, hire-purchase agreements and finance leases, the same advantages will apply to finance companies. They will normally retain their existing priority.
- To materials suppliers who use 'retention of title' clauses. Although the scheme will require them to file, it will enable them to take a security interest over 'new' goods made out of their materials.
- To buyers of goods from a company:
  - they will not be affected by any unfiled non-possessory security of which they were not aware;
  - it will be clear when they will be bound by filed security interests, and so should search the register, and when not;
  - with vehicles, the system will allow a search by vehicle identification number alone; if no filing is found they can buy in confidence that they will not be affected by any finance agreement over the vehicle.
- To liquidators and administrators, who will find it much easier to determine who has an effective security interest over what assets.
- Companies House would no longer have to check particulars of charge documents; the register will show the information as supplied by the secured party.
- The law on:
  - priority of competing interests; and
  - the respective rights and duties of the parties in the case of default by the company (for example, the procedures for realising collateral)

  will be clearer and easier to find.

1.15 The scheme that we have outlined above is one that we put forward for consultation. We would very much welcome views and comments.

PART 1
INTRODUCTION

1.1 This consultative report sets out in detail our provisional recommendations for a scheme of electronic 'notice-filing' for mortgages and charges over the property of companies,[1] and associated rules on priority. Notice-filing would replace the current scheme of paper registration of charges created by companies under Part XII of the Companies Act 1985. This is the second formal consultation document we have published as part of this project.[2]

1.2 The title of this consultative report - Company Security Interests - reflects the fact that our provisional recommendations and draft legislation cover more than company charges. English law currently treats mortgages and charges in a different way from other transactions that have a security purpose, such as title-retention devices and the sale of expected income ('receivables'). If our recommendations were accepted in full, the scheme would apply also to these 'quasi-securities', and there would be a legislative statement of the rights and remedies of the parties to all transactions involving personal property that have a security purpose.

1.3 In addition, we recommend that the notice-filing scheme should be extended to cover security interests over personal property created by unincorporated businesses. It would replace the Bills of Sale Acts 1878 and 1882. This will require separate legislation.

1.4 The current law has been the subject of serious criticism for many years.[3] It is claimed, for example, that the registration provisions for company charges are inefficient; those for other businesses are extremely complex and restrictive. Neither set of provisions gives a complete picture of which of a debtor's apparent assets are in fact encumbered by a security interest. The priority rules are complex, sometimes uncertain in their operation and frequently inappropriate to modern needs. The law on the remedies available is full of distinctions that make little functional sense.

1.5 The notice-filing scheme that we provisionally recommend is not our invention. It is a scheme whose essential features were devised in the United States over fifty years ago as Article 9 of the Uniform Commercial Code (UCC). Article 9 has been hailed as a great success.[4] A similar scheme was adopted in Ontario in

[1] Mortgages and charges over land and various other assets for which there is a specialist register would be excluded: see below, para 2.20.

[2] See below, para 1.10. We have, however, circulated on a limited basis a number of draft papers which have formed the basis of discussion at a number of seminars: see below, para 1.13.

[3] Eg, Report of the Committee on Consumer Credit (1971) Cmnd 4596 (the 'Crowther report'), Parts IV and V; A L Diamond, *A Review of Security Interests in Property* (1989) (the 'Diamond report'). For details of the criticisms, see below, paras 2.3-2.5.

[4] See further below, para 2.129.

1967 and Personal Property Security Acts (PPSAs) have now been enacted in all but one of the Canadian provinces. Most recently, New Zealand adopted a PPSA[5] that follows the same model. Adoption is under active consideration in Australia[6] and Singapore.[7] Notice-filing also forms the basis of a Model Law promulgated by the European Bank for Reconstruction and Development.[8] Legislation based on this model has been adopted in ten jurisdictions of Central and Eastern Europe. Not only have we been able to draw on these earlier legislative schemes, we are also able to draw on the years of experience of their operation in North America. We must not assume that what has worked well in North America will necessarily work as well here; but the fact that Article 9 and the PPSAs have been so successful means that they deserve very careful consideration.

THE IMPORTANCE OF CREDIT AND OF SECURITY

1.6 Credit is vital to business, both to support the start-up or expansion of a business and to finance its operating costs in relation to staff, premises, equipment and the various stages of dealing with its products or services. Many of these costs will be incurred before the final products or services are sold in the marketplace, and even then the customer may delay payment, whether by agreement or otherwise. In order to cover these costs a business will frequently need to borrow funds or to delay payment to its own suppliers. As the Cork Committee put it, '[c]redit is the lifeblood of the modern industrialised economy'[9] - words that are as true today as when they were written in 1982.

1.7 Those who lend or who supply goods or services on credit will often take steps to protect themselves against the risk of the business to whom they are supplying becoming insolvent before it has repaid what it owes. This protection can be achieved by taking security (usually in a non-possessory form, such as a mortgage or charge), or, when goods are supplied on credit, by the supplier retaining title to goods until payment is made, as with a conditional sale or a hire-purchase agreement. The fact that the loan or credit is effectively secured will usually mean that the charges for credit will be lower than if the credit were unsecured.[10] Secured credit is thus seen as being of great importance to the economy. As Professor Goode has put it:

> Security in personal property has become enormously important both within a country and in relation to cross-border transactions.

5 Personal Property Securities Act 1999.

6 See CP para 1.44, and (2002) 14 Bond LR.

7 See G McCormack, "Reforming the Law of Security Interests: National and International Perspectives" [2003] Singapore JLS 1.

8 CP para 1.47.

9 Report of the Review Committee on Insolvency Law and Practice (1982) Cmnd 8558, para 10, quoted in the Diamond report, para 8.1.7.

10 There may be other reasons for taking security: see R Goode, *Legal Problems of Credit and Security* (3rd ed 2003) paras 1-01-1-02 (pp 1-3).

> Without an adequate legal regime for personal property security rights, it is almost impossible for a national economy to develop.[11]

1.8 It is no doubt possible to exaggerate the importance of secured credit. We have been told that its importance varies from one sector to another. Many large, public companies are apparently able to borrow as cheaply on an unsecured basis as on a secured one, as lenders see the risk of the company defaulting as low. Small and medium-sized enterprises, however, present a higher degree of risk to a creditor. For them, the ability to offer security to the creditor may be vital to their survival and growth. Even public companies frequently make use of forms of security. Many large projects are now carried out through 'single (or 'special') purpose vehicles' (SPVs), companies that are set up, often jointly between a number of public companies, for the particular project. The public companies that finance the SPV will normally wish to take security over any physical assets bought or built by the SPV, as well as the stream of income from the ultimate client by whom the project was commissioned. Secured financing is also a crucial feature of financial markets.[12]

TERMS OF REFERENCE

1.9 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.[13] That Group developed a set of provisional proposals to establish a 'notice-filing' scheme, but had not had the time to discuss them widely.[14] 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,

[11] 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.

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

[13] *Modern Company Law for a Competitive Economy: Final Report* URN 01/942, ch 12.

[14] See Registration of Security Interests: Company Charges and Property other than Land (2002) Consultation Paper No 164, paras 1.12-1.15.

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;

(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 CONSULTATION PAPER

1.10 In July 2002 we published our consultation paper on Registration of Security Interests: Company Charges and Property other than Land (CP).[15] The central provisional proposal of the CP was that a new scheme of 'notice-filing', and associated rules of priority, should 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. (In this consultative report we work on the basis that consultees will have read the CP or can refer to it.[16])

1.11 In the CP we approached the matter in distinct tranches. We first examined how notice-filing for company charges could operate in general terms, and considered what charges should be registrable. We then asked whether a 'functional approach' should be taken, so that 'quasi-securities' would be included. We next considered whether the notice-filing system we proposed for companies should be extended to cover unincorporated businesses and individuals. Lastly we examined what degree of legislative statement of the law of security, if any, would be needed as part of any notice-filing reforms. (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 the CP.)

1.12 We received 68 responses to the CP, from a range of practitioners, academics and interested groups. The notice-filing scheme for the registration of company charges that we provisionally proposed, and its associated priority rules, received the broad support of all but a handful of consultees, though many consultees had particular reservations and some questions were raised about the effects of the scheme and its implementation. There was also broad support for our provisional proposal that the scheme should be extended to cover unincorporated businesses. The proposal to extend the scheme to include quasi-securities proved to be more controversial.[17] Some consultees approved this proposal,

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

[16] The CP is available on the Law Commission's website: http://www.lawcom.gov.uk.

[17] The principal concerns are addressed in Part 2. We will note the views of consultees on other issues as they arise during the course of this consultative report.

others opposed it and the greatest number said that they wished to see how the scheme would operate in more detail before deciding whether it was justified. A particular question 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.

FURTHER CONSULTATION

1.13 The CP had been prepared and was published on the understanding that the best chance of implementing any legislative scheme was as part of the DTI's proposed wider reforms of company law arising from the Company Law Review process. This meant that the CP had to be produced in a shorter time than we would ordinarily have wished. As a result the scheme was not fully developed in the CP, and there was not time to meet with many interested groups before it was published. After the end of the formal consultation process we circulated a number of informal discussion papers and held meetings and seminars with interested groups, to help us to develop our policy.[18]

1.14 Consultees have several times stressed that in order to be able to comment on our proposals in detail, they needed to know how our provisional proposals would actually be effected in legislative form. We agree. The purpose of this consultative report is therefore to explain how the scheme we provisionally recommend would operate and to seek comments, both on the overall scope of the scheme and on its detail, as set out in this consultative report and the accompanying draft legislation. Many of the issues dealt with in both the consultative report and the draft regulations are complex.

1.15 This further consultation has also had to be carried out within tight time constraints, in order to meet the DTI's timetable for wider company law reforms. It will not be possible for us to take into account comments received after the closing date for consultation, November 23, 2004. In order to maximise the time available to consultees, we are making this consultative report available on our website before printed copies can be made available.

1.16 Our terms of reference and the CP covered security interests created by debtors of all types. In this consultative report, however, we deal principally with security interests created by companies, and the draft legislation included in Appendix A is limited to companies and limited liability partnerships. Whilst we would prefer a scheme that would apply to at least all 'business' debtors (we have not at this stage reached any conclusions as to security interests created by consumer debtors), we have received clear advice not to insist on such an approach if there is to be any chance of implementation in even the medium-term. We are in any event of the view that the introduction of a scheme just for companies would have sufficient benefits to warrant adopting such a course, rather than insisting on an 'all or nothing' approach.

[18] Amongst these included seminars in September and October 2003 hosted by the Society for Advanced Legal Studies, Norton Rose, Clifford Chance, Allen & Overy and Berwin Leighton Paisner (the Law Commission was not in a position to proceed with a seminar planned to be held at Freshfields Bruckhaus Derringer).

1.17 After analysis of responses to this consultative report, we plan to amend the draft regulations and publish a Final Report by the summer of 2005. That will set out our final recommendations on a scheme for security interests created by companies. Depending on the results of consultation, we expect that the Final Report will also address our final conclusions on the question of extending the scheme to non-corporate businesses (although it would probably not include any legislative provisions in this respect), and we hope that it may also be possible to make recommendations on security interests created by consumers.[19]

STRUCTURE OF THIS CONSULTATIVE REPORT

1.18 In this Part we have set out a brief history of the project and developments since the publication of the CP. Below, we explain the derivation of the draft regulations and give a very short summary of the scheme we provisionally propose. In Part 2 we address what we consider to be the 'critical issues' raised by the new legislative scheme that we provisionally recommend, and we provide a brief overview of the main aspects of the scheme. In Part 3 we explain the central features in detail, and in Part 4 we deal with security interests over financial collateral, for which we recommend particular rules. In Part 5 we provisionally recommend the inclusion of a statement of the rights and obligations of the parties to a security agreement, which is aimed at clarifying and simplifying the law. Part 6 contains a list of our provisional recommendations and questions for consultation. We attach as Appendix A the draft regulations, with brief notes and cross-references to the text). We identify in Appendix B the changes that would have to be made to the legislation if a more limited scheme were to be introduced simply for 'traditional' securities and sales of receivables, rather than one that includes title-retention quasi-securities (as the draft legislation currently does).

THE DRAFT REGULATIONS[20]

1.19 The draft legislation that accompanies this consultative report is in the form of regulations rather than a Bill. The work on this project has always been based on our understanding from the DTI that the most likely way of implementing any recommendations we make in this area would be by secondary legislation[21] under a forthcoming Companies Bill.[22]

1.20 In general terms, the draft regulations follow the equivalent legislation in force in all but one of the provinces of Canada. In the absence of an up-to-date version of

[19] We consulted on the question of including consumers in the CP, although we received fewer responses than for businesses, and we are continuing work on this area.

[20] For convenience, although we use the term 'draft regulations', we will use the term 'DR' when referring to a particular numbered draft regulation contained in Appendix A.

[21] We have been advised that even if the scheme were not, in the first instance, to be confined to companies it would be preferable to have a short Bill and the details of the scheme in secondary legislation.

[22] As a result, instead of the approach generally taken by the PPSAs, of having the main provisions in primary legislation with detailed additional requirements introduced by secondary legislation, we are proposing that any Companies Bill which implements our draft regulations give the Registrar rule-making powers in certain areas (such as determining the exact detail of a financing statement): see below, para 1.29.

the model Canadian statute, we have used the Saskatchewan Personal Property Security Act 1993 (SPPSA) as a model. The decision to use overseas legislation as a guide was taken partly due to constraints of time, and partly because we see no need to re-invent the wheel. Our draft regulations do, however, reflect policy variations and differences of English law and practice, which are sometimes significant. Moreover, in several areas covered by the draft regulations – particularly those concerned with financial collateral – the Canadian legislation is no longer up-to-date. The relevant law reform bodies in Canada have proposed amendments to the model PPSA law that follow Revised Articles 8 and 9 of the UCC, and we have broadly followed the same approach. In some places we have followed the provisions of the UCC more directly. We have also examined the New Zealand Personal Property Securities Act 1999 (NZPPSA). We are grateful for the work done by all those involved in the models upon which we have relied.

1.21 Unlike other schemes, our draft regulations are concerned only with security interests created by debtors who are registered companies, limited liability partnerships and, in some cases, companies incorporated outside England and Wales.[23] However, this difference is reflected in only a few of the individual draft regulations, as in most cases the legislative wording would be identical regardless of legal personality.

1.22 There are some issues with which the draft regulations do not deal, such as the service of notices or the power of the Registrar to charge fees. These are better addressed in the Bill itself. However, the draft regulations contain some provisions that might ultimately be better placed in the Bill, but which we have included because of particular concerns of consultees that the issue should be addressed. An example is the meaning of 'knowledge';[24] at a later stage it may be found to be equally applicable to other Parts of the legislation and be removed to the Bill. The draft regulations also contain a number of provisions that require something to be done within a certain time period. These time periods appear in square brackets in the draft regulations, to emphasise that as in many cases we have no strong view as to the appropriate length.[25]

SUMMARY OF THE SCHEME

1.23 The scheme that we provisionally recommend in this consultative report is in its essentials the same as that proposed in the CP. Some elements - particularly the proposals on security interests over financial collateral - are considerably more developed than they were at the earlier stage. Other topics - for example, the issue of security interests created by foreign companies - were touched on only briefly in the CP. Throughout there have been many refinements as the result of the responses to our formal and informal consultation and of further work.

[23] However, there are provisions relevant to non-corporate debtors where transfer of collateral between different types of debtor is concerned.

[24] See DR 10.

[25] We have also used the concept of 'business days', a term already used in the Civil Procedure Rules, but again we have no strong views on this issue.

1.24 In summary, the draft regulations apply to security interests created by companies registered in England and Wales (and, by consequential amendment, to limited liability partnerships). They also apply to security interests created by companies registered in Scotland or incorporated outside Great Britain over property in England and Wales (whether here at the time the security interest is created or when subsequently brought in) or to which the law of England and Wales would apply for the purposes of determining questions of perfection and priority.

1.25 The draft regulations define a 'security interest' in wide terms, to encompass interests in personal property that in substance secure payment or performance of an obligation. This will include not only what is treated by the current law as security (charges, mortgages and pledges), but also title-retention transactions that have a similar functional effect and various allied transactions, in particular sales of receivables – the so-called 'quasi-securities'.[26]

1.26 The distinction between fixed and floating charges effectively disappears under the rules of the scheme. In effect the floating charge is replaced by a new form of security interest that has the same advantages to lender and borrower,[27] but with fewer disadvantages to the lender.

1.27 The draft regulations set out when a security interest attaches and when and how it may be perfected (that is, what steps need to be taken to ensure as far as legally permissible, its effectiveness and priority against third parties). Perfection can be achieved in several ways, including by filing and possession. Special rules apply to 'investment property' (shares and other financial instruments) and bank accounts; with these, perfection can also be achieved by 'control'.[28] Failure to perfect a security interest will result in loss of priority and ineffectiveness against the administrator, liquidator and other secured parties on insolvency.

1.28 A clear, detailed scheme of rules is established to determine the priority of conflicting security interests over the same 'collateral'. These include rules to give those who supply the funds for the acquisition of the relevant collateral priority over prior financiers (by way of the 'purchase-money security interest'), and for those who choose to perfect their security interest by a particular method.[29] Rules are also included to determine the position of those who buy collateral that is subject to a security interest.

1.29 The draft regulations set out provisional recommendations on perfection of a security interest by filing. However, not all the detail is contained in the draft regulations. It is more appropriate that much of it should be covered by Rules to

[26] Although the draft regulations apply to quasi-securities, we make clear that this is an issue open to consultation. In Appendix B we indicate the few provisions of the draft regulations that will need to be amended in order to allow for a scheme to be introduced that applied only to 'traditional' securities and sales of receivables.

[27] Ie, enabling the debtor to continue to dispose of the property that is subject to the charge without the secured party's consent for each disposition.

[28] Perfection by control will bring priority benefits over perfection by another method.

[29] Eg, by control rather than filing, in the case of investment property and bank accounts.

be made at a later stage, probably by the Registrar of Companies for England and Wales, under powers created by any enabling Companies Bill.

1.30 Given the significant changes that the draft regulations would bring about, there would need to be a period of time before they came into effect. In addition, the draft regulations include transitional provisions. We provisionally recommend that if quasi-securities are to be brought within the scheme, there should be a relatively long transitional period in order to avoid the need to register most existing quasi-securities.

SCOTLAND

1.31 At the time we were first approached by the DTI about this project, it was wondered whether some form of joint project between the Law Commission and the Scottish Law Commission (SLC) might be possible. However, for various reasons a separate reference was made to the SLC, in more limited terms than our own. At the end of 2002 the SLC published its Discussion Paper on Registration of Rights in Security by Companies,[30] in which it made provisional proposals which did not involve any form of 'notice-filing'. At the time of writing this consultative report the SLC has yet to publish its final recommendations.

1.32 At present the Companies Act 1985 imposes a similar registration regime, although the substantive law of security is different in the two jurisdictions. If a scheme along the lines of that provisionally proposed by the SLC were to be implemented, the registration schemes operating under Scots law and English law would be different, even were English law to remain unaltered. In Scots law, only floating charges would be registrable; the charge would have to be registered as a condition of its validity; and it is possible that the charge document itself might have to be registered.[31] Were our proposals to be implemented the divergence would be greater still. Final policy in this area will depend on how, if at all, the provisions of the Companies Act 1985 are to be modified or replaced in relation to Scottish companies. If the provisional proposals by the SLC were to be enacted it seems likely that there would have to be changes to the present arrangements for 'cross-border charges', whether or not our proposals were implemented.

CONSULTATION QUESTIONS

1.33 In this consultative report we have followed our usual practice of highlighting in bold text our provisional recommendations and specific questions for consultees. However, we would welcome comments on any aspect of the scheme, whether or not it is the subject of a specific question, and on any of the accompanying draft regulations.

1.34 We would particularly welcome comments on the costs to which the scheme might give rise and the benefits that it might bring. This issue is addressed in Part

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

[31] DP No 121, in particular paras 2.11, 3.12, 4.12 and 5.11.

2 in particular but is one that we hope consultees will address on each point discussed in the consultative report.

ACKNOWLEDGEMENTS

1.35 A full list of acknowledgements will be published as part of our Final Report, but at this stage we express our thanks to the many people who have helped us since the publication of the CP, and acknowledge our debt to all of them. Professor Harry Sigman, Professor Sarah Worthington, Louise Gullifer and Professor Sir Roy Goode QC have acted as consultants. Kate Gibbons, Dr Dermot Turing, Andrew Dickinson, Malcolm Turner, William Glaister and Marisa Chan of Clifford Chance, and Graham McBain, have helped on several occasions and have given us valuable advice. We have met and been advised by various practitioners, including working groups from the Company Law Committee of the Law Society, the Banking Law sub-committee of the City of London Law Society, the British Bankers' Association, the Finance and Leasing Association, and the Factors and Discounters Association, as well as Martin Brassell and Professor Iwan Davies on behalf of HPI. Professor Ian Fletcher, Professor Robin Morse, Professor Jacob Ziegel, Dr Joanna Benjamin, Philip Wood and Dr Frédérique Dahan have also given us help and advice, as have the firm of SJ Berwin. We are also grateful for the help and advice given by members of the Insolvency Service and the Financial Services Authority. The contents of this consultative report are, of course, our responsibility and ours alone.

1.36 We are also grateful to the Society for Advanced Legal Studies, Norton Rose, Clifford Chance, Allen & Overy, Berwin Leighton Paisner and Freshfields Bruckhaus Derringer for their help in organising and hosting a series of seminars, and to all those who attended those seminars.

PART 2
CRITICAL ISSUES

INTRODUCTION

2.1 In this Part we explore the issues that we think are critical in deciding whether a scheme of notice-filing should be adopted and the scope that such a scheme should have. Issues that go to the detail of the scheme will be dealt with in Parts 3-5, where the scheme is explained in full.

2.2 In the light of responses to the CP, and of our further work, we think that the critical issues may be grouped under five headings. These are:

(1) Do the disadvantages of the current scheme of registration and priority of company charges justify replacing it with a notice-filing scheme?

(2) Should the scheme ultimately apply also to security interests created by unincorporated businesses? (The question of security interests created by consumers is not dealt with in this consultative report.)

(3) Should the scheme be extended to cover 'quasi-security' devices, including title-retention transactions (such as finance leases) and outright sales of receivables; and, if so, should the extension be made while the scheme applies only to companies or be left until it is extended to other business debtors?

(4) Should the scheme (though, for the most part, not the registration requirements) apply to security over financial collateral such as investment securities and bank accounts?

(5) Should the scheme include a statement of the rights and obligations of the parties, and in particular the remedies available upon default by the debtor?

REPLACING THE SCHEME OF REGISTRATION AND PRIORITY FOR COMPANY CHARGES

Weaknesses of the current scheme

2.3 In the CP we argued that the current scheme has serious weaknesses when judged by the basic functions that a registration and priority scheme should perform. A scheme should (1) provide information to persons who are thinking of extending secured lending, credit rating agencies and potential investors[1] about the extent to which assets that may appear to be owned by the company are in

[1] Potential buyers of the property that is subject to a security interest should be added to this list.

fact subject to security in favour of other parties; and (2) determine questions of priority.[2] We suggested that the current scheme does neither effectively.

2.4 The vast majority of consultees agreed with our conclusions. We conclude that the 'public notice' function is not performed effectively because:

(1) The requirement to register charges by sending to Companies House particulars of the charge and a copy of the charge document is unnecessarily cumbersome and expensive for what it achieves.[3]

(2) The scheme imposes a considerable burden on Companies House that in practice it is not fully able to discharge because it is not feasible for its staff to check every particular against the charge document.[4] (We understand that the current scheme requires Companies House to have a dedicated registration team of around 28 people. Moreover, we are told that the quality of the information relating to charges is of 'considerable concern'. The complex nature of some charges has meant that problems have sometimes arisen between the registry staff and the mortgagor/chargor or its advisers over whether the précis of the information contained on form 395 that is produced by the registry staff has captured the essence of the charge properly.)

(3) As a result, the registered particulars may not be completely accurate but the charge will be properly registered and will be effective according to its terms.[5]

(4) The list of charges is out of date and incomplete, and it is not certain whether charges over certain types of assets must be registered.[6]

(5) The system requires dual registration of charges over property such as land for which there is also a specialist register of mortgages.[7]

(6) There is no mechanism for registering a charge before it has been created, for example during negotiations to take a security.[8]

[2] See CP para 3.4. In relation to priority, we argued that a scheme should enable potential secured parties to be confident (a) that they can take a security without any risk that it will be subject to other existing interests of which they had no reasonable means of knowing; (b) that, having checked the register, they will be able by taking simple steps to ensure the priority of any security they subsequently take over one that is taken in the meantime by another party; and (c) that registration will ensure the priority of their security against any subsequent security interest (unless there are good reasons of policy for the later interest to have priority). See CP para 3.5.

[3] CP paras 3.21 and 3.45.

[4] CP para 3.16.

[5] CP para 3.16.

[6] CP paras 3.12-3.15.

[7] CP para 3.46.

[8] CP paras 3.29-3.30 and 3.45.

(7) The charge must be registered within 21 days and a court order is required for later registration.[9] (The staff at Companies House have told us that the 21-day period has caused them difficulties, with many documents being filed close to the end of the period. Moreover, they tell us that they reject about 3000 applications each year for being 'out of time'.)

(8) Charges over assets of oversea companies that have an established place of business in England and Wales are invalid if the assets are here and the charge is not registered. This applies even though the company has not registered with Companies House. This also applies even though the goods were only brought into the country more than 21 days from the creation of the charge, so that it is too late to register.[10]

(9) The company's own register of charges that each company is required to keep at its registered office is not in practice a useful source of information; these registers are often not up-to-date, they do not provide complete information to enquirers and they are seldom relied on.[11]

2.5 As to priority:

(1) The rules are complex, varying from one type of asset to another and depending on a complicated interplay of factors - the date of creation, whether the competing interests were legal or equitable, whether the charge was registrable, whether it was registered within the 21 days allowed and, in some cases, whether a subsequent secured party had notice of a negative pledge clause in an earlier charge.[12]

(2) The rules that apply to competing assignments, where priority depends primarily on the date of notice to the debtor, are not appropriate to modern business practice.[13]

(3) The 21-day period for registration means that a valid charge may be 'invisible' to other creditors who search the register within 21 days of the creation of the charge. Consequently, subsequent creditors may be postponed to earlier interests even though they had registered first.[14]

(4) The rules applying to persons who buy property that unknown to them is subject to a security are unclear and not satisfactory.[15]

[9] CP para 2.29.

[10] CP paras 3.33-3.40.

[11] CP paras 3.18-3.20.

[12] CP paras 3.25-3.28.

[13] CP para 7.43.

[14] CP paras 2.37 and 3.26.

[15] CP paras 2.58-2.61.

2.6 **We provisionally conclude that there are significant weaknesses in the way the current company charge registration system operates.**

Amendment of the current scheme or adoption of notice-filing?

2.7 How can these weaknesses best be addressed? One approach would be to retain the current scheme but to amend it in a number of ways. This had been proposed by the Company Law Review Steering Group in its consultation document *Modern Company Law for a Competitive Economy: Registration of Company Charges*.[16] The proposal did not find favour with consultees and it was this that led the Steering Group to recommend the introduction of a notice-filing system.[17] In our CP we also suggested a series of amendments to the current law that might be made instead of the notice-filing system,[18] but expressed our strong preference for the more radical approach. There was very little support for the alternative of amending the current scheme.[19] Only four consultees even thought it worth commenting on the amendments in any detail.[20]

2.8 The notice-filing scheme for the registration of company charges that was proposed in the CP, and the associated rules of priority, received the broad support of all but a handful of consultees.[21] Many emphasised the various advantages of the scheme. We will deal with what, in the light of the responses, we see as the principal positive reasons for adopting the scheme below, after we have given an outline of what is proposed.[22]

2.9 Some consultees did have reservations or questions about the effects of the scheme and whether the changes proposed were justified. The issues raised are of serious concern to us but we feel able to answer them. As it is easier to

[16] *Modern Company Law for a Competitive Economy: Registration of Company Charges* URN 00/1213.

[17] See CP para 1.34.

[18] See CP Appendix A.

[19] But see para 2.8 n 21 below.

[20] There was, on the other hand, wide agreement with our conclusion that the relevant provisions of the Companies Act 1985 are not incompatible with the Human Rights Act 1998. This was a concern that had been raised by the Steering Group: see CP paras 3.41-3.42. The risk of incompatibility has been reduced even further by the decision of the House of Lords in *Wilson v First County Trust Ltd (No 2)* [2003] UKHL 40; [2003] 3 WLR 568. See also J de Lacy, "Company Charge Avoidance and Human Rights" [2004] JBL 448.

[21] Only one response from this country and one from Australia were completely opposed to notice-filing for company charges. A number of other responses made suggestions that we do not think are compatible with a notice-filing scheme as we envisage it (or as adopted in the other jurisdictions). Some of these will be discussed in this Part or in Part 3. However, we cannot discount the possibility that some respondents may have changed their views since submitting their response to the CP. We understand that at least one respondent representing legal practitioners may now have moved to a position where it considers only minor reform of the law relating to registration of company charges is desirable.

[22] See below, para 2.43.

evaluate these issues after we have outlined the scheme that we provisionally recommend, we deal with them below.[23]

2.10 Some respondents would wish to see a notice-filing system only as part of a larger scheme that would include quasi-security.[24] We return to this issue later in this Part,[25] but note at this stage that the detailed explanation of the scheme in Part 3 is made on the basis that the scheme would include quasi-security.

2.11 In the light of consultation, for company charges we provisionally recommend the adoption of a scheme of notice-filing and priority along the lines outlined in paragraphs 2.12-2.40 below, and developed in more detail in Part 3. The outline follows closely the scheme proposed in the CP. It is not identical because consultees made numerous helpful suggestions which have influenced our proposals. (To avoid repetition, the bulk of our provisional recommendations and consultation questions are left for Parts 3-5, where we deal with the relevant points in more detail. Before consultees comment on or respond to the provisional recommendations and consultation questions set out in this Part, we recommend that they consider the remaining Parts of this consultative report.)

The notice-filing scheme for company charges in outline

A note on terminology

2.12 It may be helpful to begin with a note on terminology. (We will deal with other definitions as we come to them.)

(1) 'Debtor'. In the CP, following the UCC and PPSA models, we referred to the company or other person creating the security as 'the debtor'. Consultees pointed out that a security-giver is not always a debtor; a charge may be by way of guarantee of a third party's debt or obligation.[26] There is also the danger of confusion with 'account debtors', those who owe debts which are made the subject of security interests. For the purposes of a companies-only scheme we could refer to 'the company' but that would mean a change of terminology were the scheme later to be extended. We have not found a better alternative and we continue to use 'debtor'.[27]

(2) 'Security interest' (SI). For the purposes of this outline we include only the traditional securities – mortgages, charges or pledges. (We will

[23] See below, paras 2.44-2.69.

[24] Eg, the Law Society's Company Law Committee and the Bar Council Law Reform Committee (joint response).

[25] See below, paras 2.81-2.137.

[26] The UCC designates the third party as an 'obligor'; the PPSAs deal with this by stating that the meaning of debtor varies according to the context.

[27] See below, paras 3.9-3.14.

discuss later whether the scheme should be extended to apply to title-retention devices and outright sales of receivables.[28])

(3) 'Secured party'. Similarly, for present purposes this refers to the mortgagee, chargee or pledgee. It includes parties who hold an SI on behalf of another.[29]

(4) 'Collateral'. This is the general term used in the UCC and PPSAs for the personal property that is subject to an SI. We have followed this usage for convenience.

Attachment and perfection

2.13 In the CP we suggested that it would not be necessary to define or explain these terms, which some commentators already use in describing English law. In the light of consultation we realise that it is necessary to define attachment (the point at which a secured party acquires a proprietary right in the relevant collateral) and to set out the ways in which an SI may be 'perfected' (in the sense of the steps that need to be taken to secure, so far as legally permissible, the effectiveness and priority of an SI as against third parties[30]).

2.14 Attachment will occur when:

(1) there is a security agreement for an SI and the collateral is sufficiently identified either in the agreement or by subsequent appropriation;

(2) value is given; and

(3) the debtor has rights in the collateral. [31]

An SI may attach even though under the security agreement the debtor has the right to dispose of the collateral free of the SI.[32]

2.15 Perfection[33] means the taking of any necessary steps to secure, so far as legally permissible, the effectiveness and priority of an SI as against third persons. To be 'perfected' an SI must also have attached (although attachment and the taking of the necessary steps to perfect can occur in any order). Thus an SI that has attached may be perfected:

(1) by filing a financing statement;

[28] See below, paras 2.81-2137. The scheme described in Part 3 and the draft regulations contained in Appendix A are drawn up on the assumption that title-retention devices and outright sales of receivables will be included. Appendix B lists the provisions that would not be required were title-retention quasi-securities to be omitted from the scheme.

[29] See below, para 3.16.

[30] See below, para 3.86.

[31] See below, para 3.72.

[32] See below, para 3.73.

[33] See below, paras 3.86-3.91.

(2) by the secured party taking possession of the collateral;

(3) where the goods are in the possession of a bailee, by the bailee attorning to the secured party or issuing a document of title in the secured party's name;[34] or

(4) for SIs over limited types of property such as investment securities and bank accounts,[35] by the secured party taking 'delivery' or obtaining 'control'.[36]

In a few cases (particularly in relation to investment property and bank accounts) no filing, possession or control is needed: these cases would be treated as ones of 'automatic perfection'.[37]

2.16 Further, in some circumstances an SI that has been perfected by one method that has ceased to apply may remain 'temporarily' perfected for a limited period, for example, where an SI over negotiable documents was perfected by possession and the documents are released to the debtor for sale or presentation.[38] This is not an independent perfection 'method'.

The scheme

2.17 What follows is a summary of the overall scheme, as applicable to 'traditional' securities. A more detailed account of the scheme in given in Part 3.

SCOPE

2.18 The scheme will apply to mortgages, charges and pledges created or provided for by debtors who are:

(1) companies registered under the Companies Act 1985 (or its successor) in England and Wales,[39]

(2) limited liability partnerships (LLPs),[40] or

(3) companies registered in Scotland or incorporated outside Great Britain, so far as the relevant assets are in England and Wales or are ones to

[34] Or, if the bailee issues a negotiable document of title, by taking possession of that: see below, paras 3.99-3.101.

[35] See further below, paras 2.138-2.159.

[36] See below, paras 4.38 and 4.42-4.47.

[37] See below, paras 3.96-3.97; 4.59 and 4.84.

[38] See below, paras 3.108-3.112.

[39] We seek views in Part 3 as to whether unregistered companies should be included, and if so, to what extent: see below, para 3.8.

[40] The provisions of Part XII of the Companies Act 1985 currently apply also to LLPs by virtue of the Limited Liability Partnerships Regulations 2001, SI 2001 No 1090; the latter would be amended to apply the new scheme to LLPs.

which the law of England and Wales would apply for the purposes of determining questions of perfection and priority.[41]

2.19 A non-possessory mortgage or charge over any type of asset comprising personal property will need to be perfected by filing unless the scheme provides that it may be perfected by a different method[42] or it is specifically exempted from the scheme as a whole.[43]

2.20 Charges over land, registered aircraft, many registered ships and registered intellectual property rights will be outside the scheme. Therefore such charges will not have to perfected by filing at Companies House and priority as between competing charges will be governed solely by the rules of the specialist scheme.[44] Some other interests, such as any charges arising from Lloyd's trust deeds, will also fall outside the scheme altogether.

ATTACHMENT AND PERFECTION

2.21 We noted the meaning of attachment and perfection above.[45] The parties will remain free to agree that the SI is to attach at a later time than that discussed above, but a reference in a security agreement to the charge as a 'floating' charge will not of itself be an agreement that the SI is to attach at a later time.[46] SIs in after-acquired property will attach without specific appropriation by the debtor when the debtor acquires rights in the property.

2.22 The elements of attachment and perfection may occur in any order. Thus filing may be made in advance, though the secured party will acquire no rights in the collateral until the SI attaches, for example, when the security agreement is made or, if the debtor does not yet own the collateral, when it acquires it.

2.23 Where the method of perfection changes, and where there is no period when the SI is unperfected, perfection will be 'continuous'. This will have the practical effect of backdating priority to the time of perfection by the first method.[47]

FILING

2.24 The filing system should operate on a wholly electronic basis (with a register run by or on behalf of Companies House). The Registrar will have power to make Rules relating to the detailed operation of the system.[48]

[41] 'Conflicts' issues are dealt with in Part 3, paras 3.343-3.383.

[42] Principally in relation to financial collateral, see below, paras 2.148 and 2.157.

[43] See below, paras 3.58-3.67.

[44] See below, paras 3.289-3.342.

[45] Paras 2.13-2.16.

[46] On 'floating charges' under the new scheme, see below, paras 2.56-2.60.

[47] See below, para 3.91.

[48] See below, para 3.115.

2.25 A filing will be made through the submission of an on-screen 'financing statement',[49] which will contain:

(1) the name and, where there is one, the registered number of the debtor;

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

(3) brief details of the collateral;

(4) the duration of the filing (which may be for a fixed or an unlimited period), and

(5) any other matter prescribed by Registrar's Rules.

2.26 The financing statement will be treated as filed at the time when a date, time and number are assigned to it by the registry; this will be done automatically as the on-line form is submitted, unless the system rejects it, for example, because the company name and number do not match. Once a filing has been made, a verification statement will be issued to the secured party by the registry; a copy of this must be sent by the secured party to the debtor unless the debtor has waived the right to receive it.[50]

Searching

2.27 The register will be a 'real-time' system in the sense that the financing statement will appear on the register and be available to searchers as soon as the on-screen registration process is completed. The register will be searchable electronically by company name and number, and (where applicable) the unique identifying number of the collateral. Searching will also be possible by the financing statement number assigned on registration.[51]

Financing change statements

2.28 Changes to the filed details or a discharge of the financing statement will be made through the use of a financing change statement; the financing statement and financing change statement will be linked by a common identifying number. A search by this number will reveal all amendments.

The effect of errors

2.29 Errors contained in the filed details will render a filing ineffective only where the error is such that a reasonable person using the search criteria set by the Registrar would not locate the financing statement. In practice this should not occur unless the filing has been made against the wrong company or, with collateral that has a unique serial number (such as a vehicle),[52] that number is

[49] See below, paras 3.118-3.136.

[50] See below, paras 3.147-3.150.

[51] See below, para 3.171.

[52] And is designated as such by the Rules.

entered incorrectly. Other errors in describing the collateral will not invalidate the filing or affect security over collateral that is described correctly, though a filing will perfect an SI only to the extent that the collateral is covered by both the financing statement and the security agreement.

2.30 The debtor may require the secured party to correct an inaccurate financing statement (including one that is no longer correct because collateral has been released), or to discharge a financing statement that does not relate to a subsisting security agreement (including an agreement that has now been discharged), by means of a financing change statement.[53]

Effect of failure to perfect

2.31 Filing will not be compulsory but failure to perfect an SI by filing or another permitted method will have the following consequences for an SI:

(1) it will be ineffective against the liquidator or administrator in the event of the debtor's insolvency;[54]

(2) it will be ineffective against an execution creditor who seizes the collateral before the SI is perfected;[55]

(3) it will lose priority to any other SI that is perfected, or for which a financing statement is filed, first;[56] and

(4) it may also be ineffective against most buyers.[57]

2.32 'Last minute' filing by 'connected persons' before the onset of insolvency will be of no effect.[58]

Obtaining additional information about the SI

2.33 The debtor can demand that the secured party supply it or a third party (such as an intending lender) with:

(1) a written statement of the outstanding amount of indebtedness, or a written approval/correction of the debtor's estimate of the amount, or

(2) a written approval/correction of an itemised list of personal property (provided by the debtor) indicating which items are collateral.

[53] See below, paras 3.154-3.160.

[54] See below, para 3.152.

[55] See below, para 3.250.

[56] See below, para 3.201(1).

[57] See below, para 3.255.

[58] This will be done by consequential amendment to the Insolvency Act 1986, s 245. See below, paras 3.142-3.146.

Failure without reasonable excuse to provide this information can ultimately result in the court invalidating the SI and the discharge of any filed financing statement.[59]

2.34 If the debtor, or anyone who can reasonably be expected to rely on the information supplied by the secured party, relies on the information to their detriment, the secured party will be estopped from denying that the information supplied is correct. The secured party may also be liable in damages to anyone who can reasonably be expected to rely on the information if, without reasonable excuse, it supplies information that is incorrect.[60]

PRIORITY AS BETWEEN COMPETING SIS

2.35 The general rules[61] governing priority will be:

(1) Perfected SIs take priority over unperfected ones.[62]

(2) As between perfected SIs, priority goes to the first to file or perfect by another means. This means that where all the competing SIs are perfected by filing, the first to file will have priority. Where the competition is between an SI perfected by filing and one perfected by a different method,[63] if the filing pre-dates the other SI being perfected, priority will go to the SI perfected by filing, even if that SI was not created or did not attach until after the competing SI was perfected.[64]

2.36 However, specific priority rules mean that a 'purchase-money security interest' (for example, one that secures only the purchase price of the collateral) will, subject to certain safeguards, have priority over SIs that were perfected earlier.[65] There are also specific rules to protect transferees of negotiable collateral.[66]

2.37 An SI will continue into the proceeds of collateral that has been sold by the debtor. There will be rules as to when further steps will be required to perfect this continuing SI and as to priority of competing claims over proceeds.[67]

[59] See below, para 3.196.

[60] See below, para 3.193.

[61] These will be overridden where there is a different specific rule: eg, a secured party who takes control of investment property will have priority over one who has perfected by other means: see below, para 2.149(6).

[62] Where none of the competing SIs has been perfected, priority is determined by the date of attachment. See below, para 3.201(3).

[63] Which in nearly all cases except those involving financial collateral, will mean by possession.

[64] See below, paras 3.201(2) and 3.202.

[65] See below, paras 3.204-3.205.

[66] See below, paras 3.229-3.236.

[67] See below, paras 3.183-3.187.

PRIORITY AS AGAINST BUYERS OR LESSEES

2.38 A buyer or lessee of an unperfected SI without knowledge of the SI will take free of it.[68]

2.39 A buyer or lessee of goods of a kind that the seller sells on a regular basis will take free of any SI created over the goods by the seller, unless the buyer had actual knowledge that the sale was in breach of the security agreement.[69]

2.40 A buyer for 'private purposes' of collateral for a purchase price of £1000 or less (or a lessee of goods of that market value) will take free of any SI over the collateral, whether created by the seller or a previous owner.[70]

Support for the notice-filing scheme for company charges

2.41 As we have noted,[71] in response to our CP there was widespread support for the introduction of a notice-filing scheme along the lines outlined above. Consultees had suggestions on particular points that we have gratefully adopted.

2.42 A number of consultees did raise possible difficulties or have reservations about the proposed scheme of notice-filing for company charges. In the sections that follow we discuss the advantages of the scheme and the principal reservations and difficulties.

Advantages of the notice-filing scheme

2.43 Although English law does not suffer from many of the weaknesses that prompted the development of Article 9 of the UCC or the subsequent adoption of the PPSA schemes in Canada,[72] many consultees saw significant advantages in the notice-filing and priority scheme for company charges outlined above. In the light of the responses and our own further work, we think the principal advantages of the scheme would be the following:

(1) Electronic, on-line filing would be simple, fast and (in the long term) cheap.[73] The same is true of searching.

(2) At least in a companies-only scheme, the risk of an error that might invalidate a filing would be very small. This is because under the notice-filing scheme the chief risk of such an error lies in making a mistake in the debtor's name. With companies registered in the United Kingdom

[68] See below, para 3.255.

[69] See below, paras 3.257-3.260.

[70] See below, paras 3.261-3.262.

[71] See above, para 2.7.

[72] For example, in the US it was not possible to create a floating charge; there were very serious concerns over lack of uniformity between the States; and there were problems over registration requirements. The last was also a major concern in Canada. See G McCormack, "Personal Property Security Law Reform in England and Canada" [2002] JBL 113, 118-120.

[73] See the discussion of costs below, paras 2.61-2.69.

(UK) the system will be able to cross-check the name and company registration number. It could then warn the party filing of the mismatch and ask for confirmation of the company against which the filing is to be made.[74]

(3) The risk of inaccuracies in the description of the collateral is reduced because a simple description will suffice, and the danger to third parties is greatly reduced as an SI will not be effective as regards collateral that is not within the description in the financing statement.

(4) It will be possible to file while a security agreement is being negotiated to protect the lender's priority position.[75]

(5) 'Dual registration' of charges over land, many registered ships, registered aircraft and patents, trade marks and registered designs will generally no longer be necessary.

(6) The rules of priority will be more rational and better suited to modern conditions, for example in relation to assignments of receivables. They will still be complicated but they will be significantly clearer than under current law.

(7) The distinction between fixed and floating charges, with all the associated uncertainty over the borderline between them, will in practice disappear. The floating charge will be supplanted by a single type of SI that shares all the advantages of a floating charge and has fewer disadvantages to the lender.

There would be major additional advantages, in our view, were the scheme to be extended to cover (1) unincorporated debtors; (2) quasi-security devices and (3) financial collateral. We deal with these separately later in this Part.

Major reservations of consultees

2.44 There were some reservations expressed in relation to the scheme as provisionally proposed in the CP, and some suggestions that we have not adopted. A few went to the nature of the scheme. We deal with them here.

REGISTRATION OF THE CHARGE DOCUMENT

2.45 It was suggested by a couple of consultees that the charge document itself should be registered in an electronic format, and possibly that registration should be an essential element of the validity of a charge. This, it was said, would provide more information than the financing statement, while priority could then depend simply on the date of creation. We do not favour this approach for three

[74] The issues of foreign companies, and of other debtors if the scheme is to be extended, are considered below, paras 3.343-3.383 and 2.70-2.80 respectively.

[75] It will also be possible to file just once for a series of transactions; but that is more important in relation to title-retention devices, see below, paras 2.53-2.54.

reasons.[76] First, many expressed concern that the proposals made in the CP to require the secured party to provide certain third parties with information about the terms of the charge, or perhaps a copy of the charge document itself,[77] might mean that confidential information would have to be made public. Partly because of these objections, we no longer propose that the secured party should have to provide information about the terms of the charge or a copy of the document (nor indeed do we propose to allow anyone other than the debtor to demand information from the secured party). In particular, to require the secured party to give a copy of the charge document might mean that the documents had to be drafted so that the 'charge' was in a separate document from matters that were properly confidential. The suggestion that the charge document itself should be registered would risk the same problem. Secondly, the requirement would inevitably lead to problems over incomplete documents being filed and arguments over what constitutes 'the charge'. Thirdly, as one of the consultees admitted, this approach would not be compatible with bringing quasi-securities into the scheme, because with these the relevant document is the whole of the sale agreement or lease and because it would prevent the possibility of advance filing, which is particularly important for quasi-securities.

Reduction of information that is publicly available

2.46 Company charge registration was intended to prevent the implication of false wealth, whereas its role in governing priorities has grown almost by accident.[78] Several consultees have correctly pointed out that the proposals involve a shift of emphasis: registration would be made easier, and there would be clear and rational rules of priority, but at the expense of some loss of information. The question is, how much useful information would no longer appear on the Companies House register?

Financing statements compared to particulars of charge

2.47 It may appear that relatively little information would be required on a financing statement: the details of the debtor, those of the secured party, the duration of the filing and a brief description of the collateral. In fact the current scheme requires only two additional items: the amount secured by the charge and the date it was created or on which the company acquired the property subject to the charge.[79] The statement of the amount secured is not a useful piece of information since,

[76] However, we note that the SLC provisionally proposed in its discussion paper that registration should effect the creation of a floating charge: DP No 121 para 2.11.

[77] See CP para 4.63. The secured party would have been obliged to provide the information to anyone with an interest in the company's property: our provisional proposals have now changed to the extent that only the debtor can demand such information.

[78] See J de Lacy, "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) p 76.

[79] See CP para 2.24 n 58. There are separate provisions for charges securing issues of debentures (see CP para 2.22 n 54) but we understand that these are seldom created nowadays: CP para 5.14. If necessary the Registrar could make rules requiring additional information about such charges (such as the total amount secured by the series) to be filed.

unless the charge is for a fixed amount, it is most unlikely to be accurate by the time anyone searches the register.[80] 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.[81] Thus we do not think the reduction of information on the financing statement as compared to what is currently required is significant.

Specialist registers

2.48 SIs over assets for which there is a specialised register – aircraft, ships, certain types of intellectual property rights and above all land – would no longer be registrable at Companies House.[82] This would avoid the need for dual registration and allow priority issues to be governed by the rules of the relevant register alone. It would however mean that an enquirer would no longer be able to discover such charges merely by searching the Companies Register.

2.49 In relation to charges over land, the first point is that any subsequent secured party intending to take security over the land, and any buyer, will normally want to check, and register in, the relevant land register; if they do so they will inevitably discover an existing SI. It is true that at present an equitable mortgage over registered land may bind a subsequent purchaser even though it is not on the land register, and that some equitable mortgages over company land appear to be registered only on the Companies Register.[83] This is likely to change when electronic conveyancing is introduced under the Land Registration Act 2002: then all mortgages and charges will have to be registered.[84]

2.50 Thus we are concerned principally with other enquirers, for example unsecured creditors. We certainly accept that unsecured creditors, or at least credit rating agencies, rely on the Companies Register.[85] It may be questioned whether it would be a significant burden on a credit rating agency to have to check the relevant land register in addition to the Companies Register. But in any event we may be able to use information technology to make this unnecessary. The Land Registration Act 2002, section 121 allows for the Land Registrar to transmit applications to register charges over land onward to the Registrar of Companies.

[80] See CP para 3.17.

[81] See further below. Some consultees called for a provision to require the date of creation to be recorded once the charge had come into being. Others were firmly opposed to any requirement to file a second time. We agree that this should not be required. It appears that a principal reason for the suggestion was a fear that the register will be 'cluttered' with filings that do not represent actual charges. We deal with this point below, para 2.54. It is worth noting that under the proposed system it is generally date of filing rather than date of creation that determines the priority of non-possessory SIs.

[82] See below, paras 3.289-3.342.

[83] See below, paras 3.301-3.302.

[84] See the Land Registration Act 2002, s 93.

[85] The New Zealand Government accepted an argument that unsecured creditors do not rely on the register, and the NZPPSA does not contain the usual section making an unperfected SI ineffective as against a liquidator. We have not suggested following that model.

The purpose was to avoid the need to register twice. That would not be necessary under our scheme, but implementing the forwarding provision would ensure that the necessary information would normally be shown on the Companies Register. Alternatively it would be possible to establish links between the two registers so that a search against a company at Companies House would also reveal mortgages that are registered in the Land Registry against the company's land.[86]

2.51 Mortgages and charges over registered aircraft and ships that have been registered on the relevant specialist mortgage register will no longer have to be perfected by filing at Companies House. We are told by experts that the taking of security over such assets is very specialised, and that no lender that is seriously looking to the ship or aircraft as security will rely on registering or searching merely at Companies House. We also very much doubt that a credit rating agency assessing the worth of a company known to have registered aircraft or ships would not check the aircraft or ship register and it would be very little additional burden then to check the relevant mortgage register.[87] We conclude that loss of information from the Companies Register about registered mortgages over registered aircraft and ships will be of little practical consequence. (We take a similar approach in relation to interests affecting intellectual property rights, where they are capable of being registered at the Patents Office, where the registers are held.)

Registration will be voluntary

2.52 Registration (notice-filing) will no longer be compulsory and there will be no time limit, save that registration at the 'last minute' before insolvency will not be effective.[88] Consultees have suggested that this will make the register less reliable. Again, only unsecured creditors would be affected: if an SI has not been perfected, it will not bind buyers unless they know of it and it will lose priority to a subsequent secured party who files (or perfects its interest in some other way, for example by taking possession) first. In any event, it seems unlikely that many secured parties will not file promptly, given the severe risks that not perfecting will entail – loss of priority and ineffectiveness of the SI in the debtor's insolvency.

Filing before an SI is created

2.53 The scheme allows filing in advance of the security agreement. This allows a potential secured party to file while negotiations are proceeding (providing the debtor consents to the filing being made).[89] It is pointed out, quite correctly, that there would be a risk of the register becoming cluttered with items that do not

[86] See below, paras 3.304-3.306.

[87] Floating charges over aircraft and ships are not registrable in those registers but in practice such general SIs will cover other assets and thus will be perfected by registration at Companies House.

[88] See below, para 3.146.

[89] It will also permit a single filing for a series of transactions between the same parties but that is more relevant in relation to quasi-security transactions and is considered below, paras 3.138-3.139.

represent actual SIs. This has exercised us too; but enquiries in other jurisdictions suggest that this has never proved a problem there and that the risk is small.

2.54 First, filing will only be effective if done with the debtor's consent and it can be expected that debtors will be circumspect in giving their consent to a filing.[90] Secondly, if further finance is sought from another secured party, it will insist before anything else that any filings that are not concerned with existing security agreements are removed. (The debtor has the right to require the removal of 'empty' filings.[91]) If the new secured party does not insist on this, it takes a risk that the party who has already filed might subsequently advance funds to the debtor and, because of the earlier date of its filing, have priority. The effect of this practice is that the register is to a degree 'self-cleansing'. The small risk of 'clutter' seems clearly outweighed by the advantages of permitting advance filing, particularly as it enables a secured party to file just once for a series of future transactions with the same debtor. As we shall see, this is particularly useful for title-retention devices, but we think that it would be of value even for a scheme applying only to company charges.[92]

Conclusion on 'loss of information' overall

2.55 We accept that were notice-filing to be introduced there would be some overall reduction in the amount of reliable information that could be obtained by a search of the Companies Register. However our conclusion is that the reduction will not be significant. In practice potential chargors already have to obtain further information from specialist registers or from the parties to existing charges. The advantages of the notice-filing scheme seem to outweigh the likely 'loss of information'.

THE FLOATING CHARGE

2.56 The other issue that concerned consultees, including many of those who said that they were in favour of the notice-filing scheme, was that the effect of the scheme on the floating charge was not clear from the CP. There was concern that the scheme should not prevent lenders from using a floating charge or its equivalent.

2.57 We agree and we accept the criticism that in the CP we did not make the effect of the scheme on the floating charge as clear as we should have done. We used old labels to describe new concepts, continuing to speak of 'floating charges' when under the notice-filing scheme the distinction between fixed and floating charges

[90] See below, para 3.140.

[91] See above, para 2.30.

[92] Several of those concerned about advance filing suggested that there should be a scheme of provisional registration, 'priority notices' or 'priority searches' allowing a party who is negotiating to take security priority in respect of any charge actually taken within a fixed period after the registration, notice or search: compare the Land Charges Act 1972, s 11; the Land Registration Act 2002, s 72 and see CP paras A.43-A.45. In the light of consultation we maintain our conclusion that advance filing offers greater advantages.

will in practice disappear. In place of the floating charge[93] there will be a new form of SI that seems, at least from the point of view of the secured party, to have all the advantages of the floating charge without most of the disadvantages.

2.58 Under the scheme, any security agreement may permit the debtor to dispose of the collateral free of the SI without obtaining the secured party's consent at the time.[94] Even if the security agreement does not give such authority, a buyer of goods from a debtor who normally sells goods of that kind will take free of any SI created by the seller/debtor unless the buyer knows the sale to be in breach of the security agreement.[95] Thus the company will remain entirely free to continue to trade its inventory in the normal way. Conversely, a person buying goods from a dealer in the kind of goods in question need not search the register.[96] Sales of other goods - one-off sales of capital equipment, for example - will require the secured party's consent if the buyer is to take free of the SI. This in effect gives the lender what currently will be achieved by taking a combination of a fixed charge over capital equipment and a floating charge over inventory. As the scheme permits the parties to agree that the debtor may have the right to dispose of any item free of the charge, it gives the charge the same flexibility as the current law.

2.59 In addition it gives the chargee a more secure priority position. Provided the SI is perfected, it will retain its priority over subsequent SIs other than purchase-money security interests (PMSIs).[97] (PMSIs will of course be over 'fresh' property.[98]) Thus in future there will be no question of a 'floating' charge being overtaken by a subsequent 'fixed' charge, nor any need for a negative pledge clause. Even with inventory, the SI will be treated as attaching as soon as the debtor acquires the property. The secured party will therefore also have priority as against judgment creditors who might seize the collateral. Crystallisation will no longer be relevant unless the parties deliberately agree to postpone attachment until some event occurs. To make the position absolutely clear, especially with charges that were created before the scheme came into operation,[99] the scheme provides that attachment will not be postponed merely because the SI is described as 'floating'.

[93] As noted earlier (see above, para 2.21), it will be possible for the parties to agree that attachment should be postponed until the occurrence of some event such as the appointment of a receiver, so in effect replicating the floating charge; but it is hard to see any advantage in doing so.

[94] See below, para 3.253.

[95] See above, para 2.39 and below, paras 3.257-3.260. Similar rules will apply to those who lease goods from a party whose normal business is to lease such goods.

[96] This assumes that the goods are new. With used goods there is the possibility that a previous owner has created an SI over the goods and that this will bind the buyer – though the buyer may be able to trust the dealer to have discovered any outstanding SI. See further below, paras 2.92-2.95.

[97] See above, para 2.39 and below, paras 3.246-3.249.

[98] See below, para 3.198.

[99] These will continue to be effective but from the date of commencement will be treated for priority purposes like SIs created under the new scheme: see below, para 3.379-3.404.

2.60 Some uncertainty remains over the exact effect of the scheme, because the distinction between fixed and floating charges is of importance in the legislation relating to insolvency.[100] Policy issues relating to insolvency are issues for the Government rather than the Law Commission: our brief does not include insolvency. However, it is clear that if the scheme we provisionally propose were to be implemented, a good deal of consequential amendment would be needed to the current insolvency legislation. We have discussed our scheme with the Insolvency Service, and although we have identified some areas that will need amendment, we are continuing to work on this area. It is our intention that our reforms should effectively be insolvency-neutral).[101] One particular area of concern relates to preferential creditors and the unsecured creditors' fund. We do not know how the Government will choose to deal with this, but it seems appropriate for the Law Commission to suggest a possible solution. So far, the most promising candidate is that adopted in New Zealand. In broad terms the NZPPSA identifies the kind of collateral that, in practice, is not likely to be subject to any security or 'quasi-security' interest other than the floating charge, and gives preferential creditors priority over any SI over that kind of collateral. The provision is explained in detail in Part 3, but in broad terms the preferential creditors have first call on inventory that is not subject to a PMSI and on receivables which are subject to an SI that was not for new value at the time.

WOULD THE COST OUTWEIGH THE BENEFITS?

2.61 The other major reservation expressed by several consultees was simply whether the cost of implementing the scheme will outweigh the benefits. Many of these respondents accepted that the old scheme has deficiencies, but said that it is not completely unworkable; we have lived with it for years and could no doubt continue to do so.

2.62 Whether the benefits justify the costs of change is a critical question that affects every aspect of the scheme. One reason for issuing this consultative report is to provide an opportunity for those affected to make an accurate assessment. An assessment needs to be made of the costs and benefits of notice-filing for company charges, and then separate assessments for the extensions to SIs created by unincorporated debtors, to quasi-security and to investment property, and in respect of the statement of rights and obligations. We deal here just with notice-filing for company charges.

2.63 In the long term, the cost of registering charges should be reduced considerably. Electronic filing will be much easier and cheaper than registration under the current scheme, and will require less skilled staff.[102] Court proceedings for filing

[100] See, eg, *Buchler and another v Talbot v another* [2004] UKHL 9; [2004] 1 BCLC 281, where the House of Lords recently held that the costs and expenses of winding up a company were not payable out of the assets subject to a floating charge, until the whole of the principal and interest had been paid.

[101] See below, para 3.411.

[102] In New Zealand the fee is NZ$5; here, Companies House have indicated informally that they have no intention of making a profit on registration, so a low fee can be expected here too. On-line filing is simple (the New Zealand Registry provides very helpful tutorial exercises), and for regular users the New Zealand scheme allows for special arrangements

out of time will be unnecessary (as will the administrative inconvenience of alternatively executing a new charge). There should also be considerable savings for Companies House. No précis of detailed charge documents will need to be undertaken by Companies House staff, indeed no details will be entered onto the register by staff at all: this will all be done by the user. We are told that in New Zealand the Personal Property Securities Register has been operating without any permanent full-time staff – essentially someone simply has to check the computer from time to time. New Zealand has a much smaller population and a less commercialised economy than our own but there is no reason to think that a larger operation would involve disproportionately higher costs.

2.64 There would undoubtedly be short-term and transitional costs. The cost of setting up the register would probably not be great – we have been told that in New Zealand it cost just over US $1m and paid for itself in seven months. There would be some cost for regular users to set up the direct links to enable them to transmit their data directly to the registry without further input.

2.65 The most significant short-term cost will be that to secured parties and their lawyers or agents, in changing their procedures and re-training their staff. It is not possible for us to make an accurate assessment of these costs but, in relation to a scheme for company charges only, we would not expect these costs to be very great. The rules on what needs to be filed and the methods of filing and searching will be significantly simpler and may well mean that financiers no longer need to employ lawyers for the purpose. The rules of priority would not be simple – though we suggest that they would be simpler, and a great deal easier to discover, than the current law – but only a relatively small number of specialists need to know them, and many lawyers involved in aspects of secured finance are broadly familiar with them already through working with SIs taken under one of the laws of North America. It is not much of an exaggeration to say that most staff concerned need learn only two rules – before you lend against a security, (1) search; and (2), file – even if you are not sure whether you need to.[103]

2.66 There would be transitional costs, but fortunately these may be lower than we at one stage feared. We thought initially that in order to avoid having two schemes for company charges – one old, one new – running in perpetuity, it might be necessary to require re-registration of existing charges. That would be costly and time-consuming; we are told that chargees often have poor records of what charges they have taken. It now seems that this will not be necessary. We understand from Companies House that the electronic registers can be set up so that a single search against a company will reveal both SIs under the new scheme and charges registered before the commencement of the scheme. (It may be necessary for secured parties to file financing statements for previously unregistrable charges within a transitional period. This should depend on whether the benefit of making the electronically-searchable record complete would be

under which information entered into a secured party's own system (eg, when the contract to sell or the lease is recorded) can be forwarded to the registry without further data input.

[103] For this reason the draft regulations allow for filing on a 'precautionary' basis, even if, in fact, there is no security agreement or SI under the scheme: see DR 46(3).

outweighed by the cost of finding these charges and filing – a question on which we ask for views.[104])

2.67 Thus while we are not in a position to make an accurate assessment of the costs and benefits of the scheme, our provisional view is that the costs of changing from the current scheme of registration and priority of company charges to the notice-filing scheme outlined earlier would not be great and would be relatively slight compared to the benefits to be obtained. This conclusion and the nearly unanimous support for this change from those who responded to our CP lead us to recommend that, unless the response to this consultative report reveals convincing reasons to the contrary, a notice-filing scheme for company charges should be adopted. The details of the scheme will be considered in Part 3.[105]

2.68 **We provisionally recommend that a wholly electronic notice-filing scheme for company charges, and an associated scheme of priorities, should be introduced.**

2.69 **We would welcome consultees' estimates of the costs and benefits of introducing the scheme as set out in the draft regulations, but limited to 'traditional' securities.**

UNINCORPORATED BUSINESSES

2.70 In the CP we provisionally proposed that the notice-filing scheme should apply not only to company charges but also to those created by other debtors.[106] The Bills of Sale Acts 1878-1891 impose highly complex and draconian registration requirements on mortgages and charges created by unincorporated debtors. They make it very difficult for unincorporated businesses to create fixed charges over their equipment and effectively prevent them from granting floating charges. We suggested that the Bills of Sale Acts should be repealed and replaced by the same scheme as is proposed for companies.

2.71 This consultative report is primarily concerned with SIs created by companies, but the question of how best to deal with them is connected with what should be done about SIs in general. At several points we will refer to this question, particularly when we discuss extension of the notice-filing scheme to quasi-security.[107] We therefore take this opportunity to report that among those who commented on the issue in response to our CP and subsequently there was very wide support for replacing the Bills of Sale legislation by the proposed scheme for notice-filing for mortgages and charges.

2.72 What did concern many consultees was the proposal to introduce legislation on SIs created by companies before that for unincorporated debtors. It was said that this would lead to an unacceptable fragmentation of the law in principle and to

[104] See below, paras 3.94-3.97.

[105] Although there we consider the scheme as constructed to include quasi-securities.

[106] CP paras 10.21(1) and 10.61.

[107] On quasi-securities, see below, paras 2.81-2.137.

difficulty in practice. We have sympathy with this view; we too would prefer a single piece of legislation dealing with SIs created by all forms of debtor. However we do not think that this would be a crucial issue were the scheme to be limited to include only mortgages and charges (that is, 'traditional' securities). The law governing the registration of company charges is already completely different from that applying to charges governed by the Bills of Sale Acts and as a result the rules of priority also differ to some extent. Where the issue becomes important is in relation to the extension of the scheme to quasi-security issues. We return to it below.[108]

2.73 In terms of the costs and benefits of extending the scheme for registration of charges to cover unincorporated businesses, the benefits should be significant. It is evident from the replies of consultees, even from the few who doubted the need to change the current law in this area, that the present system does create barriers to small business raising finance in flexible ways; it works only because a business that needs to borrow on a secured basis can incorporate.

2.74 The additional cost could be quite small. The overall scheme would apply just as it would apply to companies. We see three possible additional elements of cost.

2.75 There might be a significant cost if it were thought that extending the scheme to charges created by unincorporated businesses made it necessary to set up a new registry, whether to deal with all charges over personal property or just those not registrable at Companies House. In our view there would be no need to set up a new register in any more than name if only charges created by unincorporated businesses were to be brought within the notice-filing scheme. The system that (we assume) Companies House will already be operating will be dealing with companies that are not registered in this country,[109] and we think Companies House could properly be asked to take charges created by unincorporated businesses onto its computer system even if, nominally, they were to be registered under a separate 'unincorporated businesses' scheme. It would really require little more than a separate website linking into the same electronic database as for companies. We would add that, although we expect the number of such charges to increase from the very small numbers of security bills of sale currently registered, the overall numbers would probably remain relatively low. (We return to the issue of a separate register when we consider quasi-securities.[110])

2.76 The second additional cost might be in developing a system to identify unincorporated businesses. A person seeking to register a charge or to search against a company will be able to work via both the company name and its registration number. If the name and number being used do not match, the system will give a warning.[111] It would be an advantage if something similar

[108] See below, paras 2.120-2.122.

[109] See below, paras 3.364-3.372.

[110] See below, para 2.124.

[111] Or, depending on the system ultimately set up, refuse to accept the filing until a correct match has been entered.

applied to unincorporated businesses, but as they do not have to be registered at Companies House or elsewhere, there cannot be an exactly parallel system. However, we think that for the majority of businesses against which charges are likely to be registered an equivalent check could be devised, perhaps using the VAT registration number. Even without that, we think that it will usually be obvious from the address shown on the financing statement whether or not the correct debtor has been identified. Thus we do not think that the second possible cost will be a significant one.

2.77 The third cost is simply the transitional cost of changing to a new system. Given the very small numbers of security bills of sale registered against unincorporated businesses, we do not think either that the cost of requiring these to be re-registered, or the cost of re-training any staff who have been involved in making such registrations in the past, will be significant.

2.78 The CP also contained our provisional proposal that some SIs created by consumers should be within the scheme. We suggested that the present rule preventing consumers from charging their after-acquired property should be maintained and asked whether consumers should also be prevented from creating non-PMSIs over their property, as had been proposed by the Crowther and Diamond reports. We asked whether 'consumer SIs', particularly those over property other than motor vehicles, should have to be perfected by registration. Few of the responses tackled these issues in any detail. Fortunately they have little impact on the remainder of the scheme, and we do not cover them in this consultative report. We are continuing to work on them and plan to include recommendations in our final report.

2.79 **We provisionally recommend that the notice-filing scheme for companies should be extended to SIs created by other business debtors as soon as possible.**

2.80 **We would welcome consultees' estimates of any additional costs and benefits of extending the companies scheme as set out in the draft regulations to all business debtors.**

QUASI-SECURITY DEVICES

2.81 In our CP we provisionallyp roposed that the notice-filing scheme should apply not only to traditional securities (mortgages, charges and pledges) but also to any device that is 'functionally equivalent' to a security. This would include title-retention devices such as hire-purchase agreements, finance leases and conditional sales.

2.82 We also provisionally proposed that other transactions that do not or may not have a security purpose, but that are hard to distinguish from those that do should be brought within the scheme for certain purposes. Thus all outright transfers (sales) of receivables would be registrable, as would commercial consignments that do not have a security purpose and operating leases of over

one year.[112] The schemes adopted in North America and New Zealand all require registration to perfect all sales of receivables and all consignments; most PPSAs require it for operating leases over one year, but the Ontario PPSA and the UCC do not.

2.83 There are a number of reasons for including 'quasi-security devices' within the scheme.

(1) These devices serve the same purpose as traditional security devices. For example, under a conditional sale or hire-purchase agreement the seller or owner retains title only in order to ensure that, in the event of default, it may repossess the goods and use the proceeds of their disposition to satisfy the outstanding debt. However, current law looks to the form, not the substance, and treats quasi-security in a very different way from, for example, a charge.

(2) Quasi-securities do not have to be registered. This means that a company may be in possession of assets that are, in functional terms, subject to an SI; but potential secured lenders (and other purchasers of a company's assets), creditors and investors will not know, in the absence of information from one of the voluntary registration schemes[113] or the company itself, that assets which are apparently free from registered charges are in fact not the absolute property of the company. The Cork report called for retention of title clauses in particular to be registrable.[114]

(3) Title-retention devices are treated differently from securities in that the former are not subject to the same rules on default. Under a mortgage any surplus achievable on resale would have to be returned to the debtor; under a quasi-security such as a sale and lease-back it would be retained by the lender. In the case of retention of title clauses the courts have tried to reduce the differences in effect by means of implied terms and the law of restitution.[115]

2.84 The Crowther and Diamond reports recommended that all transactions that have the effect of securing repayment of a loan or performance of an obligation should be treated in the same way as traditional security devices. All the North American schemes and the NZPPSA are to this effect.[116]

2.85 On the question of including quasi-security the responses to our CP were divided. Some were strongly in favour, others against and a large number wished to know more about the details of the scheme so as to be able to evaluate the costs and

[112] If the statement of rights and remedies is included in the scheme, it would not apply to outright sales of receivables or transactions that do not have a security purpose. See further below, para 2.160.

[113] Schemes are operated by HPI and Experian Ltd.

[114] Insolvency Law and Practice (1982) Cmnd 8558, para 1639.

[115] See CP para 6.21.

[116] See CP para 7.1.

benefits.[117] Interpreting the responses of consultees is complicated further by two factors. The first is that some expressed different views depending on the nature of the scheme to be introduced (that is, 'companies-only' or 'all debtors').[118] We think the way to approach this is to consider first whether a 'full' scheme (that is, one applying to SIs created by both companies and other incorporated businesses) should cover quasi-securities. If our conclusion on this point is that it should, we will then return to the question of whether a companies-only scheme should include them.[119]

2.86 The second factor is that some supported the inclusion of some types of quasi-security more strongly than they did others. We take them in turn.

Sales of receivables

2.87 There was quite wide support for including the sales of receivables within the scheme, even among consultees who opposed the inclusion of title-retention devices.[120] This is because it is at present hard to find out whether a company has sold, rather than charged, its receivables; and because the new priority rule, depending on the date of filing, appears to be much more suitable to modern conditions than the existing rule, under which priority depends primarily on the date of notice of the assignment to the account debtor. It is not practicable to check with each account debtor to find out whether a notice of assignment of the debt has been given, nor will the assignee always wish to give notice simply in order to preserve its priority as against a competing assignment.[121] There was some disagreement as to whether the scheme should apply only to receivables sold on a recourse basis (that is, if the debt is not paid the seller must repurchase the debt or make good the loss), as these resemble a secured transaction more

[117] Eg, the Commercial Bar Association (who were not opposed, but sceptical whether a case for reform had been made); and the Finance and Leasing Association (who were unable to give a definitive view without further analysis).

[118] Eg, the Law Society's Company Law Committee and the Bar Council Law Reform Committee (joint response), were in favour of including quasi-securities but not of taking a 'two stage' approach (ie, companies first and then all debtors later), and so it is unclear whether they would support a 'company only' scheme which included quasi-securities. Conversely, the Consumer Credit Trade Association also favoured including quasi-securities, but thought implementation should be staged: initially notice-filing for those company charges that are already registrable; then an extension to all other SIs for companies later, and a third stage of extending to all debtors.

[119] A third difficulty was the question of whether there should be any statement of rights and remedies (ie, security law). In the CP we provisionally proposed that if quasi-securities were to be introduced there should ultimately be a statement of the law on the creation and enforcement of SIs as part of the 'all debtors' scheme: CP para 11.47. There was an issue as to whether the scheme should be extended to quasi-security before such a scheme could be developed. We have since had sufficient time to be able to prepare a statement of rights and remedies for the 'companies-only' stage if one is thought desirable. See further below, paras 2.160-2.191.

[120] For example, the City of London Law Society. The British Bankers' Association also supported this inclusion, although they were also in favour of including quasi-securities more generally.

[121] The assignee may of course wish to give notice in order to ensure that the debtor does not pay the assignee; but we understand that much receivables financing is on a non-notification basis.

closely than those sold without recourse. However many supported the argument in the CP that it is so hard to distinguish between those that resemble a secured transaction and those that do not (for example, a sale may be made without recourse but with a warranty of payment from the assignor) that it would be better to bring all outright sales within the scheme.[122]

2.88 We have therefore provisionally concluded that if the scheme is to include any quasi-securities, all sales of receivables should be within the scheme for the purposes of perfection and priority. The scheme of remedies discussed in the CP and provisionally recommended in Part 5 of this consultative report, and in particular the rule that any surplus must be paid to the debtor, would not apply to sales of receivables.[123] In this sense, sales of receivables are 'deemed' rather than 'in-substance' SIs.[124]

Title-retention devices

2.89 Consultees were divided or undecided over the proposals to include title-retention devices within the scheme. Many simply accepted that because the devices have the same functional purpose as security, they should be treated in the same way as security, and did not give detailed reasons for their support. It was pointed out that accounting standards sometimes require a 'substance over form' approach to accounting.[125] Other arguments in support will appear below.

2.90 Consultees opposed to including title-retention devices made several arguments. Requiring registration will provide more information but it will impose a burden on finance companies. Bringing in title-retention devices will have little impact on priorities, since as PMSIs they will still rank ahead of other SIs. Further, title-retention devices will in effect be re-characterised as SIs despite the parties' deliberate choice of a different structure. If the SI is not registered, and sometimes even when it is, the debtor will have power to transfer ownership to a buyer without notice even though the debtor is not an owner. Other consequences would follow if the scheme set out in the statement of rights and remedies that we propose in Part 5 were to be adopted. If after default and repossession the goods realise more than is due to the secured party (including interest and costs) the surplus must be returned to the debtor. There may be consequences for the tax treatment of finance leases. Finally, it was argued that it was not appropriate to include title-retention in a companies-only scheme.

2.91 These are strong arguments. There are also counter-arguments. It is helpful to consider separately the advantages of a registration scheme for title-retention devices over (1) motor vehicles and similar items that have unique serial numbers; (2) other equipment supplied to the company for use; and (3) inventory

[122] See CP para 7.45.

[123] See CP para 7.41 and below, para 5.10.

[124] See below, paras 3.44-3.45.

[125] Eg, the UK accounting standard Statement of Standard Accounting Practice (SSAP) 21 and the international accounting standard IAS 17 both take a substance over form approach to accounting for finance leases (although there are differences between them).

in the form of either materials for manufacture or finished products for resale. We will then consider re-characterisation.

The advantages of title-retention devices

VEHICLES

Finance leases

2.92 With vehicles and other (designated) forms of goods that have unique serial numbers it will be possible to provide for registration of the vehicle identification number (VIN) in the financing statement and for searching by VIN alone. A serial-number search would reveal any SI that has been perfected by a full filing, whether created by the person who is offering the vehicle for sale or a previous owner. Most finance agreements over vehicles are now registered voluntarily with commercial organisations such as HPI and Experian (who share information).

2.93 Our scheme would go further than providing information. Under current law, a finance company that fails to register an agreement with a voluntary register such as HPI is not thereby prevented from enforcing its agreement.[126] Several representatives of members of the Finance and Leasing Association volunteered that they would like to see this rule changed. Our scheme would have that effect. Under our proposals, if the VIN were not included, any buyer without actual knowledge of the existing SI would take free of it. Conversely, if the financing statement did contain the correct VIN, any buyer should be bound by the SI.[127]

2.94 Many of those to whom we have spoken in the motor finance trade have welcomed our proposals warmly.[128] Some of the organisations concerned have suggested that there might be difficulties in dealing with company vehicles alone; this is a real difficulty that we discuss below.[129]

2.95 One of the companies that operates a voluntary registration scheme also suggested that our proposals might interfere unjustifiably with its business if it permitted searches by assets. Our scheme would affect the role of organisations such as HPI and Experian but we do not believe it would diminish it in practice.

[126] *Moorgate Mercantile Co Ltd v Twitchings* [1977] AC 890. (The position between members of HPI may now be different because of contractual obligations to register.)

[127] Exceptions could be made for private purchasers who buy from a dealer (ie, its inventory), when it would be unreasonable to expect them to search for SIs created by prior owners; and possibly for any non-trade buyer, as under the Hire Purchase Act 1964, Part III. However we doubt the need for the latter kind of protection now that organisations such as HPI make information about vehicles – including outstanding finance agreements – readily available to members of the public. This is discussed below, paras 3.170-3.175.

[128] This would apply only to SIs over vehicles created by companies until the legislation is extended to other debtors. The CP suggested leaving provisions for motor vehicles until the scheme was extended to all debtors; discussion with the industry suggests that it may be worth including provisions dealing with motor vehicles even at the 'companies-only' stage, but views on this are not unanimous.

[129] Para 2.121. It was also suggested that improvements in the arrangements for vehicles could be achieved by more modest changes. That may well be true but the scheme has many advantages overall and could deal with vehicles very simply at the same time.

We anticipate that many finance companies would wish to file through them as agents because they can offer data 'cleansing' or checking services – for example, checking that all the information about a vehicle tallies with that held by DVLA – that Companies House would not be able to provide. Equally we think it unlikely that either dealers or members of the public will search the Companies House register directly for vehicle data. HPI and Experian can provide a great range of other information (for example, whether a vehicle has been reported stolen or is an insurance write-off) in addition to that about SIs. We anticipate that there will be a continuing demand for all this information, including that on SIs derived from the Companies House register.

Operating leases of over one year

2.96 In the CP we proposed that any lease of goods for more than one year should be brought within the scheme of perfection and priority, whether or not it had a 'security purpose' in the sense of securing a debt or the performance of an obligation. Thus an operating lease for more than one year would be treated in the same way as a finance lease in that, if it were not perfected by filing, the lessor would risk loss of priority to a buyer or subsequent secured party and, if the lessee became insolvent, the lease would not be effective against the administrator or liquidator.

2.97 Article 9 of the UCC does not treat operating leases as SIs. We understand that in the early years after the introduction of Article 9 there was a great deal of litigation between finance companies and trustees in bankruptcy over whether leases of goods were finance leases and were thus ineffective because no filing had been made; but that this kind of dispute is now very uncommon. The explanation is simply that if there is any possibility that the lease might be viewed as a finance lease, the lessor will file as a precaution. The later Canadian schemes[130] and the NZPPSA have taken the practical step of *requiring* filing for operating leases of more than a year if they are to be fully effective. This makes it much easier for would-be buyers, subsequent secured parties and liquidators to determine whether the goods belong outright to the company or are subject to a lease, while reducing disputes over which kind of lease is involved to a minimum. It is only in the relatively small number of cases in which the lessee defaults and the goods have a value of more than the outstanding debt that there will be any point in seeking to determine which type of lease was involved. If the lease was a finance lease, the scheme of remedies and, in particular, the rule that any surplus must be paid to the debtor, applies. If it was an operating lease, these provisions do not apply. Like a sale of receivables, an operating lease is a 'deemed' SI.[131]

2.98 In the CP we asked whether all leases of over one year should be registrable, or only those that have a security function. Opinion among consultees was divided, but subsequent discussion with those in the industry and others suggests that many do see an advantage in bringing operating leases of over a year within the scheme of perfection and priority, particularly where vehicles are concerned, as

[130] The OPPSA does not cover operating leases.

[131] See above, para 2.88 and below, para 3.37.

the register would then give a more complete picture of whether a vehicle is subject to a lease or other title-retention agreement. Therefore in Part 3 we make the provisional recommendation that leases of over one year that do not have a security purposes, as well as all leases that do have a security purpose, should be within the scheme. We think that to include these would increase the register's value to those involved in vehicle finance and leasing.

OTHER EQUIPMENT

2.99 With equipment that does not have a unique serial number, the advantage is not so obvious because there is no possibility of searching against the piece of equipment itself. An intending buyer or subsequent secured party can only search against the name of the seller and, though it will take free of any unperfected SI created by the seller, it will take subject to any perfected SI created by a prior owner. Nonetheless a number of experts from the finance leasing industry have told us that having a registration scheme, with the associated sanction for non-registration, would still be worthwhile from their point of view. This seems to be confirmed to some extent by the fact that HPI and the other organisations receive a significant number of registrations of finance agreements over equipment that does not have a unique serial number.

2.100 There would also be advantages to other financiers or potential buyers, who would have a clearer idea of what equipment is owned by the company outright and what is subject to an SI. This information would also be of value to liquidators.

2.101 Again there is the question whether to include operating leases within the scheme. We think that this would give added value to the scheme, just as with vehicles.[132]

INVENTORY SUPPLIED UNDER A RETENTION OF TITLE CLAUSE

2.102 The last case is inventory supplied under a retention of title clause that, expressly or by implication, gives the buyer the right to consume the inventory or to resell it free of the SI. Registration would again provide useful information to other secured parties (particularly 'stock' financiers who specialise in lending against that part of a company's inventory that they consider is not likely to be subject to a retention of title clause) and equally to liquidators.

2.103 Is there any advantage under our scheme for the retention of title supplier itself? There is no obvious advantage. The supplier will be unable to enforce its right to claim the goods in the buyer's insolvency unless it has filed. However, the scheme as a whole does provide such a supplier with some benefits that are not readily available under current law. Many retention of title clauses purport to give the supplier a right to goods made from what it has supplied or to the proceeds of sale. These clauses are almost invariably held to be ineffective as unregistered floating charges and we understand that few are registered because of the trouble and cost of registration – particularly as, unless the transactions are very

[132] See above, paras 2.92-2.95.

carefully structured under a master agreement, each separate contract to sell will require separate registration.

2.104 Under our scheme that will change. One filing per debtor (the buyer) will suffice and, as we have already said,[133] filing on-line will be cheap and easy. For high-volume users such as suppliers who normally use retention of title clauses in their conditions of sale we anticipate special arrangements under which information entered into a secured party's own system (for example, when the contract to sell is recorded) can be forwarded to the registry without further data input.

2.105 We expect that many suppliers would take advantage of easy filing to file for SIs over 'new goods' and 'proceeds'. Thus there is 'something in it' even for the retention of title supplier.[134]

2.106 To avoid doubt, the draft regulations contain a provision that where a transferor retains an SI in goods the regulations only govern the security aspect of the transaction. For other purposes, and to the extent that they are not inconsistent, the law relating to contracts of sale or supply of goods governs the transfer.[135]

Re-characterisation

2.107 The argument that the scheme would mean some re-characterisation of the transaction is quite correct. The question is whether the degree of re-characterisation involved is justified by the advantages that it would bring. In fact re-characterisation may refer to a number of changes that need to be considered separately.

RE-CHARACTERISATION (1): THE SUPPLIER MAY LOSE ITS TITLE

2.108 One form of re-characterisation is that legal title may be lost if the SI is not perfected. Thus if a finance lease or an operating lease for over a year has not been perfected by registration, a sale or further lease to a buyer or lessee who does not have actual knowledge of the SI will give the buyer or lessee a title free of the SI. The degree of change on this point may easily be overstated. We are used to the idea that a buyer in possession can pass title that it does not have;[136] we are less used to it in relation to hire-purchase (save where the Hire Purchase Act 1964, Part III, applies) and quite unfamiliar with it in relation to finance leases. Our scheme involves widening the exceptions to the basic principle that a person cannot pass a title he or she does not have.[137] But the basic principle is already riddled with exceptions; and it should be noted that what the motor vehicle financiers – who usually are the legal owners of the vehicles – seem to be seeking is just this form of re-characterisation, at least with finance leases and

[133] See above, para 2.43(1).

[134] The question how far the retention of title supplier's PMSI priority over proceeds should extend, particularly as against a receivables financier, is discussed below at paras 3.222-3.223.

[135] DR 72(2).

[136] Factors Act 1889, s 9; Sale of Goods Act 1979, s 25.

[137] Often still expressed in the Latin tag, *nemo dat quod non habet*.

possibly with operating leases of over one year.[138] The hirer or lessee is not an owner, but if the financier has not filed, a sale or other disposition by the hirer or lessee should give the innocent purchaser rights in priority to those of the financier. What to lawyers may be a painful change to familiar conceptual structures may be precisely the practical relief that industry needs.

2.109 The scheme also has the effect that if the financier has not perfected its SI the collateral may be seized by an execution creditor;[139] and the debtor may create a second SI in the collateral – an SI that, if the first SI had not been perfected by filing, will take priority but that otherwise will be junior to the earlier SI.[140] Similarly, if the debtor becomes insolvent, the collateral may be taken by the liquidator.[141] These are further aspects of the same form of re-characterisation. Those in the industry who have welcomed the scheme seem to view these rules as necessary sanctions to encourage filing.

RE-CHARACTERISATION (2): THE RIGHT TO ANY SURPLUS

2.110 A different form of re-characterisation of title-retention devices would occur if the scheme for the statement of rights and remedies that we propose in Part 5 were to be adopted. This is in relation to the surplus rule. This too may seem a major wrench to current concepts. But we have been told repeatedly, though not universally, that all title-retention financiers are concerned about is to recover the sum owing under the agreement, including interest and charges, plus any costs they have incurred. In the unlikely event that there is any surplus after these have been recouped, it is a windfall in which they have no particular interest.[142] They would be content for this to be returned to the debtor. Indeed, we are told that well-drawn agreements (which we take to mean, those involving large enough sums to make negotiation over the terms worthwhile) frequently provide for the return of any surplus to the debtor. We have also been told that if the lessee is insolvent, a finance company that has received from the proceeds of disposition all that is due to it will often, if asked, voluntarily hand any surplus to the liquidator for the benefit of other creditors. Here again legal concepts and practical needs may be different. Once more there appears to be an argument in favour of re-characterisation.

RE-CHARACTERISATION (3): TAX CONSEQUENCES

2.111 A form of re-characterisation that has given us cause for concern relates to the tax treatment of finance leases. This is whether treating finance leases as security devices, and subjecting them to the scheme of remedies that we propose

[138] See above, para 2.93.

[139] See DR 20(3).

[140] See DR 33(1) rule 2. These rules apply even though the agreement contains a contractual restriction: see DR 41.

[141] See DR 20(1).

[142] This argument does not apply to an operating lease. Then the lessor has a very clear interest in recovering the equipment or its value. Operating leases would not be subject to this form of re-characterisation because the surplus rule would not apply to them. See above, para 2.97.

in the statement of rights and remedies in Part 5, would mean that the lessor (the finance company) was no longer treated as the owner of the leased goods for tax purposes, so that it would no longer be able to claim the current tax advantages.

2.112 The issue appears to be this. Finance leases take a variety of forms. They frequently envisage that the lessee will in effect pay the full capital value of the goods, plus the costs of financing the transaction, and will obtain the economic benefit (and risks) of ownership. Thus many finance leases provide that for 'the primary period' the payments will be at a high rate, to pay most of the value of the goods; once that is complete, there is a secondary period during which the lessee has the right to use the equipment at a low rental. This might continue until the equipment has reached the end of its useful life. It is then returned to the lessor or disposed of for it by the lessee and scrapped. Alternatively (or in addition) the lessee may be empowered to dispose of the equipment as agent for the lessor and to retain, typically, 95% of any difference between the net sum obtained and the balance due under the lease. Thus neither type of lease has any provision for the lessee to become owner of the goods.[143]

2.113 We are told that in the past this has been a critical question for the purposes of the accounting and tax treatments of finance leases. As far as accounting is concerned, finance leases were a form of 'off balance sheet' arrangement. We understand that this has now changed and that assets held on finance leases must be shown on the balance sheet,[144] as must property that is subject to a charge. The tax treatment of finance leases, however, still differs from that accorded to either hire-purchase or property that is bought with funds from a lender to whom it is subsequently charged. The fact that the company leasing the goods never becomes legal owner of them means that the finance company can use capital depreciation allowances on the goods. This allows it to defer payment of tax and the savings resulting from this deferral will be (in part at least) passed on to the lessee. The question is whether our scheme would have the effect that a finance lease would be re-characterised so that this tax advantage would be lost.

2.114 It is certainly nott he purpose of our scheme to alter the tax treatment of any form of security device, but at first sight it does seem that if the tax treatment depends on the ownership of the asset, the tax position might be altered. The effect of the scheme is, for example, to treat a sale on retention of title terms in a similar way to a true sale coupled with an SI in favour of the seller; and the same might be said of its treatment of a finance lease. For example, the UCC and PPSA schemes include a set of remedies that in the event of default apply to any transaction that, like a finance lease, has a 'security purpose'. As we have seen, one of the central provisions is that if the secured party repossesses and

[143] A finance lease is thus different from a hire-purchase agreement, under which either the hirer has an option to buy the goods for a nominal sum once the full credit price has been paid, or which provide that the hirer will become the owner at the end of the hire-period but give the hirer the option to terminate the hiring at any time.

[144] Since 1984 finance leases have had to be shown on the balance sheet under SSAP 21.

disposes of the collateral, any surplus must be returned to the debtor.[145] In all the schemes except the NZPPSA this is a mandatory provision.

2.115 Further analysis suggests that it does not necessarily follow that the tax treatment of finance leases will change, because (in our view) neither ownership in a formal legal sense nor ownership in an economic sense will change.

2.116 Formal legal ownership will not change. The lessor will remain the owner. The change will be that, if the lessor fails to perfect its interest, that interest is liable to be lost to a buyer of the goods. That is something that can happen in a number of different cases - for example, if the owner is estopped from denying the authority of someone who purports to sell the goods on its behalf[146] - but it has not been suggested that the power of the third party to transfer title means that, before any transfer takes place, the 'owner' is not the owner after all. Equally, the lessor who fails to perfect may lose to an execution creditor or the liquidator, but the lessor remains, formally speaking, the owner.

2.117 Will the lessor remain owner in an economic sense? Provided the lessor perfects the interest, it is not liable to be lost to an execution creditor or to the liquidator, nor do we think that the other rules of the scheme mean a change. It appears that the provision that the lessor will ultimately get back either the equipment or 5% of its value is sufficient for the lessor to be treated as an owner in the economic sense. This will not change. If, as will happen in the vast majority of cases, the agreement runs its course without a default, the contractual provisions will be followed and the equipment, or 5% of any residual value realised when the equipment is sold, will be returned to the lessor. The lessor's right to the machine or the 5% is therefore one of the obligations of the lessee under the agreement. The scheme of remedies that we would introduce requires the surplus to be paid to the debtor,[147] but it is the surplus left after application of the proceeds to various items including 'the satisfaction of obligations secured by the security interest'.[148] The obligation to return the machine or pay 5% to the lessor, will normally be one of the obligations secured. Thus the lessor will still be entitled to the residual value of the machine, or the agreed percentage. There is therefore no reason why ownership in the economic sense should be changed by our scheme.

2.118 We have recently submitted our view to the Inland Revenue for their opinion; they have not yet had time to consider the issue fully. Pending their response, it is our view that our scheme will not necessarily lead to the re-characterisation of finance leases for tax purposes.

2.119 Even if we are wrong, it may not be a matter of great moment. We have been told by contacts in the finance leasing industry that the tax advantage of finance

[145] See below, paras 5.18-5.27.

[146] This may occur at common law, see R Goode, *Commercial Law* (2nd ed 1995) pp 451ff, or as a result of the Factors Act 1889, s 2.

[147] See below, paras 5.12-5.18 and Appendix B, SPPSA, s 60(2); also UCC Section 9-615(d).

[148] Section 9-615(a)(2).

leases is now a relatively minor concern. Whether this is universally true we do not know; it may not apply to leases of very 'big ticket' items.[149] We would welcome information from consultees. It is worth noting also that the Government is currently considering reform of corporation tax, including changing the way in which leasing transactions are taxed.[150]

Companies only

2.120 The remaining argument was that it is inappropriate to include title-retention devices in a companies-only scheme. We are concerned about the awkwardness of having to apply these rules to title-retention devices where the lessee, hirer or buyer is a company when, at least for a while, our scheme is unlikely to be extended to unincorporated debtors. It would certainly make the law on 'title-retention devices' more complex. For example, until extended to all debtors, the rules on when the purchaser of a vehicle will take free of an unperfected SI over the vehicle would vary according to whether the debtor who created the SI was a company or not.

2.121 One consultee suggested that differences in treatment would often lead to practical difficulties or 'turbulence in the [vehicle] market'. We are not convinced. It will normally be clear whether the SI in question was created by a company or some other debtor and thus which set of rules should apply. For example, if the dispute is as to the priority of competing interests over a debtor's property, which set of rules governs will depend simply on whether the debtor is or is not a company. If the question is whether a buyer has taken free of an SI, the question will depend on whether the debtor that created the SI was a company.[151] It is of course true that an item of property may at different times have been dealt with by a company and by an unincorporated debtor, so that different rules about transfer of title will apply at different stages, but similar issues arise under the current law when property has passed through a number of hands. For example, the rules affecting motor vehicles under the Hire Purchase Act 1964, Part III, vary according to whether the person who bought a vehicle was a 'trade buyer' or a 'private buyer'. However, we accept that it would be unfortunate for the law to be unnecessarily fragmented between companies and other debtors.

2.122 We are faced with a stark choice. The anticipated Companies Bill gives us an opportunity to establish the notice-filing scheme for companies. If we do not seize that opportunity, we reduce the chance that any of the scheme will ever reach the statute book. A Bill introducing this scheme from scratch would require much more Parliamentary time and Departmental effort than to take powers, and have regulations made, under a Companies Bill. It is true that primary legislation would then be needed in order to extend the scheme to unincorporated debtors; but it would in substance be merely a re-enactment of the companies scheme with a

[149] Leases of registered aircraft would be outside our scheme: see above, para 2.20 and below, para 3.309.

[150] See *Corporation tax reform: a consultation document* (2003), published by the Inland Revenue and HM Treasury in August 2003, following on from their *Reform of corporation tax: a consultation document* of August 2002.

[151] The status of the buyer is irrelevant.

wider scope of application. That should require much less Parliamentary time and Departmental effort. It would be ideal to insist on enactment of the entire scheme all at once but those with close knowledge of the legislative process have advised us not to recommend an all-or-nothing approach. The best might be the enemy of the good. We have concluded that, on balance, if (as we provisionally recommend) the scheme should ultimately cover quasi-securities for all business debtors, these should be included at the 'companies-only' stage.

Costs and benefits

2.123 We have described the benefits that we think would flow from bringing the various types of quasi-security within the scheme. We have also mentioned that the cost of filing would be low, both in terms of any fee and in terms of the time and level of expertise involved. This would particularly be so for secured parties using the system regularly. What of the costs? Again they fall into several groups.

2.124 There would be some additional cost in terms of setting up the register. Compared to a charges-only scheme there would be a much higher volume of registrations, particularly if title-retention devices were to be included. Thus the computer equipment used would have to have a higher capacity for data entry, storing and searching. We are not able to put a figure on this cost but it seems unlikely to be enormous.

2.125 If at a later stage the scheme were to be extended to cover security and quasi-security created by unincorporated businesses, it might be thought necessary to set up a separate registry, whether to deal with all SIs over personal property or just those not registrable at Companies House. However, as we suggested when we discussed the extension of notice-filing to charges created by unincorporated businesses, this may be no more than creating a new or separate 'public face' or gateway to the same database that will hold records of SIs created by companies. Once the system is up and running, the human input required is limited. While it may be too much to hope that a system as large as would be required would need proportionately only the same number of staff as the New Zealand Personal Property Securities Registry (which employs no full-time staff), we think the numbers would be small.

2.126 There would be some cost involved in registering existing quasi-securities. We aim to minimise this by having a relatively long transitional period. New quasi-securities would have to be perfected (by filing or otherwise) from the commencement date, but existing ones would be treated as perfected, and would retain their existing priority position against purchasers, until the end of the period.[152] Only if they had not been perfected by the end of the period would they be subject to the usual consequences of non-perfection. If the period were set at, say, seven years the vast bulk of existing title-retention devices would have run their course before it ended, so that it would never become necessary to file

[152] See below, paras 3.98-3.409.

them.[153] It is true that this would mean that the scheme would not become fully operational for seven years, but that seems preferable to imposing the cost of registering all quasi-securities within a shorter time.

2.127 As with the notice-filing scheme generally, the principal cost will be the human one of adapting business systems and training staff to deal with the new system. However we repeat that for most staff 'learning the new system' will be simple. They need learn only two rules – before you lend against a title-retention device, or purchase a receivable, (1) search; and (2) file – even if you are not sure whether or not you need to.

Conclusions on quasi-securities

2.128 For the reasons given earlier,[154] we consider that sales of receivables should be brought within the notice-filing scheme for the purposes of perfection and priority (but not the statement of remedies explained in Part 5).

2.129 The question of title-retention devices is much more nuanced. The UCC and all the PPSAs enacted in Canada and New Zealand do include quasi-securities. We have not been able to conduct our own research into the success or otherwise of those schemes but there is evidence that the schemes as a whole are regarded as very successful.[155] A survey of practitioners in Ontario - probably the province whose economy comes closest to our own in complexity and sophistication – found a high level of satisfaction with the scheme.[156] Criticisms were made of the scheme but the inclusion of quasi-securities was not one of them – indeed 70% of those who expressed a view on the question thought that the scheme should be *extended* to cover operating leases.[157] The authors of the survey concluded that commercial lawyers in Ontario were very pleased with the PPSA and 'fully supported the radical changes' that it had made.[158]

2.130 It is true that unlike Ontario and many of the jurisdictions that have introduced PPSAs, English law does not currently impose any registration requirements on title-retention devices; and that we have well-established voluntary schemes that

[153] We understand that in the motor vehicle financing world, for example, the standard financing period is about 3 years. (Most ships and aircraft, where long leases are common, will fall outside the scope of our scheme in any event: see below, paras 3.13-3.333.)

[154] See above, para 2.87.

[155] Professor Elizabeth Warren of Harvard Law School, who is a leading specialist in insolvency law in the US, told us that the notice-filing system has substantial benefits in effectively requiring powerful creditors to file. This both provides a 'gold standard on information' and has 'an important monitoring effect on the relationship between powerful creditors and the troubled debtor.' We think that the more complete the range of SIs that need to be registered, the greater these effects will be.

[156] J Ziegel and D Denomme, 'How Ontario Lawyers view the PPSA: an Empirical Survey' (1992) 20 CBLJ 90, 97. The survey related to the version of the PPSA introduced in 1967; it was revised in 1989. Many of the criticisms made by respondents have been addressed in the revised PPSA.

[157] *Ibid*, p 103. It will be recalled that operating leases are included in most PPSAs but not OPPSA nor Article 9: see above, para 2.97.

[158] *Ibid*, p 122.

deal efficiently with some of the worst problems. However, for the reasons we have given, we think that there would be overall advantages to most of those who are affected by the law of title-retention – suppliers, finance houses, buyers, unsecured creditors and liquidators – were the scheme to cover title-retention devices.

2.131 We also think that there would be definite advantages in subjecting leases of over one year that do not have a security purpose as SIs for the purposes of perfection and priority.[159]

2.132 We recognise that the questions whether or not the ultimate scheme of registration and priority should include quasi-securities, and whether any extension should be made at the companies-only stage, are difficult and controversial. We agree with the many consultees who argued that it is difficult for them to give an answer without seeing the detail of the proposed scheme.

2.133 We therefore decided to work up a scheme that would include quasi-securities. We also provisionally decided that the disadvantages of a 'split system' would be less than those of having no reform at all, and thus we provisionally recommend a companies-only scheme as the first stage, to be followed as soon as possible by an extension to SIs created by other debtors. Therefore the scheme that has been worked up includes quasi-securities at this first, companies-only stage; quasi-securities are included in this consultative report and in the draft regulations in Appendix A. However, we also decided that, so far as possible, the scheme should be drawn up and the legislation drafted in such a way that the provisions dealing with the extension to quasi-security should be severable from the remainder. If after analysing the responses to this consultative report we decide not to recommend the extension to quasi-securities, the relevant provisions can be omitted without bringing down the rest of the scheme. Equally it would be possible to defer the implementation of those provisions.

2.134 We have already said that a cost-benefit analysis must be central to the decision whether or not to adopt a notice-filing scheme. The Law Commission does not have the expertise or the capacity to conduct a detailed analysis of either the costs that particular businesses would face were the scheme to be introduced, nor of the benefits they would derive from it. One of the purposes of this paper is to enable businesses to make that evaluation in the light of a fully worked up scheme. We hope that as many as possible will do so and will let us know their conclusions.

2.135 **We provisionally recommend that even at the companies-only stage:**

(1) sales of receivables should be brought within the notice-filing scheme for the purposes of perfection and priority (but not the statement of remedies); and

[159] See above, paras 2.96-2.98. We would do the same for commercial consignments: see below, paras 3.41-3.43.

(2) title-retention devices that have a security purpose should be brought within the scheme (including the statement of remedies).

If consultees do not agree with these recommendations we ask whether they think that the relevant SIs should be brought into the scheme:

(a) only at an 'all business debtors' stage, or

(b) not at all.

2.136 **We ask consultees whether they agree that operating leases of over one year and commercial consignments that do not have a security purpose should be brought within the scheme for the purposes of perfection and priority:**

(a) at the 'companies-only' stage (our provisional recommendation), or

(b) only at an 'all business debtors' stage, or

(c) not at all.

2.137 **We would welcome consultees' estimates of any additional costs and benefits of including (a) sales of receivables, and (b) title retention devices in the scheme as set out in the draft regulations. If it is possible, it would be helpful if consultees were to give separate estimates for both a companies-only scheme and one for all business debtors.**

FINANCIAL COLLATERAL

2.138 In the CP we raised the issue of charges over securities and bank accounts. We explained that Revised Article 9 of the UCC provides a special method of perfecting an SI over these types of asset, particularly to deal with SIs over shares and other investment property held in dematerialised form, by the secured party taking 'control' of the registered holding, securities entitlement or bank account. With investment property, an SI perfected by control will have priority over one perfected by any other means; with bank accounts, the SI can only be perfected by control. 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.

2.139 The responses we received are not easy to interpret.[160] Many of them, for example, called for registration of all charges over shares and bank accounts, but

[160] Our proposal about charges over shares was supported by fewer consultees than were opposed to it, but the latter were divided between those who thought that security over shares should be left right outside the scheme and those who thought that charges over shares should always have to be registered. As we will explain (below, para 2.142), European law now prevents us requiring registration in all circumstances. Subsequent discussion with some of those originally opposed suggests that they would prefer a scheme that allows for perfection based on control to leaving investment property outside the scheme altogether. On bank accounts, those opposed to our proposal again

this has now become impossible under European law.[161] Subsequent discussion suggests that there is wide, though not unanimous, support for bringing charges over these types of property within the scheme but permitting perfection by control. In the circumstances, and because it is our provisional view that investment property and bank accounts should be within the scheme, we thought it best to develop this aspect in this consultative report, and to cover it in the draft regulations, so that consultees can see in detail how it would work. In this Part we explain why we think it is important for the scheme to cover security over investment property and bank accounts, and give a brief description of our proposals. The proposals will be explained in detail in Part 4.

Shares and other forms of investment property

2.140 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 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.

2.141 However the law that applies is neither clear nor satisfactory. First, there seems to be some doubt as to when a security (for the moment we will deal only with traditional security devices) has to be registered. Leaving aside for the moment the effect of the Financial Collateral Directive,[162] the position is as follows. Floating charges require registration and this will apply to a charge over just shares if the charge agreement allows the debtor to continue to dispose of the shares in the portfolio without the creditor's consent to each disposition. A fixed

outnumbered our supporters but many of them opposed it on the ground that registration should be an alternative to control, or that registration should be required in all cases. We are persuaded by the former; the latter is no longer possible under European law.

[161] This is the result of the Financial Collateral Directive, which had not been adopted at the time the CP was written. See further below, para 2.142.

[162] Directive 2002-47-EC.

charge over shares is not on the list of registrable charges but some lawyers take the view that if the charge entitles the chargee to the dividends it may have to be registered as a charge over book debts. An arrangement under which the creditor is given physical share certificates by way of security is probably not a pledge of the shares but a fixed equitable mortgage over them; it is likewise not registrable unless the creditor is also entitled to the dividends and these constitute book debts.

2.142 The Financial Collateral Directive (FCD) prevents Member States from imposing 'the performance of any formal act' where shares, bonds or other securities are 'delivered, transferred, held, registered or otherwise designated so as to be in the possession or control of the collateral taker' under a 'security financial collateral arrangement' that is 'evidenced in writing'.[163] The FCD has been implemented by the Financial Collateral Arrangement (No 2) Regulations 2003 (FCAR), which apply to security financial collateral arrangement between non-natural persons,[164] and provide that section 395 of the Companies Act 1985 does not apply to such arrangements (if it would otherwise do so).[165]

2.143 It has been suggested to us that in the light of those provisions we should simply leave security over investment securities out of the scheme altogether. We disagree, for three reasons.

2.144 The first reason is the need to clarify the law. Neither the FCD nor the FCAR define what is meant by 'possession or control'.[166] There is some doubt as to what will constitute sufficient control for the FCAR to apply. It is almost certain that merely having a floating charge over the shares does not amount to control.[167] It is certainly sufficient if the shares or entitlements are transferred into the name of the secured party.[168] Something less than this may suffice, but it is not certain what. For example, with indirectly-held investments it is unclear whether it is enough that the intermediary has been given notice of the assignment by way of charge, or whether the secured party must get the intermediary to agree to hold to its order (an attornment). With investments held

[163] FCD, arts 2 and 3.

[164] FCAR, reg 3.

[165] FCAR, reg 4(4). Although under the FCD, art 2(1)(c) this is defined as applying only where the 'full ownership of the financial collateral remains with the collateral provider', it is clearly intended to cover the English mortgage and is so defined in the FCAR, reg 3. (Compare 'title-transfer' financial collateral arrangements, below, para 2.153.)

[166] At least in respect of 'book entry' securities collateral (ie, that where the holder's entitlement is represented by an entry in the books of an intermediary, as opposed to shares held directly from the issuer) this is left to the law of the place where the relevant account is maintained: FCD, art 9.

[167] There may be 'control' under the FCD even though the collateral provider retains a right to substitute or to withdraw excess collateral, but this would probably not mean in English law that the charge could only be a floating charge. A right of use cannot mean that the secured party does not have control within the meaning of the FCD, since the FCD requires that Member States ensure that any right of use conferred by the agreement can be exercised: FCD, art 5(1).

[168] With indirectly-held securities, this would amount to a novation.

directly on the books of an issuer, since under English law an issuer may not take notice any such arrangement, it seems that the secured party must have the shares transferred into its name; with those to which title is determined by entry on the CREST operator's register, it is presumably enough that the shares have been placed in an escrow account controlled by the secured party.

2.145 The second reason is a technical one. The exemption from section 395 granted by the FCAR applies only to 'financial collateral arrangements' that involve the 'collateral provider' transferring legal and beneficial ownership to the secured party, or the secured party taking 'possession or control' of the collateral. A fixed charge over indirectly held investment securities requires the taking of control and thus would be exempt, but it is also possible to take floating charges over investment securities where the chargee has no 'control' over the investment securities.[169] These require registration, and cause no problem under current law since any subsequent fixed charge or disposition of the investment securities (for example, under a 'repo') will, because of the general rules of priority of the floating charge, have priority over it. Under our new scheme, however, there will be some fundamental changes. Floating charges as such are likely to disappear. Any security agreement may allow the debtor to dispose of the collateral free of the SI.[170] Further, the old rules of priority of subsequent fixed charges will also disappear: the SI's priority as against other SIs will depend on the date of filing or perfection. Thus, unless special provision were made under the scheme, a filed non-possessory SI over investment securities would take priority over a later one under which the secured party took (in the words of the FCD) 'possession or control'. That would defeat the aim of the FCD to ensure the ready transferability of investment securities. It is necessary to create an exception for investment securities, and the clearest way in which to do that is to provide that a secured party who perfects an SI over investment securities by taking 'control' will have priority over one who merely perfects by filing (or some other method). At the same time our scheme will define what, in English law, amounts to 'possession or control' for this purpose.[171]

2.146 The third reason is probably the most important. Experts have told us that it is vital that those who take security over investment securities should know what rules of priority apply in the event that a second secured party claims an SI over the same collateral. We also think it is vital that the priority of a secured party who takes control should not be open to challenge by one who has not done so. This might happen under current law. Although the basic rule of priority for intangibles like shares is that it depends on the order in which notice was given to the

[169] We will see below that the FCAR, reg 3 contemplates that some floating charges will also be exempt from s 395.

[170] Disposition may be sale, in which case the buyer would take free, or by creating another SI that will have priority. (Note that the word 'purchaser' denotes either a buyer or a subsequent secured party.) The debtor may have the *power* to dispose of the collateral free of the SI even if it has not been given the *right* to do so. See below, paras 3.257-3.260.

[171] These issues are left to the law of the country in which the relevant account is maintained: FCD, art 9.

intermediary,[172] a party who takes an assignment with knowledge of a prior assignment cannot gain priority by giving notice first.[173] Which rules apply seem to vary according to whether the shares are indirectly held (when the rule in *Dearle v Hall* applies) or are held on the books of the issuer (when the rules of priority depending on the date of creation and whether the second interest is legal or equitable, and was taken with or without notice, seem to apply).[174] Our scheme aims to establish clear rules of priority under which a secured party who takes control will always have priority over one who has not done so, whether or not the party who takes control knows of the other SI.[175]

2.147 In our view the introduction of the notice-filing scheme presents an invaluable opportunity to provide a clear set of rules to underpin the FCAR and to deal with priority issues. Revised Article 9 of the UCC has developed a scheme that seems to be clear and sensible. It is being considered for adoption as part of the 'Model' PPSA in Canada.[176] From the discussions we have had with experts in the area, it seems to fit with good practice in this country and to be readily adaptable to the slightly different arrangements that pertain here.

2.148 **We provisionally recommend that SIs over investment property should be brought within the scheme, and that it should be possible to perfect such SIs by 'control'.**

An outline of the notice-filing/control scheme for investment property

2.149 For investment securities such as shares and bonds, the outline of the scheme would be as follows:

(1) It will be possible for the secured party to perfect by taking 'control' of the collateral, as an alternative to perfection by filing.

(2) What amounts to control will vary in accordance with the nature of the investment property (because of its nature or the rules of the scheme under which it is held). An SI over investment securities may be perfected by 'control' in the following ways:

(a) with bearer securities, by taking possession;

(b) with certificated securities in registered form,

[172] *Dearle v Hall* (1828) 3 Russ 1.

[173] See R Goode, *Commercial Law* (2nd ed 1995) pp 704-705.

[174] The position under CREST seems particularly uncertain: a secured party who has the shares transferred into an escrow account may be subject to prior equitable interests.

[175] Under current law, a secured party who has directly-held shares transferred into its name may nonetheless take subject to an earlier equitable interest of which it had notice. A secured party who takes an SI over indirectly held shares may not obtain priority by being first to give notice to the intermediary if it has notice of a prior interest.

[176] This is the model law produced by the Uniform Law Conference of Canada: see below, para 4.2.

(i) by taking possession of the certificate and, we suggest, a signed transfer form (in which case the secured party is described as having taken 'delivery'), or

(ii) by being registered as the holder;

(c) with uncertificated securities to which the holder's rights are evidenced by an entry on the register of the operator of a settlement system such as CREST,

(i) by the secured party being entered in the operator of the settlement system's register as the holder; or

(ii) by the operator, on the instructions of the registered holder, placing the investment securities into a sub-account in the holder's own name where they are subject to the instructions of the secured party and not those of the registered holder;

(d) with uncertificated securities to which the holder's rights are evidenced by an entry on the issuer's books, by being entered as the holder;

(e) if the debtor's interest is a security entitlement in the books of an intermediary, and if the security agreement is evidenced in writing:

(i) by the secured party being entered in the accounts as the entitlement holder; or

(ii) by the intermediary agreeing that it will comply with instructions of the secured party without further consent from the entitlement holder (has entered into a 'control agreement'), whether or not the entitlement holder retains the right to deal with the entitlement; or

(iii) by the secured party being itself the entitlement holder's intermediary.

(3) An issuer or intermediary is not obliged to enter a control agreement even if the debtor directs it to do so.

(4) The control agreement may be expressed to relate either to the individual securities entitlement or to the account of which that entitlement forms part; and when an SI attaches to the account it also attaches to the entitlements held in the account.

(5) Where an intermediary creates an SI over investment securities held by it in its own books, the SI is treated as perfected as soon as it attaches ('automatic perfection').

(6) A secured party who perfects by control will take priority over an SI perfected by any other method (or which is unperfected), whether or not it has given value and whether or not it knew of the prior interest.

(7) As between SIs perfected by control, priority will (unless agreed otherwise) be in the order that the secured parties obtained control. There will, however, be exceptions to this rule:

(a) an SI created by an investment intermediary over an entitlement or account with itself will have priority over SIs in favour of other parties; and

(b) a party who takes control, gives value (including existing indebtedness) and takes without notice of an earlier SI or other adverse claim may take free of it. (Such a person is known as a 'protected purchaser'.) We say 'may' because the rules differ according to the nature of the investment property. With certificated or uncertificated securities, the rule is just as stated. For security entitlements, the purchaser will take free only if the financial asset is credited to its account (rather than a control agreement being made that the intermediary will accept its instructions without further reference to the debtor).

(8) An intermediary is not required to confirm the existence of a control agreement unless required to do so by the entitlement holder.

2.150 It will be seen that the scheme has the effect that when an SI is perfected by control, the secured party need not file, and that a secured party who perfects by control, or a buyer who obtains control, has no need to search any register beforehand. The rules fit for the most part with the general policy we adopted in the CP[177] that registration should not be necessary in order to perfect an SI if its existence should be sufficiently evident to third parties. In the cases so far described, except one, we think that any potential secured party or buyer of the investment securities will inevitably discover the existence of the SI, and that therefore it is unnecessary to require filing. The one exception relates to escrow agreements under CREST. CREST will not reveal these agreements to third parties even on the holder's instructions. This seems very minor, since if SP2 were concerned to obtain priority it should seek to obtain control, and when it attempts to do so it will inevitably discover SP1's interest. In any event we have now realised that the policy stated in the CP cannot always be achieved in a pure way without unjustifiably impairing the operation of the relevant market. Under the 'intermediaries' scheme, SP2 should be able to discover the existence of the existing SI by enquiring of the intermediary, and if the entitlement holder so requests the intermediary must disclose the SI. In any event, if it becomes the entitlement holder without knowledge of any adverse interest it will take free of it.

[177] See CP para 4.15.

2.151 We have spoken so far of SIs over investment securities. Exactly the same scheme may be applied to any asset that is held by way of book entry in an account maintained by an intermediary, for example, commodities or cash. Under the UCC and the proposed Canadian schemes there are exactly parallel provisions for commodities and commodity contracts. We are told that investment securities and commodities were treated separately purely because in the US they are subject to separate regulatory regimes. This does not apply here, but the FCAR apply only to financial instruments (and cash held in an account[178]). To make comparison easier, the draft regulations have followed the UCC pattern but we would welcome advice whether we might have a single set of provisions dealing with indirectly-held investment property of any kind.[179]

2.152 So far we have referred exclusively to charges over investment property. In the CP we pointed out that there are also forms of quasi-security – in other words, devices that have a security purpose – that are used over investment property. The principal one is the 'repo'.[180] A company that wishes to raise money on the 'security' of its shares will sell them to a lender on terms that it will repurchase identical shares, at a future date or possibly on demand, at a price equal to the purchase price plus a financing charge (calculated in the same way as interest on a secured loan). One advantage of the scheme is that it permits the buyer/lender to deal with the assets as its own, perhaps by using the securities as collateral in further transactions with third parties. The party granting the security can also be given the right to deal with them and have a right of substitution.

2.153 In the CP we provisionally proposed that transfers under a 'repo' should not be registrable.[181] All but two of those who commented on this proposal agreed.[182] The FCD and the FCAR apply to repos, which are described as 'title-transfer' financial collateral arrangements.[183] There is some doubt as to whether the provisions of Revised Article 9 of the UCC apply to repos. However it will be seen that the effect of the rules is that where the secured party has become the registered holder or the entitlement holder it will always have control,[184] so there will be no question of having to register; and it will always have priority, normally taking free of any other interest or adverse claim.

[178] See below, para 2.154.

[179] See further below, paras 4.88-4.92.

[180] In the CP we suggested that repos frequently have a security purpose, though this is not always the case (eg, a non-security purpose might be tax arbitrage). Traditionally, stock lending arrangements do not normally have such a purpose, though the 'borrower' is, in market standard documentation, required to provide security (through the outright transfer of cash or securities) for the performance of its redelivery obligations.

[181] CP para 7.50.

[182] One of those who disagreed wanted the arrangement to registrable in order to make the registration scheme as comprehensive as possible, but with the FCD this is not possible.

[183] The rights of 'use' and of 'appropriation' given by the FCD (see further below, paras 5.44-5.56) apply only to security financial collateral arrangements since the rights were thought to exist already when title has been transferred to the secured party.

SIs over bank accounts

2.154 Cash held in accounts is an important form of security. As we explained in the CP, it has long been recognised that a debtor may create a charge over a bank account in favour of a secured party other than the bank. There was doubt as to whether the bank itself could take a charge over an account held with itself, and instead a form of set-off agreement was often used; but it now appears that a bank can take a charge over an account of its own customer.[185] A charge over a bank account is probably not currently registrable unless it is a floating charge. Further, the FCD and the FCAR apply as much to cash held in an account as they do to investment securities.[186]

2.155 If we were not to make some special provision, the result would be a breach of the 'publicity principle' proposed in the CP,[187] in that there might be a charge that would not be evident either from the Companies Register or by enquiry from the bank. Under current law a fixed charge requires that the chargee take 'control' (in a different and much more restrictive sense than that word means in our scheme), in which case the SI will be evident to the bank; and a floating charge must be registered. As we have explained, under our scheme the distinction between fixed and floating charges will in practice disappear. Thus unless filing is required of charges that are not perfected by control, there might be a charge in existence that would be effective as against unsecured creditors but which has not been notified to the bank.[188]

2.156 Many consultees argued that there should be 'public notice' of any SI over a bank account. The FCD means that we cannot follow the suggestion that all such charges should be registered. However, since the FCAR apply only when the collateral taker has 'possession or control' of the account, and that phrase is left undefined, we have the opportunity to define it within our scheme so that the exemption will apply only when the SI has been agreed to by the bank, or at least is known to it;[189] and to require that any other SI be perfected by filing. It also presents an opportunity to establish rules of priority that, like those proposed for investment property, will enable bank accounts to be used as collateral with the minimum of investigation and the maximum of confidence.

[184] In agency repo arrangements, where a third party financial institution receives the collateral on behalf of the secured party, it is important that the terms of the agency arrangement are effective to confer control on the secured party.

[185] *Re Bank of Credit and Commerce International SA (No 8)* [1998] AC 214, 225-228. It is not clear that under English law a charge will give the bank any advantage over having mere rights of set-off; we have been told that charges in favour of the bank itself are mainly important under other laws which give more limited rights to use set-off in insolvency. Nonetheless these charges over bank accounts are found under English law and must be provided for, along with charges in favour of third-party secured parties.

[186] FCD, art 2(1)(d) and FCAR, reg 3.

[187] See CP para 4.15.

[188] It is true that a second party taking security over the account could protect itself under the rule in *Dearle v Hall* (1828) 3 Russ 1, by giving notice, but that will not help an unsecured creditor or credit rating agency.

[189] On this point see below, para 4.1.

2.157 Again the UCC provides a model.[190] It requires some adaptation, principally because at the insistence of the banking authorities Article 9 does not permit an SI to be perfected over a bank account otherwise than by control. This limitation seems illogical[191] and was not supported by any of our consultees. In most other respects, however, Article 9 again seems to be a useful model that fits with good practice here. **We provisionally recommend that SIs over bank accounts should be brought within the scheme; and that it should be possible to perfect such SIs by control.**

Outline of scheme for bank accounts

2.158 In outline the scheme would be as follows:

(1) An SI over a bank account may be perfected by control as an alternative to filing:

(a) where the secured party is the bank itself, without more; or

(b) where the secured party is a third party,

(i) if the bank has agreed in writing with the debtor/account holder and the secured party that it will comply with instructions of the secured party without further consent from the account holder, or

(ii) if the secured party becomes the account holder (sole or joint). This will also require a written, tri-partite agreement.

(2) The secured party (whether it is the bank or a third party) is not prevented from having control by the fact that the debtor retains the right to dispose of funds in the account.

(3) A bank is not required to enter a control agreement with a secured party even if its customer so directs.

(4) A bank need not confirm to a third person the existence of a control agreement unless so required by the debtor (its customer).

(5) An SI over a bank account that has been perfected by control has priority over those perfected in any other way (or are unperfected). This includes SIs over cash proceeds that are paid into the account.

(6) Priority between SIs perfected by control will be in the order that control was acquired, except that:

(a) where the secured party is the bank itself, the bank will have priority, unless

[190] We are not aware of Canadian proposals on this point as yet.

[191] We are told that it was based on a 'misunderstanding' by the relevant authorities.

(b) the other secured party has taken control by becoming the account holder, when that secured party will take priority over any SI of the bank itself.

(7) Where a third party secured party has an SI over a bank account, the bank may still rely on defences available against the debtor and set off against the secured party sums due to the bank from the debtor. However, set-off of sums due *from the debtor* is not available against a secured party who has taken control by becoming the account holder.

(8) The existence of a control agreement does not affect the bank's normal rights and duties in relation to the account.

These points are discussed in more detail in Part 4.

2.159 **We would welcome consultees' estimates of the costs and benefits of our provisional recommendations for financial collateral.**

A STATEMENT OF THE PARTIES' RIGHTS AND OBLIGATIONS

2.160 The UCC and the PPSAs all contain provisions setting out the law on the creation of SIs, the rights and duties of the parties to the security agreement, and the enforcement of SIs following default. These rules apply to most SIs, whether they are 'traditional' securities, such as charges or mortgages, or quasi-securities such as title-retention devices. However, the provisions relating to default and enforcement do not apply to 'deemed' SIs (that is, sales of accounts, and leases for more than one year or commercial consignments which do not secure payment or performance of an obligation).

2.161 When we have discussed whether our proposed scheme for companies should have a similar set of rules, we have in the past tended to speak of a 'restatement'. This was a shorthand term, as some - but not all - of the rules would change existing law rather than simply put it on a legislative footing.

2.162 In the CP we suggested that a restatement of the law of security would make it easier to see which rules should apply to the SI in question,[192] and we provisionally proposed that our scheme should contain a restatement.[193] However, because we envisaged (as is still the most likely outcome) that our proposals for companies would be implemented before any of those for non-corporate debtors, we also asked in the CP whether any restatement should form part of the companies stage, or whether it should wait until a scheme for 'all' debtors was implemented.[194] We in fact offered three choices:

(1) that the Regulations for 'company charges' should include a restatement;

[192] CP para 11.37.

[193] CP para 11.47.

[194] CP para 12.103.

(2) that they should include (for title-retention devices only) a clause stating that such transactions should be treated 'as if' they were true securities; or

(3) there should be no provisions in the Regulations, so that for the time being quasi-securities would be subject to filing requirements (or rather, the need to perfect) but would not be subjected to the restatement rules governing traditional securities.

2.163 We said that we did not favour (2) because it might cause uncertainty over which rules should apply to which interests. Partly because we did not think we would have time to prepare a full restatement, and partly because we felt that to include one would exacerbate the differences between companies and other debtors,[195] we provisionally proposed the third approach.

2.164 The responses to these consultation questions showed a wide range of opinions, and the complications over the 'staging' questions make it hard to get a clear picture. Some thought that if quasi-securities were to be included, a restatement would be essential. Several doubted the necessity of a full restatement, although most seem to have thought that it would be desirable, provided that there could be a second consultation on the detailed proposals. On the question of staging, more respondents agreed with our provisional proposal than on any other solution, but the picture is confused because there was (as we have noted) disagreement over whether quasi-securities should be included at the companies-only stage.

2.165 Our work on the provisions of rights and remedies of the other schemes has revealed that they are more radical than we had appreciated. The UCC and the PPSAs apply a single scheme of remedies to all types of SI, with exceptions only when necessary. (This is what seems to be meant when it is said that the UCC/PPSAs recognise a 'single security interest'.) This simplifies the law a great deal, and indeed makes it unnecessary for the parties to mould their security agreement into any of the existing forms. It will be perfectly adequate for them to agree that the secured party is to have 'a security interest' in the particular collateral. Thus a legislative statement of rights and remedies presents a major opportunity for simplification. That seems to us to strengthen the case for it. However, by the same token it suggests that it is not really appropriate to refer to the scheme as a 'restatement.' That term may be misleading. In this consultative report we use the term 'statement of rights and remedies', to avoid any confusion as to whether some changes would be brought about to the existing law: in some cases there would be such change.

2.166 Given the view of the majority that ultimately a full scheme should contain a statement of rights and remedies, and since the revised timetable for drawing up secondary legislation for the companies scheme is now such that we can have a further consultation on the detailed proposals, we include a statement of rights and remedies within this consultative report and have been able to produce draft

[195] CP para 11.42.

regulations accordingly.[196] Part 5 of this consultative report deals with this statement in more detail.

2.167 In the light of the responses to the CP and after the discussions held at the discussion seminars, our provisional view is that it would be sensible to include the statement of rights and remedies in the companies-only scheme. As several consultees pointed out, to apply the scheme only to SIs created by companies would create a further gulf between these and those created by other debtors; but we take the provisional view that the differences are already so great that the scheme would make little difference. We see an advantage in making the companies-only scheme as complete and clear as possible.

An outline of the statement of rights and remedies

2.168 To give an idea of what is involved, we list here the provisions that we have provisionally included in the draft regulations that relate to the statement of rights and remedies:

(1) Application (DR 56),

(2) Overlap with security over land (DR 57),

(3) Receivers (DR 58),

(4) Rights and remedies (DR 59),

(5) Collection rights of secured party (DR 60),

(6) Rights of secured party (DR 61),

(7) Disposal of collateral (DR 62),

(8) Disposal of collateral: requirement to give notice (DR 63),

(9) Calculation of surplus or deficiency in disposition to secured party etc (DR 64,)

(10) Distribution of surplus (DR 65),

(11) Deficiency (DR 66),

(12) Acceptance of collateral in full or partial satisfaction of obligation (DR 67),

(13) Redemption (DR 68),

(14) Determination as to whether conduct was commercially reasonable (DR 69),

(15) Applications to court (DR 70).

[196] See Part 5 of the draft regulations.

2.169 There should be a savings provision for principles of common law, equity and the law merchant, save as far as such principles are inconsistent with our legislation.

2.170 Although many of the other schemes include provisions on fixtures, accessions to goods and processed or commingled goods, these seem to reflect different common law rules in the relevant jurisdictions. In the light of discussions at the seminars held after publication of the CP we do not think such provisions should be included in our scheme.[197]

2.171 Two possible provisions suggested in the paper prepared for the seminar on this topic proved to be sufficiently controversial to merit mention at this point. One was a provision to the effect that all rights and duties that arise under the security agreement or the legislation must be exercised or discharged in good faith and in a commercially reasonable manner. The other was a provision that the rights and obligations on default set out in the scheme should be mandatory in the sense that the secured party is not permitted to reduce the debtor's rights.

Good faith

2.172 A provision to the effect that all rights and duties that arise either under the security agreement or the legislation must be exercised or discharged in good faith and in a commercially reasonable manner features, in one form or another, in the UCC and all the PPSA schemes.

2.173 UCC Section 1-203 provides that:

> Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.

Good faith is defined for general purposes as 'honesty in fact in the conduct or transaction involved'. For the purposes of Article 9 a broader definition applies: '"good faith" means honesty in fact and the observance of reasonable commercial standards of fair dealing.'[198] However it seems that this applies only where Article 9 itself refers specifically to good faith, which in the Part on remedies is only in one provision.[199]

2.174 Some of the PPSAs include a provision imposing a general obligation to act in good faith or in a manner that is commercially reasonable.[200] SPPSA section 65(2) is typical:[201]

> All rights, duties or obligations that arise pursuant to a security agreement, this Act or any other applicable law are to be exercised

[197] We deal with these issues below, paras 3.274-3.282.

[198] UCC Section 9-102(a)(43), and see Section 9-102(c).

[199] Section 9-617(b). See below, para 5.87.

[200] The Ontario PPSA has 'commercially reasonable' requirements in respect of particular powers only, eg, s 63(2) (disposal).

[201] See also NZPPSA, s 25(1); New Brunswick PPSA, s 65(2); British Columbia PPSA, s 68(2).

> or discharged in good faith and in a commercially reasonable manner.

It seems that a breach of this duty will render the party liable in damages.[202]

2.175 Requirements of good faith in this sense[203] are rare in English law. English law does not recognise any general duty to act in good faith, let alone in a commercially reasonable manner. At first sight the provisions of the other schemes appear to be a recipe for uncertainty. As one respondent put it:

> One of the great advantages of English law is the ability of the parties to write their own contract in the knowledge that a court will enforce it without replacing the parties' bargain with the courts' own judgment of what ought to have been agreed.[204]

We agree.

2.176 However it is widely recognised that though English law does not have a general doctrine of good faith, it frequently achieves similar results by particular rules.[205] Indeed, in the field of SIs some of the duties owed to a mortgagor are already couched in the language of good faith. In addition, the courts have recognised that one party may be under a duty to act reasonably, or to use reasonable care, in a number of situations. Under current law a secured creditor (or receiver appointed by it) is under a duty to exercise its power in good faith for the purpose of obtaining repayment.[206]

2.177 A clear distinction is drawn between the general duty of good faith, which is broken only if there is 'some dishonesty or improper motive, some element of bad faith',[207] and the duties of care owed in more specific circumstances. The secured party does not owe a general duty to use reasonable care when exercising its powers and in dealing with the assets of the mortgagor.[208]

[202] Under SPPSA, s 65(5); NZPPSA, s 176.

[203] The nearest analogy may be the reference in Unfair Terms in Consumer Contracts Regulations 1999, SI 1999 No 2083, reg 5(1) to a term being regarded as unfair 'if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.' However we will explain that, in our view, the provision in the schemes are of much more limited effect.

[204] R Calnan, "The reform of the law of security" 2004 BJIBFL 19(3) p 88.

[205] See the oft-quoted remarks of Bingham LJ in *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1989] QB 433, 439.

[206] *Downsview Nominees Ltd v First City Corporation Ltd* [1993] AC 295.

[207] Scott V-C in *Medforth v Blake* [2000] Ch 86, 103.

[208] See *Cuckmere Brick Co Ltd v Mutual Finance Ltd* [1971] Ch 949 and *Downsview Nominees Ltd v First City Corporation Ltd* [1993] AC 295. See also R Goode, *Commercial Law* (2nd ed 1995) p 691, and *Medforth v Blake* [2000] Ch 86.

2.178 This has not prevented the courts recognising duties to act with reasonable care in an increasing number of specific instances. Equity[209] imposes certain duties including a duty on the secured creditor to take reasonable care to obtain a proper price.[210] This duty is owed to the mortgagor and to a subsequent encumbrancer. In *Medforth v Blake*[211] the Court of Appeal held that a receiver who chose to manage a business owed the mortgagor a duty to do so with due diligence. This did not require him to continue the business but, if he chose to do so, it required him to take reasonable steps to manage it profitably.

2.179 Moreover, it is likely that a court would interpret the new scheme, so far as it could, in such a way as to avoid one party being able to exercise its rights in a way that is commercially unreasonable. For example, in the analogous field of the power of the mortgagee to set interest rates, the Court of Appeal has held that the power was fettered by an implied term. This was to the effect that not only would the lender's discretion not be exercised dishonestly, for an improper purpose, capriciously or arbitrarily but also that it was subject to a *Wednesbury*-type unreasonableness test: it could not be exercised in a way that no reasonable lender acting reasonably would do. This, as the court emphasised, is very different from requiring the lender to set a reasonable rate.[212]

2.180 Thus we think that even a general provision along the lines of those in the UCC or SPPSA would be consistent with both existing English law and current trends within it. We do not think that a provision requiring all rights and duties that arise under the security agreement or the legislation to be exercised or discharged in good faith and in a commercially reasonable manner would empower a court to substitute its own judgment for that of the parties, or to override the express rights given by the agreement. It would merely give the court an overt power to prevent a party from exercising its rights in a manner that was commercially unreasonable rather than having to achieve the same result by means of more covert techniques such as interpretation or the implication of terms.

2.181 However, we understand that in fact the impact of the general provision on good faith in the UCC on Article 9 has been very slight indeed. It appears that it is often cited but has had no appreciable effect on the outcomes of the cases. Rather, it seems that the more important provisions of Article 9 are those specific ones that require the parties (and particularly the secured party) to act in specified circumstances in a way that is commercially reasonable. The principal situation is in relation to disposing of collateral after the debtor's default, when the 'method, manner, time, place and other terms' of the disposition must be commercially

[209] In *Downsview Nominees Ltd v First City Corporation Ltd* [1993] AC 295 Lord Templeman 'insisted that [the duties owed by a receiver] were duties arising in equity and were not common law duties of care': Scott V-C in *Medforth v Blake* [2000] Ch 86, 97, referring to [1993] AC 295, 315. Scott V-C said that in his view there is no difference between the duties owed by a receiver at common law and in equity: [2000] Ch 86, 102.

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

[211] [2000] Ch 86.

[212] *Paragon Finance plc v Nash* [2001] EWCA Civ 1466; [2002] 1 WLR 685.

reasonable.'[213] There are only half a dozen other references in Article 9 to a requirement to act in a commercially reasonable manner, each one being even more specific.[214] There is only one reference to good faith.[215]

2.182 Thus it seems that a scheme of rights and remedies can be made to work without any general requirements of good faith or commercial reasonableness, provided that specific requirements are imposed where necessary. Given the importance that we attach to certainty, we have decided to follow this model and not to include any general provisions. **We provisionally recommend that any scheme of rights and remedies should not contain a general reference to 'good faith', nor a general requirement that either party exercise its rights or perform its obligations in a commercially reasonable manner. Instead there should be specific requirements when these are necessary.** So that consultees can see for themselves whether or not they agree with our assessment of how these provisions would work, we have included them within our scheme.[216] There are also two ancillary provisions. One states that the parties may, by agreement, determine the standards which fulfil the rights of a debtor or obligations of a secured party under a provision that requires commercial reasonableness, provided that the standards are not manifestly unreasonable.[217] The other gives specific guidance in various situations.[218]

Mandatory rules

2.183 A provision that the rights and obligations on default set out in the scheme should be mandatory, in the sense that the secured party is not permitted to reduce the debtor's rights, is found in the Ontario and Saskatchewan PPSAs. The UCC has a closed list of specific provisions that cannot be waived by the debtor.

2.184 In contrast the NZPPSA opted to allow the parties freedom to vary the rules, but not in such a way that might affect third parties. This seems a good idea in principle; but in practice, as we will explain in detail in Part 5, it allows the parties little additional freedom and seems to cause uncertainty. For example, the NZPPSA provides that the debtor may give up its right to the surplus. However this will not affect a second creditor who has a right over that surplus. Thus SP1 may be entitled to the surplus as against the debtor but have to pay it to SP2.

2.185 Although we are attracted to avoiding an element of compulsion over the terms of agreements where it is not strictly necessary, our provisional view is that it would be simpler and more effective to make the surplus rule mandatory. However, as we explain in more detail in Part 5, we favour the UCC's approach of a closed list of mandatory rules to the general provision of the Canadian schemes.

[213] UCC Section 9-610(b): see below, para 5.65.

[214] See Sections 9-607(c); 9-608(a)(3); 9-610(a)-(b); 9-611(e)(i); 9-615(c); and 9-627.

[215] See above, para 2.173.

[216] See DRs 59(1)-(2), 60(5)-(6), 62(6) and 65(5).

[217] DR 59(4).

[218] DR 69.

2.186 Again we have included the provisions within the draft regulations so that consultees can make their own evaluation, but in Part 5 of this consultative report we also set out the New Zealand alternative so that consultees can examine both and advise us.

2.187 In any event we think that it will be seldom that parties will find it useful to vary the scheme and very rare that any varied provisions - for example, waiving the debtor's right to receive the surplus - will actually come into play. Thus although a decision must be made one way or the other, we do not think it affects the viability of the scheme of rights and remedies set out in the statement.

Conclusion on the legislative statement of rights and remedies

2.188 Overall, we think that to include a statement of rights and remedies in the notice-filing scheme would have significant benefits in terms of clarity and simplicity. The law would be clearer than if the statement were omitted because it would set out clearly which remedies were applicable to which type of SI. As consultees pointed out, this would be particularly important if, as we also provisionally recommend, quasi-securities were to be brought within the scheme. In such a case we think that it would be essential to have at least provisions dealing with the right to any surplus following disposition; but we think that it would be highly desirable to include the other provisions we have suggested. The law would be simpler because the same set of rights and remedies would apply to every type of transaction that has a security purpose, whatever its form. Indeed it would no longer be necessary for the parties to adopt any particular form of SI. It would suffice that they had agreed that the secured party should take 'a security interest' in identifiable collateral and that the SI had been perfected by filing or any other means that is applicable under the scheme.

2.189 This would not prevent the parties from devising new forms of security device or agreeing to different remedies, provided that (subject to the decision on whether certain default rules should be mandatory) the 'floor' of rights of the debtor set out in the scheme was not touched. Given the rather basic nature of those rights we think that, even if the rules were made mandatory, there would be very little loss of flexibility in practice.

2.190 It is our provisional conclusion that to include a statement in the notice-filing scheme would have significant benefits in terms of clarity and simplicity. **We provisionally recommend the inclusion of a statement of rights and remedies in the 'companies-only' scheme**.

2.191 **We would welcome consultees' estimates of the costs and benefits of our provisional recommendations for including a statement of rights and remedies.**

CONCLUSIONS ON PRINCIPAL ISSUES

2.192 Reviewing the issues that have been explored in this Part, it is our provisional recommendation that a scheme of notice-filing with its associated rules of priority should definitely be adopted for company charges and, as soon as Parliamentary time permits, for charges created by unincorporated businesses. The current law is not completely unworkable, nor does it have such serious flaws as did American law before the UCC, with no equivalent of the floating charge and a

multiplicity of filing requirements. Nonetheless, electronic notice-filing would be much less costly and much more efficient than registration under the current law; the reduction in the 'public notice' function would be slight; and the rules of priority would be clearer and more appropriate to modern conditions.

2.193 The question of extending the scheme to cover quasi-security devices, and particularly to title-retention devices, is more difficult. Our provisional view is that the overall benefits would outweigh the costs, both in the short and long terms. However we hope that with the explanation of the details of the proposed scheme in this consultative report, consultees will be in a position to make a proper evaluation.

2.194 It is our provisional recommendation that the scheme should also include provisions on SIs over investment property and bank accounts, in particular developing the notion of perfection by 'control' and providing appropriate rules of priority. We think that this will provide an important legal underpinning of the FCAR. We believe that this will increase the confidence of those who wish to lend against the security of these kinds of property. This is particularly important for investment property: having an effective and predictable law on SIs over investment property may increase the attraction of keeping such property in accounts that are governed by English law. At present the governing law depends on the place of the relevant register but, with indirectly held investments, if the Hague Convention is brought into force, the parties will have a large measure of freedom to choose the law to govern their holding. We think that our scheme would make a choice of English law even more attractive than at present.

2.195 As to the statement of rights and remedies, we believe that it is worth incorporating even at the companies-only stage in order to clarify and simplify the law. We would not, however, include general provisions regarding good faith or commercial reasonableness.

PART 3
THE SCHEME IN FULL

3.1 In Part 2 we explained the critical features of the legislative scheme we provisionally recommend. This Part contains a detailed discussion of the features of the scheme for registration (filing) and priority of SIs over personal property in general (where these have not been dealt with in Part 2), and is intended to indicate how we anticipate the scheme as a whole operating.

3.2 There are two significant aspects of the scheme that we do not deal with in any detail in this Part. One is how the scheme will operate in relation to financial collateral. This is a complicated area, often of specialist interest, and for reasons of clarity of exposition we have chosen to separate it out as a whole in Part 4 (although cross-references will be made to Part 4 when appropriate in this Part).[1] The other is the statement of the rights and obligations of the parties and the remedies on default. This aspect is dealt with in Part 5.

3.3 In Part 2 we sought consultees' views on the question of whether the notice-filing system we provisionally recommended should include quasi-securities.[2] In order for consultees better to assess this question, the explanation of the scheme in this Part deals with 'traditional' securities and 'quasi-securities' together, as do the draft regulations. In other words, we do not follow the approach we took in the CP of first establishing a scheme for company charges, and then considering how it could be extended to quasi-securities. Appendix B contains a list of those provisions of the draft regulations that would be removed or varied were the scheme to be introduced only for traditional securities. These are, in fact, few.

STRUCTURE OF THIS PART

3.4 In this Part we begin by addressing the scope of the scheme we provisionally recommend, in terms of the persons and interests affected. We then deal with questions of attachment and perfection, and explain in detail the different methods of perfection over collateral other than financial collateral (which is dealt with separately in Part 4 due to the complexity of the issues involved). We then explain the scheme of priorities, the relationship of our scheme to the 'specialist registries'; how the scheme will apply to SIs created over assets outside the jurisdiction by companies registered here and to SIs created by companies registered in Scotland or incorporated outside Great Britain; and the transitional provisions envisaged for the scheme. An explanation of the rules forming part of the statement of the rights, duties and remedies of the parties will be dealt with in Part 5.

3.5 In this Part - and others - we highlight in bold text our provisional recommendations and also questions on which we would particularly welcome

[1] Part 4 also covers SIs over the right to proceeds of letters of credit where these are perfected by 'control'.

[2] See above, paras 2.135-2.137.

assistance from consultees. We would welcome views on any aspect of the scheme or the draft regulations.

SCOPE OF THE SCHEME

3.6 In essence the scheme applies to SIs over personal property created or provided for by companies (and which will by consequential amendment extend to LLPs, as do the current company charge registration provisions). We take each of these elements in turn, dealing with 'companies' and 'personal property' in this section and 'security interests' in the next.

Companies

3.7 The effect of the draft regulations is that they apply to SIs created or provided for by a debtor who is one of the following persons:[3]

(1) a company registered in England and Wales (as defined under the Companies Act 1985 or its successor),

(2) an LLP,[4] or

(3) a company registered in Scotland or a company that is incorporated outside Great Britain, if the relevant assets are in England and Wales (or to which the law of England and Wales would apply, for example a bank account that is governed by English law).[5]

For the remainder of this Part we shall refer to such persons collectively simply as 'companies'.

Unregistered companies

3.8 The draft regulations have been drawn up to apply only to registered companies. In the CP we provisionally proposed that unregistered companies should be included within the scheme,[6] and there was broad support from those who addressed this issue. On further consideration it seems to us that the issue of including companies which have not been registered is quite wide, and is really a question relating to 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 providential societies, for example, there are additional requirements to register

3 DR 11.

4 We did not deal with these in the CP, but as they are subject to the same charge registration requirements as registered companies, they are included within our scheme. They are not mentioned expressly, save that the consequential amendments make the necessary changes to the Limited Liability Partnerships Regulations 2001, SI 2001 No 1090, which currently apply various provisions of the Companies Act 1985 (including the charge registration provisions) to LLPs.

5 DRs 11 and 13. On Scottish and overseas companies see below, paras 3.364-3.383.

6 CP para 5.122.

charges with the Financial Services Authority.[7] **We would welcome views on whether the scheme we provisionally propose should be limited to registered companies and LLPs, or should apply also to other corporate bodies; and if so, as to which corporate bodies should be included.**

The person creating the SI and the 'debtor'

3.9 It is important to note that the scheme is one that applies to SIs created or provided for by registered companies (and LLPs). It is the legal personality of the person creating the SI that is critical to the application of the draft regulations. The secured party can have any form of legal personality.[8] Likewise, buyers and other persons who may be affected by the operation of the draft regulations need not be companies.

3.10 For the most part the scheme will apply to SIs when the debt or obligation secured is owed by a company, but this will not always be the case. A person may create an SI in order to secure a debt or other obligation owed by a third party. If the person creating the SI is a company, the scheme will apply, whether or not the person who owes the debt or obligation is also a company.[9] In the converse case in which an individual creates an SI to secure a debt owed by a company, the 'companies-only' scheme described in this Part will not apply.[10]

3.11 This is linked to the definition of 'debtor'. In the majority of cases the party creating the SI and the person owing the obligation secured will be one and the same. However, 'debtor' is defined as a person who owes payment or who is liable to perform the obligation secured, whether or not that person owns or has rights in the collateral;[11] and 'debtor' can, according to the context, either refer only to the person who has the interest in the collateral, or to the person who owes the obligation secured even though it does not have rights in the collateral, or to both.[12] This follows the PPSA model. We recognise that it is a bit cumbersome. However the approach of UCC Article 9, which designates the party who creates the security as the debtor and the party who owes the debt or other obligation as an 'obligor',[13] seems to us even more awkward. It seems counter-intuitive to refer to the person who does not owe the debt as the 'debtor', and we find the use of 'obligor' (and by implication, obligee) confusing – quite simply, it is very easy to muddle who owes and who is owed the obligation. We have therefore kept to the PPSA model.

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

8 DR 2(1).

9 DR 11.

10 The extension of the scheme to unincorporated debtors is discussed in Part 2, paras 2.70-2.80.

11 DR 5.

12 See the discussion of this point of terminology above, para 2.12. 'Debtor' also includes the transferee of, or successor to, a person referred to as a debtor: DR 2(1).

13 The UCC also contains the additional category of 'secondary obligor': see below, para 3.53 n 61.

3.12 The situations covered by the scheme may involve a third type of debtor. Where security is taken over a company's accounts receivable, for instance, there are two 'debtors': the company and the party who is liable on the receivable. We use the term 'account debtor' when referring to a person who is obligated under an account.[14]

3.13 The definition of debtor also covers expressly those persons who create 'deemed' SIs, which do not secure payment or performance of an obligation: for example, the outright sale of an account receivable. We deal with this point in more detail later in this Part.[15]

3.14 **We would welcome advice on whether we should continue to use a definition of 'debtor' that may refer to either the party creating the SI or the party whose obligation is secured, where they are not the same person, or both.[16] If not, should we refer to the first as 'the debtor' and the second as 'the obligor', as does the UCC; or do consultees have other suggestions?**

Agents and trustees

3.15 The scheme set out in the draft regulations applies not only to parties that act on their own behalf but also to those who act as agents or trustees for others. Thus a company that creates an SI may be the title holder for assets of a group of companies which the group as a whole seeks to use to raise money. In such a case there may be questions as to whether the company is the 'debtor' in both of the senses above or whether each of the companies in the group is separately liable for its share of the obligation secured.

3.16 Equally, a secured party may hold an SI for its own benefit or for the benefit of others. The definition of 'secured party' covers a person who holds an SI beneficially and one who holds an SI for the benefit of others including, where the SI is embodied in a security trust deed, the trustee for the holders of debt obligations.[17]

Personal property

3.17 In the draft regulations we use the term 'collateral' to refer to personal property that is subject to an SI. Personal property can comprise different types of asset, including goods, documents of title, instruments, accounts, money, investment property, bank accounts and intangibles. Each of these categories is defined in the draft regulations.

[14] DR 2(1).

[15] See below, paras 3.34-3.50.

[16] As set out in DR 5. An alternative approach to that of using 'debtor' might be to adopt the language used in the FCAR, and refer to the 'collateral provider'.

[17] DR 2(1).

Goods

3.18 Goods are defined as tangible personal property[18] other than documents of title, instruments, money and certain tangible forms of investment property.[19] A company can hold goods either as inventory or equipment. The definition of inventory is wide: it includes goods which are held for sale or lease, furnished under a contract of service, raw materials or work in progress, or materials used or consumed in a business. 'Equipment' is defined simply as goods that are not held as inventory.[20]

3.19 Many types of goods now incorporate software without which the goods cannot be used. To date English law does not have specific rules on this; the software is treated as goods, at least where it is already embedded in the goods or comes on a disk or other tangible medium.[21] We do not think it necessary that the scheme should follow the UCC approach of expressly including 'embedded software' within the definition of goods.[22]

Instruments and documents of title

3.20 'Instrument' refers to negotiable instruments. The definitions of instruments and documents of title are limited to paper documents although for other purposes, a document can be in electronic format.

Accounts

3.21 An 'account' is defined as being a monetary obligation (whether or not earned by performance), and will cover book debts and other receivables.[23] Monetary obligations evidenced by an instrument are excluded from the definition, as are investment property and bank accounts. Certain rights to payment for money or funds advanced or sold are also excluded, as with the UCC. This exclusion exists to prevent loans being classed as accounts (for example, where a lending bank credits its borrower's bank account for the amount of the loan, this advance of funds is not a transaction which gives rise to an account). It also effectively

[18] The definition includes fixtures, crops, trees which have been severed and the unborn offspring of animals.

[19] It also excludes certain minerals which, although severed from the land, fall within the definition of land under the Land Registration Act 2002 and the Land Charges Act 1972.

[20] DR 2(1). There is no scope under the draft regulations for a debtor to hold personal property as 'consumer goods', which is a term used in the other schemes, although there is the possibility of someone acquiring inventory or equipment from the company for its own private 'consumer' purposes: this is addressed in the rules relating to purchasers: see DR 31.

[21] See *Chitty on Contracts* (29th ed 2004) para 43-005 n 21.

[22] See UCC Section 9-102(a)(44).

[23] The UCC contains a separate category of 'payment intangibles', which covers not only accounts, monetary obligations evidenced by an instrument, bank accounts and investment property but all other types of monetary obligation. We have not included such a category in our draft regulations. Most of the collateral that would comprise payment intangibles under the UCC will comprise accounts under our draft regulations, or will fall into one of the other categories mentioned. We see no need to include the few that are not covered, such as loan participations. See further below, para 3.21 n 24.

excludes from the definition of accounts the sale of loan participation (that is, where the original lender sells part of the loan, and the security given with respect to it, to a third party). The sale of loan participation will fall entirely outside our scheme.[24]

Intangibles and money

3.22 'Intangibles' form a residual category defined on an exclusionary basis: it is personal property that is not goods, a document of title, an instrument, investment property, an account, a bank account or money. Licences are expressly included.

3.23 'Money' means coins and notes in valid currency.[25]

3.24 The definitions of investment property and bank accounts are dealt with in Part 4.

'Chattel paper'

3.25 Unlike the UCC and PPSAs, our provisionally recommended definition of personal property does not refer to 'chattel paper', nor does our scheme have special rules for it. Parties who have disposed of inventory by way of conditional sale, hire-purchase or finance lease may use the income stream as a form of collateral as under a block discount arrangement. In North America it appears that the transaction is often effected by a physical transfer of the document recording the agreement; the effect of the North American legislation is that physical transfer of the chattel paper to the secured party transfers both (a) the right to the payments due and (b) the transferor's right (by virtue of its retained ownership) to repossess the goods on default.[26] This transfer of 'chattel paper' is subject to special rules of priority under the UCC and PPSA schemes. We have consulted experts in the finance industry who tell us that there is no equivalent practice in the UK of handing over the physical document or of always transferring the right to repossess to the assignee of the debt that is due under the agreement. Therefore no special rules for chattel paper are required. The right to payment may be transferred by assignment like any other account; if necessary, the right to repossess can equally be assigned to the transferee of the account.

SECURITY INTERESTS

3.26 The concept of the 'security interest' is fundamental to the scheme. The definition in the draft regulations is wide enough to capture both those interests that are currently regarded by the law as being security and interests that are not so

[24] As a loan participation falls outside the definition of accounts, it would be caught within our definition of intangible. However, unlike the UCC (which includes sales of participation but provides that they are automatically perfected), we have not brought sales of intangibles within the scheme (unlike sales of accounts, which, as will be seen, fall within our definition of 'security interest').

[25] We note at this stage a distinction between 'money' and 'cash', the latter being wider than just notes and coins: see below, para 3.232 n 285.

[26] It is not clear to us whether this practice pre-dated the UCC Article 9 or was enabled by it.

regarded, but which have a security purpose. As we noted in Part 2, the question of whether the term should include quasi-securities divided consultees; quasi-securities have been included in the draft regulations so that consultees may evaluate the scheme properly.[27]

3.27 The definition is intended to be sufficiently flexible to accommodate the emergence of new forms of transaction that have a security purpose, and therefore does not simply comprise a closed list of particular transactions or devices currently used by business. Commentators sometimes refer to those interests that have a security purpose (whether comprising what would currently be 'traditional' security or quasi-securities) as 'in-substance' SIs.

3.28 The definition of an SI in the draft regulations also includes sales of accounts and promissory notes, as well as those commercial consignments and leases for a term of more than one year that do *not* have a security purpose. These are sometimes referred to by commentators as 'deemed' SIs (although neither the term 'in-substance' nor 'deemed' appears in the draft regulations). The distinction between 'in-substance' SIs and 'deemed' SIs is important in relation to the application of the scheme's rules relating to the rights and remedies of the parties on default under the security agreement. As we discuss later, these provisions apply only to 'in-substance' SIs and not 'deemed' SIs.[28]

3.29 For the purposes of discussing our proposed definition of 'security interest', we consider the position of 'in-substance' SIs and 'deemed' SIs in turn.

'In-substance' SIs

3.30 As drafted for the purposes of consultation, the definition of an SI means 'an interest in personal property which secures payment or performance of an obligation'.[29] This is without regard to the form of the transaction which creates or provides for the interest or to the person who has title to the collateral. This definition is thus wide enough to encompass those devices currently regarded by English law as security, such as mortgages, charges and pledges, and title-retention devices such as conditional sales, hire-purchase agreements and finance leases, as they can be said to have a security purpose.

3.31 For the avoidance of doubt, DR 3(2) sets out in paragraph (a) those transactions that clearly have a security purpose and in paragraph (b) those that may or may not. For example, a lease may have a security purpose if it is what is commonly termed a finance lease, but an 'operating' lease does not have a security purpose.[30]

[27] See above, para 2.132.

[28] See below, para 5.10.

[29] DR 3(1).

[30] Our list does not contain flawed asset arrangements (which are expressly included in the NZPPSA, s 17 definition), as we do not consider these contractual arrangements to involve the creation or retention of a property right.

3.32 Whether the interest secures payment or performance of an obligation is not a question of the intention of the parties or merely of interpretation; it is one of characterisation of the transaction to which they have agreed.[31] Thus whether a lease has a security purpose (and so is what we refer to as a 'finance' lease) or not (and so is what we term an 'operating' lease) will depend on factors such as whether the lessee is required to pay the bulk of the capital cost of the equipment; whether after that period the lessee has the right to continue to use the equipment for a reduced payment; whether if the equipment is not required by the lessee it is to be returned to the lessor or sold by the lessee as agent for the lessor; how the proceeds of any disposition are to be divided between the lessee and lessor; and who bears responsibility for maintenance of and repairs to the equipment during the currency of the lease.[32] We have not thought it necessary to list these factors in the draft regulations, but it would be possible to do so if consultees think that would be desirable.[33]

3.33 **On the assumption that the scheme should apply to quasi-securities, we provisionally recommend that the definition of 'security interest' should encompass all those transactions that have a security purpose, irrespective of the form of the transaction or who has title to the collateral.**

'Deemed' SIs

3.34 In addition to providing the 'in-substance' test for an SI, the definition in the draft regulations also provides that the following are SIs:

(1) sales of accounts and promissory notes;

(2) leases for a term of more than one year that do not secure payment or performance of an obligation, and

(3) commercial consignments that do not secure payment or performance of an obligation.

The common feature is that none of the above transactions secures payment or performance of an obligation. They would fail the 'in-substance' test, and unless

[31] Compare the characterisation of a charge as fixed or floating: see, eg, *Agnew and another v Commissioner of Inland Revenue* [2001] UKPC 28; [2001] 2 AC 710, at para 32.

[32] FRS 5 already takes into account the economic effect of a number of transactions (such as sale and repurchase agreements, factoring of debts and securitised assets). Leases are governed by SSAP 21, which still defines two different types of lease: finance and operating leases. (The Accounting Standards Board have said that they 'regard existing leasing standards as deficient because they omit material assets and liabilities arising from operating lease contracts…For some time, users have called for finance leases and operating leases to be treated consistently." Source: ASB website. We also understand that the ASB is currently undertaking a research project to inform the International Accounting Standards Board's development of a new leasing standard.)

[33] UCC Section 1-201(37) contains a brief list though the factors stated are not directly applicable to England and Wales where practice differs.

they were expressly brought within the definition, they would not be SIs.[34] Thus they are informally said to be 'deemed' rather than 'in-substance' SIs.

3.35 This means that a transfer of accounts receivable, for example, is a 'security interest' within the meaning of the scheme whether it is a transfer by way of charge (when it will be an 'in substance' SI) or an outright sale of the accounts (when it will be a 'deemed' SI). However, it is very important to note that although these 'deemed' SIs will be subject to the rules of the scheme in relation to attachment, perfection and priority, they fall outside the rules on surplus and the scheme of remedies that we discuss and provisionally recommend in Part 5. Thus if the lessee (the debtor) under an operating lease defaults, the remedies of the lessor (the secured party) will be those provided by the lease agreement and even if the re-possessed equipment is worth more than the outstanding debt, there will be no question of the lessor having to pay any surplus to the lessee. For the avoidance of doubt, we have made this point plain on the face of the draft regulation dealing with the meaning of SI.[35]

3.36 The reason for including these types of interest within the scheme for perfection and priorities is that first, they are difficult to distinguish from transactions that give rise to an interest that has a security purpose; and, secondly, if they are not given 'publicity', they may be equally misleading to third parties, including other secured parties and buyers, who may not realise that the asset in question is not the property of the company. All the overseas schemes include provisions relating to sales of accounts and commercial consignments, but they vary over leases. We take leases first.

Leases that do not have a security purpose

3.37 The UCC Article 9 does not apply to leases that do not have a security purpose, but we are told that in practice leasing companies find it easier to register all leases of any length, since it costs little and can do no harm.[36] Virtually all of the Canadian and New Zealand schemes build on this practice by requiring that operating leases be registered unless they are of less than a year's duration (to avoid catching short-term rentals of such things as vehicles or plant-hire).[37] Thus

[34] Of course, a lease – of whatever length – that *does* secure payment or performance of an obligation (ie, a finance lease) would fall within the 'in-substance' test for an SI. Similarly, if what purports to be a sale of accounts has a security purpose, it will be re-characterised as an 'in-substance' SI, just as under current law a mortgage disguised as a sale will be treated as a mortgage (see CP para 6.8).

[35] DR 3(3).

[36] Our draft regulations also include a similar provision that 'registration is without prejudice…' (DR 46(3)). We initially did not think it was needed, as one features only in the UCC and the Ontario PPSA, which both do not include operating leases within their scope. The SPPSA and NZPPSA, which do, do not have such a provision. However, we see no harm in including such a provision, and in any event, it may also allow other 'disputed' interests to be filed (eg, *Quistclose* trusts: see below, para 3.61(1)).

[37] Commentators note that in Ontario, which alone of the common-law provinces in Canada only includes 'true' leases, there has been litigation over the characterisation of leases, with the result that recommendations – as yet not accepted by the Ontario government - were made to include 'one year plus' leases within the Ontario PPSA. However, as with the UCC, lessors can 'avoid unpleasant surprises' as the Ontario system permits

it is only in the small minority of cases in which there is a default that it will become necessary to determine whether a lease of goods, for instance, was a finance lease or an operating lease.[38] In the CP we asked whether all leases should be registrable (if over a certain minimum period), or only those that have a security function.[39] The majority of those who responded favoured the first option.

3.38 **We provisionally recommend that leases for over one year that do not have a security purpose should be brought within the definition of 'security interest' for the purposes of perfection and priority.**

3.39 The definition in the draft regulations of 'lease for a term of more than one year' includes not just the obvious lease of goods for a term of more than one year, but also leases for an indefinite term; leases for one year or less where the lessee, with the lessor's consent, actually remains in possession of the goods for more than a year,[40] and a series of short, renewable leases that together add up to more than one year.[41] It should be noted that, in common with the PPSAs, the definition of 'lease for a term of more than one year' only applies where the lessor is regularly engaged in the business of leasing goods.[42]

3.40 We have said that leases (and consignments) that do not have a security purpose fall outside the scheme of remedies. Moreover, some of the other non-default based rules will only apply to 'in-substance' SIs, such as the right of the debtor to demand certain information from the secured party.[43] Of course leases of whatever length (and consignments) may have a security purpose, and hence may fall within the 'in-substance' definition of an SI; and when they do so the normal provisions, including the remedies for default, will apply. **We ask whether consultees agree with the way 'lease for a term of more than one year' has been defined in the draft regulations.**

Commercial consignments that do not have a security purpose

3.41 The issues relating to consignments are parallel to those for leases. As we noted in the CP,[44] a consignment may be for a financing purpose or some other commercial purpose. For example, where cars are consigned on sale-or-return, with the dealer paying a deposit equal to the price less tax, this in itself does not seem to have a security purpose. We asked whether a consignment should be registrable only if it secures payment or performance of an obligation, or whether

'precautionary' filings: J Ziegel and D Denomme, *The Ontario Personal Property Security Act Commentary and Analysis* (2nd ed 2000) para 2.2.3 (pp 57-58).

38 The benefit of moving the 'litigation point' in this way seems to us to outweigh any risk of 'clutter' on the register of filing all leases, which was a concern raised by a few consultees.

39 Para 12.81.

40 DR 8(1), although this is a slightly hybrid position: the lease does not fall within the definition until the lessee's possession extends for more than one year.

41 DR 8(1)(c).

42 DR 8(2).

43 See DR 18.

44 CP paras 6.22-6.23 and 7.27.

it should be registrable whatever its purpose. Again a majority favoured registration whatever the purpose.

3.42 A commercial consignment is, in effect, one where both the consignor and consignee in the ordinary course of their businesses deal with goods that are delivered for sale, lease or other disposition by way of consignment.[45] Therefore there is no need to file for the occasional consignment for sale. The delivery of goods for auction is also excluded.

3.43 **We provisionally recommend that commercial consignments that do not secure payment or performance of an obligation should nonetheless be 'deemed' to be SIs.**

Sales of accounts and promissory notes

3.44 We have explained in Part 2[46] the reasons for bringing outright sales of accounts within the scheme, and have noted that the provisional proposal in the CP that all sales of receivables (for example under a factoring or block discounting agreement or a securitisation) should be registrable received[47] widespread support, even among some who were opposed to bringing other forms of quasi-security within the scheme. Receivables now come within our provisionally proposed definition of 'accounts' in the draft regulations; an 'account' is defined in the draft regulations as meaning a monetary obligation other than investment property, bank accounts or monetary obligations evidenced by an instrument and certain rights to the payment for money advanced.[48]

3.45 We have already noted that some transactions involving accounts have a security purpose. A charge over book debts, for example, would satisfy the 'in-substance' test of an SI. In contrast, a true sale of accounts does not have a security purpose, and would fall outside the 'in-substance' test described earlier. It will fall within the overall definition of an SI and be subject to the perfection requirements (that is, it will need to be filed) and to the rules of priority.[49] The 'surplus' and 'remedies' provisions do not apply. In the CP we pointed out that the rules on default remedies, for example, accountability to the seller for a surplus, should not apply to outright assignments of accounts (receivables).[50] If, for example, accounts are assigned outright on a non-notification basis under a block discount agreement and, because the assignor has become insolvent, the assignee notifies the account debtors and recovers the sums due, there should be no question of the discounter having to account for any 'surplus' to the assignor. There was general agreement with this. Thus the 'surplus' rule and the remedies

[45] DR 9.

[46] See paras 2.87-2.88.

[47] CP para 12.82. There was equally strong support for the proposals that there should be exceptions for negotiable instruments and when book debts are sold as part of a larger transaction such as the sale of the overall business.

[48] See above, para 3.21.

[49] See above, paras 3.30-3.33.

[50] CP para 7.38.

for default set out in Part 5 will apply only if the assignment was by way of charge (that is, an 'in-substance' SI).[51]

3.46 For the purposes of consultation we also include sales of promissory notes within the 'deemed' SIs. It is not even necessary to file in order to perfect such a sale (they are 'automatically perfected'[52]) but they are subjected to the rules of priority of the scheme. This is an extension found in UCC Revised Article 9. We understand that it was made at the specific request of banks involved in securitisations.[53] Promissory notes are apparently often sold as part of a securitisation but may not actually be handed over to the Special Purpose Vehicle.[54] Apparently sales of promissory notes were included within Revised Article 9 to put it beyond question that the sale is effective against the trustee in bankruptcy. We would welcome advice as to whether the draft regulations should retain a similar provision.

3.47 If promissory notes are to be included, we would welcome views as to whether sales of bills of exchange should be similarly treated. For the present, we have not included such sales within the definition of an SI.[55]

3.48 **We provisionally recommend that sales of accounts should be treated as SIs for the purposes of perfection and priority.**

3.49 **We ask consultees whether, for the purposes of priority, sales of promissory notes should also be treated as SIs that are automatically perfected. We also ask consultees whether sales of bills of exchange should be treated as SIs in the same way as sales of promissory notes.**

'Deemed' SIs and the definition of 'debtor'

3.50 The definition of 'debtor' in the draft regulations reflects our provisional recommendation that certain interests should be treated as ('deemed') SIs even though they do not secure payment or performance of an obligation. 'Debtor' includes a person who receives goods under a commercial consignment, a lessee under a lease for a term of more than one year, and the seller of an account or promissory note.[56]

[51] This is made very clear in NZPPSA, s 105(b)(i) and is the effect also of UCC Section 9-608(b). SPPSA, ss 3(2) and 55(2)(a) are less clear and it may be that the remedies in the SPPSA, Part V do apply to transfers of accounts that have a security purpose.

[52] See further below, para 3.89.

[53] UCC Section 9-109(a)(3).

[54] Bringing sales of promissory notes within the UCC seems to have the result that a person who knows of the SI over the promissory note will not be a holder in due course for the purposes of UCC Article 3, which deals with instruments (see Section 3-102), but under Article 9, a purchaser of an instrument will take free unless it knows the sale is in violation of the rights of the holder of the SI: Official Comment 7 to Section 9-330.

[55] Under the UCC they are automatically perfected: Section 9-309(3).

[56] See DR 5(1). We have not thought it necessary for the definition of 'secured party' expressly to include a consignor or a buyer of accounts or promissory notes, as these

SIs in 'supporting obligations'

3.51 Although it is hard to find clear authority, we understand the current law to be 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 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'.[57] Even if it is not the current law, it seems a sensible rule; there seems very little point in requiring a separate assignment of the supporting obligation.[58]

3.52 Such a rule has been included in Revised Article 9 of the UCC through the concept of the 'supporting obligation.' In essence, the UCC provides that if a monetary obligation such as an account is supported by a guarantee or indemnity from a third party, or by a letter of credit from a bank, then an SI created over the monetary obligation should of itself also create one over the 'supporting obligation'. There is no need for a separate assignment of rights over the guarantee or under the letter of credit, nor of separate filing or other means of perfection. Under the UCC there are specific rules on attachment, 'automatic' perfection and priority for supporting obligations.

3.53 For purposes of consultation we have included equivalent provisions within our scheme. The term 'supporting obligation' is defined in the draft regulations.[59] It covers the right to proceeds of a letter of credit[60] as well as guarantees or indemnities in respect of the non-performance of the principal obligation.[61] However, a supporting obligation falls within the definition only if the principal obligation that it supports consists of an account, a document, an intangible, an instrument, or investment property.

3.54 Where an SI attaches in collateral, an SI attaches automatically in a supporting obligation for the collateral.[62] Perfection of an SI in collateral also perfects an SI in a supporting obligation.[63]

people will fall within the general definition of someone in whose favour an SI is created or provided for.

57 R Goode, *Commercial Law* (2nd ed 1995) pp 695-696.

58 The assignor would have no interest in retaining the supporting obligation, and it is not possible for the principal obligation to be assigned to one person and the supporting obligation to another

59 DR 2(1).

60 The UCC terms these 'letter-of-credit rights', but we have not adopted this terminology, preferring instead the 'right to proceeds of a letter of credit'.

61 Compare UCC Section 9-102(a)(77). We have not used the term 'secondary obligation', as the UCC does, for guarantees and indemnities.

62 DR 15(11). Compare UCC Section 9-203(f). The Official Comments indicate that this seems to be the intended effect of the UCC, although the Article itself provides merely that '[t]he attachment of a security interest in collateral … is also attachment of a security interest in a supporting obligation for the collateral'. Official Comment 8 states that this result was 'implicit' under 'old' Article 9.

63 DR 21(6). Compare UCC Section 9-308(d).

3.55 The draft regulations also provide that for the purposes of the 'residual' priority rules (which we explain below,[64] but which essentially give priority to the first secured party to file or perfect its SI), the time of filing or perfection as to an SI in collateral supported by a supporting obligation is also the time of filing or perfection as to an SI in the supporting obligation.[65] Like the UCC, we have provided that an SI in a supporting obligation has the same priority as an SI in the collateral which it supports.[66] We have also included specific perfection and priority rules relating to control over the right to proceeds of a letter of credit. We deal with this aspect in more detail in Part 4, when we address the issue of financial collateral more generally.[67]

3.56 Since we did not raise this issue in the CP or, in any detail, the subsequent informal seminars, we would particularly welcome the views of consultees. Before responding on this point they may wish to read the last section of Part 4, which deals with 'control' over the proceeds of letters of credit.[68] This may be important if the assignment of the principal obligation were not perfected, or were the principal obligation to be assigned to two assignees.

3.57 **We provisionally recommend that:**

(1) where an SI attaches to a monetary obligation an SI attaches automatically to any supporting obligation for the collateral;

(2) perfection of an SI in the collateral also perfects an SI in the supporting obligation.

PARTIAL AND TOTAL EXCLUSIONS FROM THE OVERALL SCHEME

3.58 The draft regulations exclude some interests from the application of the scheme, even though they would, or might arguably, fall within the wide definition of SI. All the overseas schemes have a similar list of excluded interests.[69]

3.59 Some of these exclusions, for example, of interests over land, are total. Others are partial, in that the scheme applies only to the extent that it gives priority to such interests over conflicting SIs that are wholly within the scheme.

3.60 The complete exclusions are made for a number of reasons. Some are excluded for the avoidance of doubt even though, for example, we think there is no question of a proprietary interest arising; another group because they do not

[64] See below, paras 3.201-3.203.

[65] Compare UCC Section 9-322(b)(2).

[66] Compare UCC Section 9-322(c)(1). (We have not thought it necessary to replicate UCC Section 9-310(b)(1), which provides that it is not necessary to perfect by filing an SI that has been automatically perfected in a supporting obligation under Section 9-308(d). That seems self-evident.)

[67] See below, paras 4.133-4.150.

[68] See below, paras 4.141-4.150.

[69] Ours is shorter because the scheme applies only to SIs created by companies. Thus we do not need to consider whether to exclude assignments of wages, for example.

really have a 'financing purpose'; and the last group because SIs over the type of asset, or at least some SIs over them, are registrable in a specialist registry.

3.61 The interests that are partially excluded comprise:

(1) Interests arising through operation of law, such as liens. A common feature of all the overseas schemes we have looked at is that they apply to consensually-created SIs. We suggested having this exclusion in the CP.[70] Consultees who addressed the question were unanimous that security created by operation of law should be excluded.[71]) An issue that this exclusion does not settle is whether a special purpose trust - a *Quistclose* trust - is a consensual SI. We provisionally suggested in the CP that special purpose trusts should be 'outside the requirement to register', either because no security arises, or alternatively because any security arises through operation of law.[72] A clear majority of those who addressed the question agreed with our provisional proposal, although there was disagreement amongst consultees as to the nature of a special purpose trust. This issue has been the subject of debate,[73] and on further reflection we do not think our draft regulations should seek to determine the issue one way or the other. It should be left to the courts to determine the issue if and when it should arise in litigation. As the 'secured party' will in any event be able to preserve its position by filing a financing statement 'just in case' it is held to be a consensual SI,[74] we do not think our position on this will cause significant problems.

(2) Rights of set-off. In the CP we proposed to exclude these because they do not purport to create proprietary rights.[75] Almost all those who responded on the point agreed.[76] The concept of set-off is referred to in relation to bank accounts.[77]

3.62 Interests that are wholly excluded because the transactions do not have a 'financing purpose' are:

[70] CP para 4.18.

[71] The draft regulations contain a priority rule giving liens that arise in the ordinary course of business for the supply of materials or services priority over a competing SI under our scheme: see below, para 3.249.

[72] CP para 7.54.

[73] See, eg, M Bridge, "The Quistclose Trust in a World of Secured Transactions" (1992) 12 OJLS 333, 345-346, and J Ziegel and D Denomme, *The Ontario Personal Property Security Act Commentary and Analysis* (2nd ed 2000) para 2.2.6.2 (pp 70-71).

[74] DR 46(3) provides for a 'precautionary' filing to be made, even if there is, in fact, no SI involved.

[75] CP paras 7.51-7.52.

[76] Our draft regulations on this point does not include the additional wording found in the NZPPSA also excluding 'netting' and 'combination of accounts' although we would welcome views on whether consultees think it necessary to have express exclusion of these practices: compare NZPPSA, s 23(c), and see DR 12(1)(b).

[77] See below, para 4.130.

(1) Interests created or provided for by the transfer of an unearned right to payment under a contract to a person who is to perform the transferor's obligations.[78] A further reason for this exclusion is that there is no risk of misleading third parties that the transferor retains rights under the contract.[79]

(2) The assignment of accounts or promissory notes solely to facilitate collection on behalf of the person making the assignment.

(3) The assignment of a single account or promissory note to an assignee in full or partial satisfaction of a pre-existing indebtedness.[80]

(4) The sale of accounts or promissory notes as part of the sale of a business.

3.63 Interests that are excluded because there is a specialist register are:

(1) The creation or transfer of any interests in land, including a lease.[81] However, it is important to note that transfers of rights to payment arising in connection with an interest in land are not excluded, so that where, for example, the debt secured by a mortgage over land is factored by the land mortgagee, an SI would exist over that receivable which would fall within our scheme.[82]

(2) Interests in ships, where the ship has been registered in the UK or abroad.[83]

(3) Interests in aircraft, where the aircraft has been registered in the UK or abroad.

(4) Interests in intellectual property, where the intellectual property has been registered in the UK or abroad.

[78] See DR 12(1)(c).

[79] See UCC Section 9-109(d)(6) (and Official Comment 12); SPPSA, s 4(d), OPPSA, s 4(1)(i) (also J Ziegel and D Denomme, *The Ontario Personal Property Security Act Commentary and Analysis* (2nd ed 2000) para 4.10 (p 87)) ,and NZPPSA, s 23(e)(iii) (also M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 23.7 (p 111)).

[80] Although such single assignments relating to pre-existing debt are excluded from the scheme, we return later in this Part to whether isolated or occasional assignments of accounts should be 'automatically' perfected so that there is no need to file: see below, paras 3.97-3.98.

[81] This is discussed in Part 2, paras 2.49-2.50. This express exclusion is for the avoidance of doubt: the definition of 'collateral', which is used in the draft regulations is in any event limited to personal property.

[82] See below, paras 3.310-3.312.

[83] The reason for this exclusion, and that of registered aircraft and intellectual property, is explained in detail below, see paras 3.289-3.342. In the case of ships and intellectual property, these exclusions are qualified by a requirement that it should be possible to register a mortgage in the same register as the substantive registration of the asset.

3.64 Lastly, there will be an exclusion for interests arising from the three categories of trust deed that underwriting corporate members of Lloyd's are required to enter in support of their underwriting business. In the CP we provisionally proposed that these should be exempted from the need to file because no potential creditor of the member would think that the member owned the assets outright.[84] The majority of those who responded to this question agreed. We provisionally recommend that these trust deeds should be excluded from the scheme as a whole. We have not finalised the drafting of this exclusion in the draft regulations.

3.65 There are several exclusions found in the PPSAs which we have not sought to follow.[85] Thus SIs over interests in insurance policies are included in our scheme: there was considerable support amongst consultees for our provisional proposal to this effect in the CP.[86] Similarly we have not followed the PPSAs in excluding SIs over a right to damages in tort. We understand that in some situations these can be a significant asset, and there seems no real reason to exclude them. They are included in the UCC (although we have not sought to include any of the further specific rules that the UCC has in this respect[87]).[88]

3.66 **We ask consultees whether there are there other interests that should be wholly or partially excluded from the application of the draft regulations.**

3.67 **We provisionally recommend that the interests listed in DR 12 should be excluded from the scheme. We provisionally recommend that SIs over insurance policies and tort claims should be within the scheme.**

EFFECTIVENESS OF A SECURITY AGREEMENT, ATTACHMENT AND PERFECTION

3.68 Under current law an agreement for an SI such as a charge may have various effects according to what has been agreed and the circumstances.

(1) There may simply be an agreement that a security will be granted in favour of the creditor at some future date. This will give the creditor no more than a personal right against the debtor.

(2) There may be an agreement for a 'present' SI to cover property that the debtor acquires in the future. Obviously this cannot give the creditor the right to any piece of property until the debtor has acquired it; but it is

[84] See CP paras 5.78-5.86 and 12.70.

[85] In the case of interests relating to wages and salary for labour or personal services (SPPSA, s 4(c)) and assignments for the benefit of creditors (SPPSA, s 4(j)) this has been on the basis that such exclusions are not applicable for a scheme that - unlike the PPSAs - is limited to companies.

[86] CP para 5.39.

[87] One requirement relates to the contents of the security agreement, which we do not have rules about, and another provides that no SI attaches under an after-acquired property clause in a tort claim (UCC Section 9-204(b)). There are then several instances where certain provisions are disapplied. We do not think it necessary to follow this approach.

[88] The UCC refers to 'commercial tort' claims, although in the context of companies this means any tort claim: UCC Sections 9-109(d)(12) and 9-102(a)(13)(A).

more than a merely contractual right. Thus in *Re Lind*[89] the debtor granted the creditor a mortgage over his expectant share in his mother's estate. The debtor then became bankrupt and was discharged. The discharge had the effect of releasing him from existing contractual obligations. Later he acquired the share. The Court of Appeal held that the mortgagee was entitled to the property; its rights were not affected by the discharge in bankruptcy.

(3) Where the debtor has the relevant collateral at the time of the security agreement, or has subsequently acquired it, and the creditor has given value, the creditor may have a right, as against the debtor and some third parties such as judgment creditors, to satisfy its claim from the collateral. This depends on whether the charge has attached to the collateral. A fixed charge will attach when the conditions just stated are satisfied; a floating charge will attach only when the charge crystallises, for example on the appointment of a receiver.

(4) However, where the debtor is a company, the creditor's rights may be invalidated as against a liquidator or adminstrator if the creditor has not 'perfected' the charge by registering it within the statutory period. Equally a charge that has not been duly registered will be ineffective against another creditor claiming the same piece of collateral. However, the first creditor's rights over the collateral are only ineffective to the extent provided by legislation. If the debtor defaults and the creditor enforces its rights without the debtor becoming insolvent or a second creditor acquiring enforceable rights to the same collateral, the creditor's actions are perfectly proper since it had an otherwise valid interest.

(5) Even a charge that has attached and that was properly perfected may of course not have priority.

3.69 As we explained in Part 2, the introduction of a notice-filing scheme would change these rules to some extent. Thus the distinction between a fixed charge and a floating charge would for practical purposes disappear, and the rules of priority would be altered. In other respects, however, the scheme would replicate the current position. In particular, a security agreement would be effective to give the secured party not just a contractual right against the debtor but rights that can be enforced against third parties, except to the extent that the scheme provides otherwise – for example, because the SI has not attached to the collateral or has not been perfected.

Effectiveness of security agreement

3.70 DR 14(1) states explicitly that a security agreement is effective according to its terms as between the parties, against purchasers of the collateral and other creditors and as against an administrator or liquidator, except as the draft regulations provide.

[89] *Re Lind, Industrials Finance Syndicate Ltd v Lind* [1915] 2 Ch 345.

Attachment of SIs

3.71 For the secured party to have a right to any particular piece of collateral, it is necessary for the SI to 'attach'. We have explained that though this concept is used by some lawyers in England and Wales, consultation revealed that it was not a familiar concept. We provisionally recommend that it (and perfection) should be defined in the draft regulations.[90]

3.72 Attachment is the point at which the secured party acquires a proprietary right in the collateral, and is a necessary step for perfection to occur. For clarity, the provision dealing with attachment is drafted so that three conditions have to be fulfilled; they can occur in any order.[91] The first condition is that there has to be a security agreement that either of itself, or as the result of subsequent appropriation under it, sufficiently identifies the collateral. For example, if the agreement specifies no more than that the debtor will give an SI over equipment to be specified, and later the parties agree on specific items, or some items are delivered into the secured party's possession, the SI would attach to the items concerned.[92] The second condition is that value is given, and the third is that the debtor has rights in the collateral or the power to transfer rights to a secured party.[93] (Special rules relating to financial collateral are dealt with in Part 4.)

3.73 We have noted in Part 2 that under our scheme an SI may attach despite the fact that the debtor is given licence to dispose of the collateral free of the SI. This effects a change to what is currently the 'floating' charge.[94]

3.74 It is perfectly possible under our scheme for the parties to agree that attachment will occur at a later time, for example, only in the conditions under which a floating charge would crystallise under current law. It is not clear, however, that it would be in either party's interest to do so. For the avoidance of doubt the draft regulation makes it clear that simply referring to a 'floating charge' in the security agreement does not amount to an agreement to defer the time of attachment.

Should the security agreement have to be in writing?

3.75 There is one significant difference between our provisional recommendations and the UCC and PPSA schemes. Those schemes require that before an SI can attach, either the debtor must have signed a written security agreement[95] or the secured party must take possession of the collateral.[96] In other words, an

[90] See above, para 2.13.

[91] DR 15(1).

[92] Where the collateral is investment property or bank accounts, there would be sufficient appropriation if the secured party has 'control': see Part 4.

[93] DR 15(7) makes clear that a debtor has rights in goods that are leased (and – unlike the PPSAs – let on hire-purchase) or consigned, or sold under a conditional sale no later than when it obtains possession of the goods.

[94] See above, paras 2.56-2.60.

[95] UCC Section 9-203 requires 'an authenticated security agreement', which is designed to include digital signatures and the like: see Section 9-102(a)(7).

[96] Or in the case of financial collateral, if the secured party has 'control': see Part 4.

agreement is effective as a contract, and as an inchoate property right,[97] between the parties whatever form it takes, but it will not give the secured party any right to a particular item of collateral unless the conditions just stated are met, along with the other requirements for attachment.[98] We do not see the need to require that the security agreement be in writing.

3.76 Present law does not require writing for every kind of non-possessory security agreement. In the CP we provisionally proposed that a written security agreement signed by the debtor[99] should be necessary for any non-possessory SI.[100] There was unanimous support for this from those who commented. Further consideration, however, has led us to doubt our original proposal. It seems to us that it would be very difficult to define what must be in the writing, while the requirement of writing would be of very little value to any of the parties.

3.77 If a signed writing were to be required, we do not think it would be necessary that all the terms of the security agreement be included in it.[101] It should however show that the parties have made 'a security agreement.' This is defined by the PPSAs as a writing which is or which evidences an agreement that creates or provides for an SI, either immediately or at some future date.[102] It should also give some indication of the collateral. In the CP we proposed that the writing should give a sufficient description of the property so that it can be determined what assets fall within it.[103] Consultees agreed, one questioning whether it is necessary to state something so obvious. Further study and reflection makes us think that actually the point is not so obvious, and has led us to question the need for any writing at all.

3.78 The Saskatchewan and New Zealand PPSAs differ in their requirements on this point, but have this in common: neither requires precise identification of the collateral. Commentators say:

> The … description requirement is intended only to provide evidence consistent with a claim that a security interest has been taken in

[97] See *Re Lind*, above, para 3.68(2).

[98] NZPPSA, s 36(2) states that a security agreement may be enforceable against a third party in respect of particular collateral even though it is not enforceable against a third party in respect of other collateral to which the security agreement relates.

[99] 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 is to be required, we do not see the need to require greater formality, eg, a digital signature.

[100] CP para 12.121.

[101] If and when the scheme is extended to unincorporated businesses it will have to be decided whether to keep the requirements imposed under the Consumer Credit Act 1974.

[102] SPPSA, s 2(1)(pp); NZPPSA, s 16(1). The definition in our draft regulations is simply 'an agreement which creates or provides for a security interest'.

[103] CP para 12.122.

particular collateral. Extrinsic evidence may be necessary to identify individual items of collateral.[104]

3.79 We can see the argument that an SI should not fail when it is quite clear that it was agreed and what it covered, but the written description of the collateral was only in general terms. However it is hard to see what useful purpose is served by this attenuated writing requirement. The secured party will have to prove that there was a security agreement that covered the particular item of collateral that it claims. If it can do that by using parol evidence, why should it matter that there is no writing signed by the debtor, when the debtor will be personally liable in any event, and when third parties will not be relying on the existence of a writing that in practice they will never see? In practice the secured party will file a financing statement or take possession or control; the fact that it has done one of those things and that the debtor has not objected seems to provide evidence of the existence of a security agreement of some kind. To require in addition a signed writing that does not have to identify the collateral precisely adds very little. It is just as likely that the formal requirement might – like so many formal requirements – work to defeat meritorious claims. We think that it is better not to include any formal requirement for security agreements created by companies but, when we consider the extension of the scheme to other debtors, to reconsider whether we need formal requirements that will protect the debtor from personal liability as well as affecting the position of third parties.

3.80 The Law of Property Act 1925, section 53(1)(c) does require a signed writing for the disposition of an equitable interest. As we will see in Part 4, this has already been disapplied in financial collateral arrangements, though 'writing' is required. We see no reason to retain section 53(1)(c) for SIs over other forms of property. That would merely perpetuate a distinction between legal and equitable interests when one of the aims of our scheme is to reduce the differences. This will not affect requirements for writing made by other legislative provisions, such as for the assignment or mortgage of certain sorts of intellectual property (where it comes within the scheme).[105]

3.81 **We provisionally recommend that for a non-possessory SI to attach there should be no requirement that a security agreement should be, or be evidenced, in writing (whether signed or not), and that the Law of Property Act 1925, section 53(1)(c) should, so far as it would otherwise apply, cease to apply to SIs under our scheme**.[106]

3.82 The draft regulations have also not replicated the provision in the SPPSA that obliges the secured party, where a security agreement is in writing, to deliver a copy of it to the debtor within 10 days after its execution. The NZPPSA does not have any such requirement though there is an equivalent one under the Credit Contracts Act 1981. In England and Wales there are requirements for

[104] M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 36.6 (pp 145-148).

[105] See, eg, the Copyright, Designs and Patents Act 1988, s 90(3).

[106] See DR 14(3).

agreements regulated by the Consumer Credit Act 1974; we see no need for further provisions.

Returned and repossessed goods: reattachment

3.83 As we will explain later, there are circumstances where a buyer or lessee of goods will take free of an SI in the goods.[107] However, it may sometimes happen that the goods subsequently come back into the hands of the seller or lessor, for example, if they are returned because they are faulty, or if they were sold subject to a further SI and were repossessed on the buyer's default. There seems no good reason why the original SI should not then reattach to the goods. The PPSAs contain a provision that where goods have been sold or leased in circumstances in which the buyer or lessee takes free of the SI, and they have been returned to, seized or repossessed by the debtor, the SI will reattach to the goods if the obligation remains unpaid or unperformed.[108] For the purposes of consultation, we have included a similar provision.[109]

3.84 However, we understand that a similar provision to that contained in the PPSAs was originally included in former Article 9 of the UCC, but no longer forms a specific section of Revised Article 9.[110] We are told that this was because the circumstances that gave rise to the operation of the section arose infrequently, and that the parties were usually able to resolve matters satisfactorily, without the need for legislative intervention.[111] We would therefore welcome the view of consultees as to whether we should continue to include such a provision.

3.85 **We ask whether the scheme should contain a provision dealing with the reattachment of an SI to goods which have been returned or repossessed.**

Perfection of SIs

3.86 An SI will be perfected when it has attached and all the steps (if any[112]) required for perfection by one of the methods allowed for in the draft regulations have been taken.[113] It could be said that perfection means completing the steps to secure, so far as legally permissible and necessary, the effectiveness and priority of an SI as against third persons. However, it is important to note the *caveat* contained in that last sentence: 'so far as legally permissible'. Whilst perfecting an SI is necessary to take advantage of most of the rules of priority as against other SIs, perfection does not guarantee that an SI has priority over all other

[107] See below, paras 3.253-3.262.

[108] Eg, SPPSA, s 29.

[109] DR 30.

[110] Former Article 9, Section 9-306(5).

[111] However, Official Comment 9 to UCC Section 9-330 of Revised Article 9 contemplates that returned or repossessed goods may constitute proceeds of chattel paper. We have not included the concept of chattel paper in our scheme, see above, para 3.25.

[112] In a limited number of cases, no steps are required. Perfection is then said to be 'automatic' when the SI attaches. See further below, paras 3.89 and 3.96-3.98.

[113] DR 19. Attachment and the taking of the steps to secure perfection can occur in any order.

competing SIs: the draft regulations contain a series of priority rules which determine this issue, and in some cases a perfected SI may still 'lose' to a subsequent perfected SI (for example, a subsequent PMSI generally has priority over an earlier non-PMSI) or to a buyer.[114]

3.87 Some commentators have remarked that in the overseas systems the word 'perfection' is used in two senses: (1) the steps that need to be taken in order to perfect an SI (for example, making a registration/filing, taking possession etc.) and (2) the status that is thereby achieved ('a perfected SI').[115] This is correct, but the double sense does not appear to have caused practical difficulty in any of the systems. We have therefore - at least for this consultation - retained this familiar terminology in our draft regulations.

3.88 The draft regulations provide several ways in which an SI may be perfected. We have listed these in a single draft regulation,[116] although each method has its own detailed individual provisions. The most significant methods of perfecting an attached SI are by taking the following steps:

(1) filing, or

(2) possession, or

(3) for financial collateral only, delivery or control.

3.89 There are a few cases in which an SI is treated as being perfected as soon as it attaches; in other words the secured party need take no further steps to perfect.[117] This is sometimes referred to as 'automatic' perfection. Examples are the sale of a promissory note and SIs in supporting obligations.[118] The only others relate to financial collateral.[119] There are also special rules for goods in the possession of a bailee.[120]

3.90 In certain situations an SI that has been perfected may continue to be treated as perfected for a short 'grace period' after the perfection has ceased, provided that the SI is re-perfected or perfected by another method within that period. An example is where a documentary intangible is released from the secured party's possession and handed to the debtor for certain limited purposes.[121] This is referred to as 'temporary perfection'.

[114] See below, paras 3.208 and 3.260.

[115] See, eg, J Ziegel and D Denomme, *The Ontario Personal Property Security Act Commentary and Analysis* (2nd ed 2000) para 19.1 (pp 158-159).

[116] DR 23.

[117] See below, paras 3.96-3.98.

[118] See above, paras 3.46 and 3.54.

[119] See below, paras 4.60 and 4.84.

[120] See below, paras 3.103-3.104.

[121] See below, paras 3.108-3.112.

3.91 It is possible that an SI may be perfected initially by one method and subsequently by another – for example, a secured party might take possession of collateral and later file and hand the collateral back to the debtor. For priority purposes, provided that the SI has not been unperfected at any time, the SI is regarded as having been 'continuously' perfected, so that priority dates back to the start of the first form of perfection.[122] There are additional provisions with regards to proceeds, which we will deal with below.[123]

METHODS OF PERFECTION IN DETAIL

3.92 In this section we go through the steps that can be taken to perfect an SI over collateral in general: in particular, possession and filing. (We refer to 'filing' rather than 'registration' to signal a clear break from the transaction registration approach currently used in relation to company charges. Some of the overseas schemes refer to one, some the other.) The forms of perfection applicable only to financial collateral are dealt with in Part 4.

3.93 It should be borne in mind that an SI achieves the status of a 'perfected SI' only when it has both attached and the steps necessary to perfect it in one of the ways detailed below have been taken.[124] However attachment can occur before or after the steps below have been taken. This is an important point insofar as the priority system is concerned, as we shall explain later in this Part.[125]

Perfection by filing

3.94 Following our general recommendations in Part 2, **we provisionally recommend that the filing of a financing statement should be capable of perfecting an SI that has attached (whether before or after filing) over any type of collateral**.[126] We discuss the filing process in detail later in this Part, after we have explained the other methods of perfection.[127]

Temporary perfection

3.95 The draft regulations contain several provisions under which an SI, having been perfected, will remain perfected for a short period of time despite the occurrence of events that would otherwise result in it becoming unperfected (or for which there is a short period of 'grace'). At the end of that period of time the SI will indeed become unperfected unless it has been perfected in the meantime. This is usually referred to as 'temporary' perfection (although some of the overseas

[122] DR 33(2)-(3).

[123] See below, paras 3.182-3.187.

[124] Or where perfection occurs 'automatically' on attachment: see below, para 3.96.

[125] See below, para 3.202.

[126] Providing the interest has not been excluded by the scheme (eg, the creation or transfer of an interest in land, see below, para 3.309). However, compare the UCC, which does not permit filing as a perfection method for some forms of collateral, eg, 'deposit accounts' as original collateral: UCC Section 9-312((b)(1).

[127] See below, paras 3.113-3.181.

schemes are not consistent in their usage of this term[128]). One of the main examples is in relation to goods that have been in the possession of the secured party, but which are returned to the debtor for sale or preparation for sale.[129] Others instances of temporary perfection involve proceeds, PMSIs in collateral other than inventory, and goods being brought into the country.[130] We discuss each instance later in this Part.

Automatic perfection

3.96 In a limited number of cases in the draft regulations an SI is perfected without any particular step such as possession or filing having to be taken. Apart from sales of promissory notes and SIs over supporting obligations, which we discussed earlier,[131] the other instances of automatic perfection relate to financial collateral, and we discuss these in Part 4.[132]

3.97 There is one instance of automatic perfection which is found in the UCC but on which we have not for the present included in our draft regulations. The UCC provides that an assignment of accounts '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…' is perfected when it attaches (in other words, is automatically perfected).[133] 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'.[134] The assignment will have priority over assignments that are filed later, but be subject to any that have been filed already. Although such a provision should not be relied on as a reason not to file, it may serve a useful purpose in preventing inadvertent non-perfection, and we would welcome the views of consultees as to whether our draft regulations should contain an equivalent provision.

3.98 **Should the scheme provide that an assignment 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 will be automatically perfected on attachment?**

Perfection by possession and goods in possession of bailees

3.99 In the CP we provisionally proposed that possessory securities should be left 'out of the scope of the notice-filing system', in the sense that filing would not be

[128] The SPPSA, for example, refers to an SI being 'temporarily' perfected in some places, and 'remains' perfected for a period in others, and 'continues' perfected in others.

[129] See below, paras 3.108-3.112.

[130] See DRs 13(5) (goods brought into the country), 29 (proceeds), and 42(2) (PMSI in non-inventory collateral).

[131] See above, paras3.46-3.47 and 3.51-3.57.

[132] See below, paras 4.60 and 4.84.

[133] UCC Section 9-309(2).

[134] Official Comment 4, which goes on to note that any person regularly taking assignments of any debtor's accounts should file.

needed, save where the creditor's possession was constructive and resulted from the debtor attorning to the creditor.[135] It was proposed that the scheme should deal with the relative priority of possessory and non-possessory SIs.

3.100 The vast majority of consultees who responded on this point agreed that registration should not be required for possessory securities. Those who disagreed argued that requiring filing would make the register more complete, and that creditors might lend on the basis of the known existence of the asset in question without checking that it was in the debtor's possession. We do not think that taking such a risk would be reasonable and we therefore recommend that possessory SIs should not be registrable; or, to put it in the terms used in the other schemes, possession should be an alternative method of perfection to filing. **We provisionally recommend that actual possession of collateral by the secured party (or its agent) should perfect an SI in goods, an instrument, a negotiable document of title or money.**[136]

3.101 The draft regulations do not provide a definition of 'possession', but there are specific provisions dealing with certain forms of what might be said to constitute constructive possession.

Possession by a debtor who has attorned to secured party

3.102 In the CP we pointed out that where the collateral is in the possession of the debtor or debtor's agent, an attornment by the debtor will not suffice to perfect the SI: at least if it is in writing, it will require registration under the Companies Act 1985, section 396(1).[137] We provisionally proposed that such attornments should have to be registrable under the notice-filing scheme. Consultees agreed. **We provisionally recommend that where the goods are in the possession of the debtor or its agent, attornment to the secured party will not amount to possession by the secured party.**[138]

Possession of goods by bailees

3.103 We also provisionally proposed in the CP that where the goods are in the possession of a third party who attorns to the secured party, that should be treated as possession by the secured party. There was no dissent from this but on further reflection we think it is better to provide separately for such cases, so that, for the purposes of perfection, goods that are in the possession of a bailee are not regarded as being in the possession of the secured party.[139]

[135] CP para 4.17. We envisaged that pledges would be affected by the priority provisions: CP para 4.145.

[136] DR 24. SIs in investment property that could be 'possessed' are dealt with in detail in Part 4.

[137] CP para 4.15.

[138] See DR 24(2).

[139] This fits with DR 17 (Preservation and use of collateral), which imposes certain duties of preservation etc. on a party who has possession. We think that any such duty should be imposed on the bailee (eg, a warehouse owner) rather than on the secured party. See further below, para 5.41.

3.104 **We provisionally recommend that, where the goods are in the possession of a bailee other than the debtor, the SI may be perfected in three ways:**

(1) by the bailee attorning to the secured party;

(2) by the bailee issuing a document of title in the name of the secured party; or

(3) by the secured party perfecting an SI in a negotiable document of title to the goods, where the bailee has issued one.[140]

3.105 An SI can also be perfected by filing a financing statement, in accordance with the relevant rules.

Seized or repossessed goods

3.106 The PPSA schemes exclude from 'perfection by possession' the situation where the secured party comes into possession of the collateral as a result of seizure or repossession, typically after the debtor's default.[141] The reason is to avoid a creditor who cannot produce a signed security agreement from seizing and repossessing the collateral and arguing that the 'possession' it obtained as a result is sufficient to fulfil the requirements of those schemes for attachment (that is, possession or a signed writing[142]). We do not have such a requirement for attachment and, if the SI has attached, we see no reason to say that a secured party who failed to file but who has subsequently seized or repossessed the collateral has not thereby perfected its interest. Its SI would be subordinate to any other that had been perfected before it perfected.[143]

3.107 **We provisionally recommend that a secured party who has not perfected its SI by filing but who has seized or repossessed the goods should not be excluded from having possession of them for the purposes of perfection.**

Trust receipts and temporary perfection

3.108 A pledgee of goods or documents of title may release them to the pledgor (the debtor) for a limited purpose, such as for sale as agent of the creditor, without losing its proprietary rights over the goods; the debtor signs a trust receipt agreeing to hold the proceeds for the pledgee. This is currently regarded as a method of securing the continuance of the pledge rather than as an independent security device, and trust receipts are not registrable under the current company charges registration scheme.

3.109 The treatment of this situation under the comparable schemes is rather different. They normally contain a specific rule that applies where there is an SI over an

[140] Perfecting the SI in this way will give the secured party priority over an SI in the goods perfected otherwise after the goods become covered by the negotiable document of title.

[141] See SPPSA, s 24(1); NZPPSA, s 41(b)(ii).

[142] See above, para 3.75.

[143] See below, para 3.201.

instrument that was perfected by possession, or over goods that were in the possession of a bailee who issued a negotiable document of title or attorned to the secured party. If the collateral is then returned to the debtor for specified purposes, the SI remains perfected for a limited period of time (for example, 15 days) but thereafter will become unperfected unless steps are taken to perfect it before the end of that period. (In practice, this will mean filing a financing statement, which can be done before the goods are returned.) As we have noted, the effect of temporary perfection is that the SI will maintain its priority against other SIs over the same collateral and will be effective in the event of the debtor's insolvency.[144] Buyers of the goods or transferees of the document of title will take free of the temporarily perfected SI unless they actually know of it.[145]

3.110 In the CP we asked whether we should adopt a similar rule.[146] The question was not as well phrased as it could have been; the majority were opposed to the suggestion but for divergent reasons, some thinking that the idea was right but the period too short, others that filing should be required immediately. (None appeared to think that filing should not be required however long the collateral remained in the debtor's hands.) Some consultees[147] argued that the idea was sound but that it would be unduly burdensome to require filing in a shorter period than the normal trade cycle of 90 days. However, as far as priority over competing SIs is concerned, we think 90 days is too long a period. True, it is unlikely that unsecured creditors (who are the ones affected by the effectiveness of the SI in insolvency) will change their position in reliance on the debtor's apparent possession of the goods in less than 90 days, but we are concerned that other secured parties might lend on the apparent security of the goods. Given that the secured party to protect itself only needs to file, which will be simple and cost little in time and money,[148] we suggest that the SI should remain temporarily perfected for a period of 15 business days. The draft regulations provide accordingly.[149]

3.111 This provision applies to instruments and certificated securities, negotiable documents of title, or goods held by a bailee that are not covered by a negotiable document of title, that are made available to the debtor to enable the debtor to sell or exchange them or, in the case of instruments or certificated securities, for enforcement and registration.[150]

3.112 **We provisionally recommend that where an SI over instruments or certificated securities has been perfected by possession, or one over goods in the possession of a bailee has been perfected by the bailee**

[144] See above, para 3.95.

[145] DR 31(6). See also below, para 3.236.

[146] CP para 4.17.

[147] Including the Law Society's Company Law Committee and the Bar Council Law Reform Committee (joint response) and the British Bankers' Association.

[148] See generally below, paras 3.113-3.117.

[149] DR 28(4).

[150] DR 28(1) and (3).

issuing a negotiable document of title or otherwise, if the collateral or document of title is returned for specified purposes, the SI should remain perfected for a limited time thereafter. We ask whether 15 business days is an appropriate period.

Filing

3.113 Perfection by filing is likely to be the most common form of perfecting an SI over collateral other than financial collateral.[151] As we noted in Part 2, we think it necessary that the filing system should operate on a wholly electronic basis (although this does not appear as a requirement in the draft regulations). In brief, a filing will be made through the submission of an on-screen 'financing statement', which will contain the name and the registered number (if any) of the debtor; the name and address of the secured party or its agent; brief details of the collateral (including, where appropriate, the unique serial number of the goods if the secured party so wishes); the duration of the filing (which may be fixed or unlimited); and any other matter prescribed by the Rules to be made by the Registrar. These features are broadly in line with the provisional proposals in the CP.[152]

3.114 There was almost unanimous support for the introduction of wholly electronic filing.[153] There was broad agreement also on the content of the financing statement; particular suggestions will be noted as we deal with each item below.[154]

3.115 It should be noted that the draft regulations set out the framework for the filing system, but do not set out every detail. We think that many of the details would be more appropriate for the Rules to be made by the Registrar under the power given in the enabling clauses under any Companies Bill. The Rules are likely to reflect the sort of detail 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. However, we anticipate the system operating very much along the lines of the wholly electronic register introduced under the NZPPSA. Contact between Companies House (or whoever is to run the registry) and some of the existing overseas registries that have an electronic capability would no doubt be a sensible step.[155]

3.116 It may help to give a brief description of the filing process for those filing via the internet (large volume users would have a slightly different system that we outline below), under the draft regulations and the Rules that we anticipate being made:

[151] On this see Part 4.

[152] CP paras 12.5-12.7.

[153] The one explicit dissenter was concerned at the risk of computer failure, and opposed notice-filing entirely.

[154] We have already dealt with the suggestion that the charge document be registered: above, para 2.45.

[155] Other systems also allow for electronic filing, but have a 'paper' system as an alternative.

(1) Someone wishing to file a financing statement (in practice, the secured party) 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). The user would then be given an identification number and password that 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 register a financing statement, the user would enter data onto a series of 'screens'. Once the information has been transmitted and received by the system, a financing statement registration number would be generated by the system, as would a 'debtor personal identification number' (PIN). These numbers would appear on the 'verification statement', which would be sent automatically to the secured party, and a copy of which would be sent by the secured party to the debtor.[156]

(3) In addition to these two numbers, a 'financing statement PIN' would also be generated. This would be sent to the secured party separately; it should be kept private by the secured party. The financing statement PIN would be used to access the system to make changes to the financing statement.[157]

3.117 For regular users who may wish to file large numbers of financing statements, such as finance houses or firms that regularly supply goods subject to a retention of title clause, we anticipate that Companies House would develop a system akin to the New Zealand Government's G2B[158] 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 finance house has entered details of a finance lease and the lessee 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.

Financing Statement

3.118 A financing statement is defined in the draft regulations as meaning the data which is transmitted to the Registry in accordance with the Rules to effect a filing.[159] The draft regulations set out the minimum information that the financing statement is to include, and provide that the Registrar may prescribe further information that must be supplied.

DEBTOR'S NAME AND REGISTRATION NUMBER

3.119 The financing statement has to contain the name of the debtor and, where it has one, its Companies House registration number. The name and the number will

[156] See below, paras 3.147-3.150.

[157] See below, para 3.155.

[158] 'Government to Business'.

[159] DR 2(1). The term also includes a 'financing change statement' where the context allows.

both be searchable fields. From discussions we have had with Companies House, we understand 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, and that a warning could be given, or the system could reply that it will not accept the filing, if the name and number did not match. This should go some considerable way to reducing the risk of making a mistake in recording the details of the debtor.

3.120 We will see below that, as drafted, the scheme will apply to SIs created by companies incorporated outside England and Wales where the SI is over assets here (or to which English law applies).[160] Thus there will be instances where a debtor, within the meaning of the draft regulations, will not have a Companies House registration number. In such a case automatic checking of a name/number match will not be possible. This has implications for the search tools that should be made available.[161]

3.121 In the CP we provisionally proposed that where the debtor is acting as a trustee, this should be recorded, and our provisional proposal to this effect[162] was supported by a very high proportion of those who responded to this question. Many thought that where the trustee was a bare trustee, the beneficiary should also be identified. We can see the value in this suggestion but hesitate to require it because the more information that is required the greater the scope for errors that might accidentally render ineffective the entire filing.[163] **We would welcome views on whether the financing statement should record that the debtor is a trustee and, if so, whether the beneficiary of a bare trust should also be identified**.

NAME AND ADDRESS OF THE SECURED PARTY

3.122 Although a few consultees thought it was unnecessary to include details of the secured party, the majority thought that the name and address of the secured party, and of its agent, if any, should be required in the financing statement. Even though these are not searchable fields, it was thought to be essential that enquirers should know who the secured party is in order to know whom to approach for further information.[164] Moreover, in order to obtain PMSI status over inventory there is an obligation to notify other secured parties who have filed a financing statement over the same collateral, so these details are needed for this purpose.[165] Thus the draft regulations provide that the financing statement should contain this information. However, if the secured party has appointed an agent to deal with the SI, it will be the agent to whom enquiries need to be directed and

[160] See below, paras 3.364-3.383.

[161] See below, paras 3.171-3.174.

[162] CP paras 12.67-12.68.

[163] See further below, paras 3.163-3.168.

[164] Third parties will have no *right* to obtain information from the secured party; only the debtor may insist on that, see para 3.192 below. However in practice secured parties are likely to be willing to give some information voluntarily, at least after obtaining the debtor's consent.

[165] See below, paras 3.213-3.214.

thus whose name is important. The draft regulations therefore require the name of the secured party *or* its agent. We understand that there is concern that lenders to companies conducting scientific research or business in what some consider to be 'controversial' areas may themselves be subject to intimidation. The ability of a lender or supplier to use an agent's name rather than its own might be considered useful in such circumstances.

3.123 The financing statement will not be ineffective if the information relating to the secured party is wrong or not up-to-date. That would be unnecessary given that the debtor can supply the information if need be. However, as we noted above, it is in the secured party's interest to ensure these details are accurate, as in some cases information has to be sent to the secured party using the details recorded.[166]

A DESCRIPTION OF THE COLLATERAL

3.124 The financing statement must also contain 'a description of the collateral'. A large majority of consultees agreed with the provisional proposal that the description should be 'brief'.[167] Two concerns were clearly expressed. On the one hand, the assets subject to the SI should be clearly identified in the financing statement, but, on the other, the description should also be as brief as possible to make filing quick and simple.

3.125 The draft regulations require the financing statement to contain 'a description' of the collateral. 'Description' is not defined further in the draft regulations;[168] it is something to be dealt with in more detail in the Rules. However, we recommend that the description should be brief, with a word limit on the amount of information that can be provided (to prevent what we understand to be the current practice of just 'cutting and pasting' large amounts of the charge document onto form 395). It would probably be sensible to provide 'tick-boxes' for common and easily identifiable categories.

'Sufficient' collateral descriptions

3.126 Revised Article 9 of the UCC attempts to give some guidance as to what will suffice by way of a collateral description. In other words, the description does not have to comply with what is set down in the UCC provision but, if it does, the validity of the filing cannot be challenged on the basis of inadequate description. This is termed a 'safe harbor' approach.[169] Article 9 provides that the description may be 'specific'; by 'category'; with a few exceptions, by any of the collateral types referred to in Article 9 (for example, 'goods, 'equipment' or 'inventory'); by any method 'if the identity of the collateral is objectively determinable'; or as 'all

[166] Such as the notice mentioned above that a person intends to take a PMSI in inventory that is subject to the secured party's SI.

[167] CP para 12.5(3).

[168] DR 47(7)(d).

[169] See Section 9-504, Official Comment 2.

assets' or 'all personal property'.[170] We doubt the value of such general guidance and have not replicated this provision in our scheme.

3.127 What we think is important to get across is that a financing statement will be effective to perfect the SI even if the collateral description is broader than the underlying security agreement. Thus a security agreement over photocopiers may be perfected by a filing that refers to 'office equipment' – though of course the filing will not give the secured party the right to any office equipment other than the photocopiers covered by the security agreement. As we shall see, the debtor will be able to require that the financing statement be changed to reflect the security agreement;[171] but the filing will be effective.

Collateral type as a searchable field

3.128 The New Zealand scheme requires the collateral to be put into one of a number of collateral types that are, in conjunction with the name, then made searchable fields. Consultees from New Zealand pointed out that this can very easily lead to errors that prevent the financing statement being discoverable.[172] If the collateral is mistakenly put into the wrong category (for example, were an SI over a farmer's livestock mistakenly entered not as 'goods-livestock' but as 'goods – other', these being two of the search categories in the New Zealand system) a search using the debtor's name and the correct collateral type would not reveal the SI. We do not recommend following this approach. We think that 'check boxes' may be useful as a way of entering the description of the collateral but the register should not be searchable by collateral type.

3.129 The draft regulations provide that where collateral is of the type that has a 'unique identifying number' (at this stage, principally motor vehicles), that number can be included on the financing statement and a search can be made by unique number. We deal with this in more detail below.[173]

DURATION OF THE FILING

3.130 The financing statement will also state the intended duration of the filing. On the issue of maximum duration, there is no common approach taken by all the overseas systems. The UCC provides generally for a period of validity of five years after date of filing, renewable by the filing of a continuation statement within six months before the expiration of the five-year period. On the expiration of the period, an SI becomes unperfected.[174] The NZPPSA also has a general five-year

[170] Section 9-504, referring to Section 9-108.

[171] See below, paras 3.157-3.160.

[172] Which will mean that the filing is ineffective; see below, para 3.163.

[173] Paras 3.176-3.181.

[174] UCC Section 9-515. There are longer periods for certain transactions: see Section 9-515 (b), (f) and (g).

validity period (unless a shorter time is specified).[175] The SPPSA provides that registration is effective for the period indicated on the financing statement.[176]

3.131 In the CP we argued that a fixed period would create too great a risk that creditors would lose by an inadvertent failure to register, and provisionally proposed that the filing be effective for the period indicated on the financing statement.[177] A large majority of consultees agreed that it should be possible to file for the SI to last indefinitely; most considered it appropriate to permit filings for a fixed duration as an alternative. We note that the Saskatchewan system seeks to prevent the register becoming cluttered with 'indefinite' filings that may become out of date by charging a significantly higher fee for such filings; the same system might be adopted here should this prove to be a problem.

3.132 Thus we provisionally recommend that a filing (unless discharged) should be effective either indefinitely or for such period as has been indicated on the financing statement.[178]

OTHER MATTERS

3.133 A small number of consultees argued that the amount secured, or the maximum amount, should have to be stated on the financing statement; and some that the financing statement should state whether or not an SI has actually been created. We have already explained our reasons for rejecting these suggestions.[179]

3.134 **We provisionally 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 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.

We ask consultees to identify any additional information that they consider should be provided or any information that should not be required.

3.135 We note at this stage that we have drawn up the draft regulations in such a way that it should be clear that, subject to one qualification, the Registrar should have no 'discretion' to decide whether or not to accept for filing a financing statement that contains information in the required fields. There is no requirement for the

[175] NZPPSA, s 153.

[176] SPPSA, s 44.

[177] CP para 4.86.

[178] DR 49.

[179] See above, para 2.47.

Registrar to check the information supplied as part of the filing, nor any power to reject a purported filing on the ground that it is not believed, for example, that the information is accurate. Accuracy or otherwise of the information supplied goes to the effectiveness of the filing to perfect the SI or determine its priority, rather than to whether the filing should be accepted by the system in the first place. (As we shall see, the Registrar will have power to correct or discharge an incorrect financing statement at the debtor's demand; that is a different issue.[180])

3.136 The one qualification is that we have included a provision that is intended to enable the removal of filings on the Registrar's own initiative where they are libellous, vexatious or similarly improper. We understand from the staff at Companies House that false or libellous statements contained in information sent to them is a real issue at present, and so we have sought to address it in the draft regulations.[181]

Who files?

3.137 There is no restriction on who may file. In practice we think it will invariably be the secured party who files: it is the secured party who will lose from the SI being unperfected. Unlike with the Companies Act 1985, there will no obligation on the debtor to send anything for registration, nor any criminal sanctions for not filing.[182] **We provisionally recommend that any person should be able to file a financing statement.**

Filing for future SIs

3.138 The notice-filing scheme is not transaction-based. In other words, it does not operate on the basis of a filing being made for each SI after it has come into existence. Although, as we explain below, the consent of the debtor is needed as part of the filing process, it will be possible for the actual or potential secured party to file before the security agreement is entered into, either for a single SI or for any number of future SIs between the same parties. Providing that the information contained on the financing statement – particularly the collateral description – is sufficient to cover the future SIs, there will be no need for a new filing whenever a new SI is created. This will be of benefit to secured parties such as suppliers who conduct regular business with the same customer under separate transactions: where goods are supplied on retention of title terms, for example, one filing at the beginning of the business relationship may be sufficient to cover all future supplies to the same customer.

3.139 We have noted that our proposal to permit advance filing provoked some debate; in particular many consultees were concerned that the register might become cluttered with unwanted filings. We have already explained our reasons for concluding that this is not a serious risk and for recommending that filing may be

[180] See below, paras 3.157-3.160.

[181] DR 48(6). However, more provisions may be necessary - possibly including criminal sanctions - relating to false filings if this proves to be a significant problem: see below, para 3.141.

[182] See further below, para 3.152.

made before or after the SI has been created.[183] **We provisionally recommend that it should be possible to file before or after a security agreement has been made.**

Consent of the debtor to filing

3.140 The draft regulations provide that a filing of a financing statement or a financing change statement which either adds collateral or a debtor to a filing is ineffective unless the debtor consents to the filing.[184] (Consultees overwhelmingly agreed that the debtor should not be required to sign or authenticate the financing statement.[185]) A debtor who has entered into a security agreement is deemed to have consented to an appropriate filing. The requirement of consent is aimed at filings in advance of creation of the SI,[186] and we think that it may be a helpful check on speculative or vexatious filings: filing without the necessary consent could result in the person filing being liable for loss or damage caused.[187] It should be noted that even if at the time of filing the debtor had not consented or there was no security agreement in existence, the filing will be validated retrospectively if the debtor later gives consent or enters into a security agreement. **We provisionally recommend that a financing statement that is filed before a security agreement is made should be ineffective if it is made without the debtor's consent (whether before or after the filing).**

3.141 We do not anticipate that unauthorised filings will be a problem in a companies-only scheme.[188] In case this does turn out to be a problem, it would be possible to have a provision empowering the Registrar to require that each filer indicate that a security agreement exists or the debtor has consented to the filing being made, with criminal liability for false declarations. However, such a requirement or power does not yet feature in our draft regulations, although we note that the Company Law Review recommended that it should be an offence knowingly or recklessly to deliver false information to the Registrar.[189] If such a provision were to be a part of any Bill enabling the introduction of our provisionally proposed scheme, consultees might consider that this, together with the need for the person filing to register with the system, the verification statement process, and the process for altering or removing incorrect filings, to be sufficient safeguard against wrongful or erroneous filings. **We ask consultees whether they think a power should be taken to impose a criminal sanction on those who file without the debtor's consent when there is no security agreement in existence.**

[183] See above, paras 2.53-2.54.

[184] DR 47. A financing statement that is not 'effective' will not perfect an SI or protect its priority: see DR 46(2). A similar provision is found in the UCC, but not in the PPSAs.

[185] CP para 4.108.

[186] See above, para 3.138.

[187] See DR 71(2).

[188] We are told that in the US there have been some unauthorised, 'nuisance' filings but these have been mainly against prominent individuals, normally politicians.

[189] *Modern Company Law for a Competitive Economy: Final Report* URN 01/942, para 11.48.

'Last-minute' filing

3.142 A large majority of those who responded agreed with our provisional proposal in the CP that – unlike the current '21-day' rule for company charges - there should be no requirement to file a financing statement within a certain time after creation of the SI.[190]

3.143 However, we noted that the Insolvency Act 1986, section 245 provides for the partial or entire avoidance of floating charges given in various situations, including where the charge was given within the last two years to a 'connected person' who did not give 'new value' and 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. We pointed out that the Company Law Review Steering Group thought that in general there was no need to invalidate charges that were registered only a short time before insolvency, and that we saw no reason to disagree (although the question was raised for consultation). However, we thought that 'connected persons', and in particular directors, should be prevented from last-minute filing. Directors are particularly likely to know that a company is approaching insolvency and might be tempted to take a charge at that point. Therefore we provisionally proposed that there should be a provision to prevent last-minute filing by connected persons.[191] A small majority were in favour of the scheme containing provision to prevent last-minute filing, although it is clear from the responses of some of those who were against having such a provision that they were not against preventing last-minute filing as such, but thought that it should be done through insolvency law (as it currently is by the Insolvency Act 1986, section 245) rather than through a rule of our scheme.

3.144 Section 245 is confined to floating charges for two reasons: because these normally cover the whole, or substantially the whole, of a company's assets and because, despite this broad reach, they allow the company to continue trading. If the first of these reasons is thought to be the critical one, the equivalent avoidance provisions under our proposed scheme might be confined to 'general' SIs, that is, those that cover the whole, or substantially the whole, of the company's assets. (Like section 245, the provisions should not apply if the chargee gave 'new value'.)

3.145 However, we see no particular reason to confine any such provision to 'general' charges, nor to ones that contain a licence to deal. It seems to us that any 'last minute' charge that does not represent 'new value' given to the company may create the same mischief as a floating charge.

3.146 **We provisionally recommend that, when our scheme is introduced, section 245 of the Insolvency Act 1986 be amended to apply to any SI 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).**

[190] CP para 4.75.

[191] CP para 4.80.

Verification statement

3.147 A large majority of respondents agreed with the CP proposal that there should be a mechanism to ensure that that the debtor is aware of the filing after it has been made.[192] The question is how this should be achieved: should the debtor be notified directly by the 'system' or should the secured party be required to notify the debtor?

3.148 Some argued that the notice should be sent by the Registrar, but that has its difficulties. First, although all filing will be electronic, so that each filer – the secured party or its agent – will presumably be required to give an e-mail address to which Companies House can send confirmation of the filing, and although Companies House will have an address for each debtor that is a registered company, not all companies have e-mail addresses recorded with Companies House. It would therefore be necessary to send notification to at least some debtors by post. Companies House have expressed reservations about taking on responsibility for sending notices that a filing has been made to the debtor. Secondly, later in this consultative report we provisionally recommend that SIs created by overseas companies over assets in England and Wales should be brought within the scheme.[193] Companies House can hardly be expected to check the address details of a company incorporated outside Great Britain and not registered here. Therefore we conclude that we may have to follow the other schemes in placing responsibility on the secured party to inform the debtor that a filing has been made.

3.149 Thus, once a financing statement has been filed, the Registrar should send a 'verification statement' to the person making the filing. The draft regulations provide that the verification statement must contain the date and time of filing, the financing statement number assigned by the Registrar, and the information contained in the financing statement, together with any other prescribed data required by the Rules. We anticipate that the verification statement will be sent electronically (it would presumably be an automated action).[194] The secured party (or person named as secured party in, or the agent responsible for, the financing statement) will be under an obligation to send a copy of the verification statement to the debtor within 10 business days of receiving the statement, unless the debtor has waived in writing the right to receive a copy.[195] Failure to comply with this obligation will render the secured party potentially liable for reasonably

[192] CP para 12.24(2). Some thought that this was unnecessary; the debtor should be aware that it has created an SI. 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 3.157-3.160).

[193] See below, para 3.372.

[194] The Registrar could choose to follow the New Zealand approach, and give the secured party the option of an electronic verification statement (for free) or one in paper format (for a fee).

[195] DR 50(3).

foreseeable loss or damage under the general damages provision contained in the draft regulations, where such loss can be proved.[196]

3.150 **We provisionally recommend that, when a financing statement has been filed, the Registrar must send the secured party a verification statement. The secured party must then send a copy of the statement to the debtor within 10 business days, unless the debtor has waived the right to receive a copy.**

Effect of failure to file or perfect by other means

3.151 Except for financial collateral,[197] supporting obligations or sales of promissory notes,[198] a non-possessory SI can only be perfected by filing. In this section we discuss the consequences of failing to file or perfect by other means, for example, by taking possession. It should be remembered that even if one of the steps we have discussed in this section, such as filing or taking possession, has been taken, the SI will still be unperfected for so long as the SI has not attached.

3.152 Consultees were almost unanimous in agreeing with our provisional proposal in the CP[199] that there should be no criminal sanction for failing to file. Thus the decision whether to perfect in this or any other way will be a commercial one for the secured party. The vast majority agreed also that the consequences of failure to file (or perfect in some other way) should be invalidity (ineffectiveness) against an administrator and liquidator, and a loss of priority against a subsequent secured creditor who files first.[200]

3.153 **Thus we provisionally recommend that it should not be compulsory to perfect an SI by filing or any other means; but that an unperfected SI should be:**

(1) at risk of losing priority to one that has been perfected;

(2) ineffective against a liquidator or administrator on insolvency and other secured parties;

[196] DR 71.

[197] See Part 4.

[198] See above, paras 3.46 and 3.51-3.56.

[199] CP para 12.12.

[200] A few consultees 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. As we discussed in Part 2, two consultees argued that registration should be a condition of the validity of a charge, and we have explained that we think this would be an unnecessarily radical change to our law and would also be incompatible with extending the scheme to quasi-securities: see above, para 2.45.

(3) ineffective against an execution creditor who completes execution before the SI is perfected;

(4) ineffective against some purchasers (whether a buyer or subsequent secured party) in certain circumstances.

We will return to these points in more detail during the course of this Part.[201]

Financing change statements

3.154 Amendments to an existing filing are made through filing a financing change statement. A financing change statement is defined in the draft regulations as the data transmitted to the registry in accordance with the draft regulations and the Rules to amend a financing statement or discharge a filing.[202]

3.155 As we noted above, we anticipate that the Rules will establish a system whereby the 'original' filing will generate a financing statement number, a debtor PIN and a financing statement PIN. The financing statement number and financing statement PIN will be necessary for making changes to the filing. The system should automatically allocate a number to the financing change statement that is linked to that of the financing statement. Thus the financing statement and any financing change statements will form a 'family' and a search that is appropriate to reveal one of them will reveal the others.

3.156 The draft regulations provide that an amendment or renewal of a filing may be done by filing a financing change statement any time before the filing expires.[203] This means that the secured party can make amendments to a filed financing statement at any time. The debtor will not be able to make amendments (providing the secured party has kept the financing statement PIN private) except under the procedures described below.

CORRECTION OF ERRORS AND REMOVAL OF UNWANTED FILINGS

3.157 In the CP we provisionally proposed that there should be provisions allowing the debtor to demand that a change to an inaccurate financing statement be made, or an outdated financing statement be removed, by the secured party within a certain period, failing which the debtor may make the change.[204] The overwhelming majority of consultees agreed.

[201] See below, paras 3.201; 3.250-3.252; 3.255-3.256.

[202] DR 2(1). As we have noted, where the context permits, a financing change statement is also included within the definition of financing statement, so that mention of a financing statement in a particular draft regulation might mean both a financing statement and a financing change statement.

[203] DR 52.

[204] CP para 12.21. To meet a concern raised by Companies House, we should make it clear that a financing statement that is 'removed' need not be removed from the Companies Register altogether, since that forms an historical record. It is simply that it will not be shown when the register is searched in the normal way: it may be removed to a separate electronic archive.

3.158 To enable the debtor to demand formally - and if necessary enforce – the removal of unwanted filings or changes to incorrect or out of date information on the register, the draft regulations provide that the debtor (or any person with an interest in property that falls within the collateral description) may require the secured party to file a financing change statement. This applies where the obligations under the security agreement have been discharged or no security agreement exists; where the secured party has agreed to release some of the collateral described in the financing statement; or where the description of the collateral is too extensive.[205]

3.159 The draft regulations enable the debtor, or any person with an interest in the property described on the financing statement, to issue a 'requirement notice', requiring that the necessary changes be made by a financing change statement. The secured party must then either make the changes or commence proceedings for a court order[206] to maintain the filing (and notify the Registrar and the person making the demand) within 15 business days after the notice was issued. The Registrar, on receiving such a notification, is required to place an indication on the register that the financing statement in question is disputed. This should warn third parties that further investigation is needed. If no order is received within 90 days after the indication that proceedings have been commenced, then the party making the request can make the changes itself.[207] We would welcome views on this.

3.160 The 'mechanics' of how the requirement notice be served, and how if necessary the debtor may make any change, will be left to the Rules. One way it could operate would be to follow the New Zealand approach (as we understand it). A formal demand for a financing change statement can be made electronically, through the debtor accessing the system and entering on the system a 'financing change demand' (in the New Zealand terminology), using the financing statement number and debtor PIN. This would indicate the changes demanded to the financing statement. The entry of this demand will generate an automatic notice to the secured party that the changes demanded will take effect to alter or discharge the filing at the end of 15 days, unless a court order (this is required in the New Zealand system; we would substitute an indication of commencement of proceedings) to maintain the filing is received by the Registrar. If no such indication is received, the changes are automatically incorporated into the financing statement and take effect to amend or discharge it.

[205] DR 55.

[206] We have differed slightly from the approach taken by the PPSAs, in that we are not provisionally recommending that a court order be *obtained* within the time limit, but rather just a notification of commencement of proceedings. Unless consultees advise us to the contrary, it does not seem to us to be justifiable to put in a requirement that would mean such urgent court action to be taken and completed. However, for the purposes of consultation we have put in the 'long stop' provision that an order must be obtained within 90 days.

[207] DR 55(7).

TRANSFER OF SECURED PARTY'S INTEREST

3.161 Consultees agreed with our provisional proposal in the CP that it should be possible to amend the financing statement when the creditor's interest has been transferred to another creditor, but that this should not be necessary in order to maintain the effectiveness or priority of the SI.[208]

3.162 **We provisionally recommend that the creditor should be able to make amendments to the financing statement by means of a financing change statement. The debtor should be able to demand that an incorrect or out of date financing statement is, as appropriate, corrected or removed.**

Errors in the financing statement

3.163 The proposals in the CP on the effects of errors in filing were, with hindsight, not formulated clearly and consultees found it difficult to provide straightforward answers. However, there seemed to be a general consensus that the system should be broadly that of the other schemes. This is that an SI is not perfected in respect of a particular piece of collateral unless the item is covered by the collateral description in the financing statement, but that an error in the description will not prevent the financing statement perfecting SIs over collateral that is properly described. A filing will only be ineffective as a whole if there is a mistake in a searchable field,[209] such that a properly conducted search will not reveal the existence of the SI. In practice, except where motor vehicles and similarly serially-numbered goods are concerned, this will occur only when the name or company registration number (if any) entered for the debtor is wrong. (Motor vehicles are dealt with below.[210])

3.164 We think the scope for errors in the name and number of the debtor will be limited. While the scheme is limited to registered companies, LLPs and some overseas companies, most debtors will have a registered name and number. We understand that Companies House would be able to cross-check the name and number entered as part of the financing statement. The system might be set up so that it would not accept a filing unless either the name and number of the debtor company correspond (and each is complete and correct), or the filing party acknowledges that it is filing against an overseas company that is not registered at Companies House. Thus when a filing is to be made against a company (or LLP) registered in England and Wales the risk the company's name is entered incorrectly should be eliminated. The chief risk will be that the filing is made against the wrong company entirely, for example, against another company that has a similar name because it is in the same group. A careful check of the number should prevent this. In any event, when the company is notified of the incorrect filing it is likely to demand a change.

[208] CP para 12.22.

[209] The secured party's name and address are not a searchable field, so errors in these details would not prevent a searcher finding the financing statement.

[210] See paras 3.176-3.181.

3.165 In practice a searcher[211] might not have to use the full company name and number as a search term. We envisage that the system might be set up so that a search by the principal names of the company (for example, 'Smith Jones Robinson') would produce a list of all the companies containing those three names - for example, all those in a group using those names with different suffixes. The searcher could then ask for details of the particular company in which it is interested. This is a point for the Rules. However, the operation of the search tools will matter when the name of an overseas company is entered incorrectly - an obvious risk with foreign company names. A filing under the wrong name will be ineffective if a reasonable search would not reveal the financing statement. A system that enabled a searcher who is not sure of the exact name of the company (for example, an oversea company) to search for any 'similar' names will reduce the scope for argument that an incorrect filing is ineffective. It is not feasible to legislate for this; for example, the outcome might depend on how many 'near misses' would be shown and how serious the errors are. The issue must be left to the court's decision as to what was reasonable, in the light of the search tools made available by the Registrar under the Rules and the facts of the case.

3.166 It is immaterial, however, whether a search has actually been carried out. The question is what a searcher would have found had a reasonable search been made. The majority of consultees agreed with this 'objective' approach.[212]

3.167 An error in describing the collateral so that it purports to cover more than is actually covered by the security agreement will not prevent the SI being perfected but it will not, of course, give the secured party additional rights. The remedy here would lie in the debtor making a financing change demand to correct the error, as explained above.

3.168 **We provisionally recommend that the effectiveness of a filing should not be affected by a defect, irregularity, omission or error in the financing statement unless it would have the result that a reasonable search, conducted in accordance with the requirements of the draft regulations and the Rules relating to searches, would not reveal the financing statement.**[213] **An error in the collateral description will result in the SI remaining unperfected in relation to collateral that was omitted but will not affect it as regards other collateral that is described in the financing statement.**[214]

Effect of unauthorised or accidental discharge

3.169 We noted earlier that a financing statement will be effective either indefinitely or for such shorter period as is indicated on the financing statement. Given that specific periods of effectiveness are permissible, it is possible that a filing will lapse through inadvertent failure to renew it. It is also possible – although less

[211] The question of searches is considered further below, paras 3.171-3.174.

[212] CP para 12.10.

[213] DR 51.

[214] See DR 51(2) and (5).

likely – that a filing could be discharged either inadvertently by the secured party or by the secured party's agent without the secured party's authorisation.[215] It seems sensible to permit the re-activation of the filing provided that other secured parties or buyers are not prejudiced and that it is done within a short enough time that it is unlikely that unsecured parties will have relied on the apparent discharge of the SI.

3.170 **We provisionally recommend that where there has been mistaken or unauthorised lapse or discharge of a financing statement, the secured party should be able to re-activate the financing statement within 30 days of the lapse or discharge. Where this is done, the lapse or discharge should not affect the priority ranking of the SI as against those SIs which, prior to the lapse or discharge, were subordinate in priority to it. However, this should not be the case as against SIs that are perfected by filing after the lapse or discharge but before the financing statement was re-activated, nor to the extent that the competing SI secures advances made or contracted for in that period.[216] The Rules should deal with the procedure for re-activation of the financing statement**.

Searching

3.171 We have explained the information that has to be contained on the financing statement.[217] Not all of this information can be used to conduct a search. The draft regulations provide that the register will have to be organised so as to allow searching by one or more listed criteria. The criteria are the company name; the company registered number (where it has one – overseas companies may not be registered at Companies House); the financing statement number (the number allocated by the registry on filing); and the unique identifying number (for collateral prescribed in the Rules as having a unique serial number, for example, motor vehicles[218]). The draft regulation also allows for the possibility that the Rules might introduce additional search criteria.

3.172 It will be possible to search by company name *or* company number. The searcher will then have to check the search result to ensure that it has 'found' the correct company. Alternatively the searcher may enter both. Companies House tell us that they should be able to configure the system so that when a name and number is entered an automatic check is run to ensure that the name and number tally with each other according to the records that they hold on registered companies. If they do not, some form of warning will appear on-screen to this effect, perhaps offering alternatives. It seems to us that this would go far to reducing the risks of identifying the wrong debtor. We have already pointed out

[215] Unauthorised discharge by anyone else is likely to be very uncommon, as the person discharging the filing would have to have access to the financing statement PIN, which the secured party should keep private.

[216] DR 43.

[217] See above, paras 3.118-3.136.

[218] See above, para 3.129.

that where a company is incorporated outside Great Britain,[219] this check will not be possible. We suggested that the Rules should make it possible for searchers who are not confident that they have the name 100% correct to search for 'near misses'. This should also reduce the risk that a financing statement will not be revealed.

3.173 The NZPPSA has provisions linked to New Zealand's Privacy Act 1993, and there is a requirement that a person searching the register make a declaration that the search is being made in accordance with that legislation.[220] We do not think similar issues arise for our system. Any requirements relating to data protection or freedom of information that Companies House is, or may become, subject to will continue to apply.

3.174 **We provisionally recommend that it should be possible to search the register on-line by the company name; the company registered number (where it has one – overseas companies may not be registered at Companies House); the financing statement number (the number allocated by the registry on filing); and (for collateral prescribed in the Rules) the unique identifying number.**

System failure

3.175 We think the risk of major loss being caused by a system failure is rather 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. This would certainly cause inconvenience but it is unlikely to cause serious loss unless the secured party is unwise enough to advance the funds before filing, in which case it has only itself to blame.[221] There is a slight danger that a defect in the software might prevent a properly conducted search from revealing a registered SI; and perhaps a greater danger from hackers deliberately interfering with the system. We suggest that income from filing and searching fees be used to establish a fund from which compensation may be paid on a 'no-fault' basis, up to (fairly low) pre-determined limits, although provisions to effect this do not form part of the draft regulations. We also suggest that there should be statutory, fault-based liability on Companies House for loss caused by errors in the system. The provisions in the draft regulations relating to damages are intended to cover this position.[222] **We ask 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.**

[219] See above, para 3.120.

[220] NZPPSA, ss 173-174.

[221] Save, of course, where the scheme allows a grace period for filing, for instance with PMSIs over equipment: see below, paras 3.215-3.219. In such a case it may be desirable to allow additional time for filing if the system becomes unavailable during the last 24 hours before the deadline, for example by extending the deadline by 24 hours.

[222] See DR 71.

SIs over vehicles

3.176 At this point it is appropriate to deal with SIs over vehicles and other types of goods that have unique serial numbers (the vehicle identification number or VIN, and/or the registration number). We explained in Part 2 the advantages that would result from permitting these to be filed using the unique serial number (or numbers – whether it is just the VIN or also the registration number is a matter for the Rules).

3.177 If collateral is of this type (that is, motor vehicles and other types of serial-numbered collateral to be identified in the Rules), then the number may be included in the financing statement. There is no obligation to include it, so that someone financing, say, a fleet of vehicles could perfect its SI by describing the collateral as 'motor vehicles' rather than recording each individual serial number, but consequences may follow from not using the serial number. A filing that is made without using the serial number, where one could have been recorded, will preserve the effectiveness of the SI as against the administrator or liquidator. In other cases the consequences will depend on whether the goods are held by the debtor as equipment or as inventory.

3.178 Where the goods are equipment, a buyer or lessee of them will take free of any SI perfected by filing, if they were serial numbered goods and the serial number was not used in the collateral description as part of the filing.[223] In addition, such a 'general' filing will not be sufficient to preserve priority as against other perfected SIs.[224]

3.179 Where the goods are held as inventory, a buyer or lessee of the goods will normally take free of any SI created over them by the seller or lessor, as the disposition will in most cases be authorised.[225] Even if it is not, it will normally be made in the ordinary course of the seller's business, so that the buyer or lessee will take free of the SI under the 'buyer' rules.[226] This means that it would be unreasonable to expect the secured party to file the serial numbers of the individual vehicles or other assets held as inventory. In turn, however, the secured party's priority against other SIs taken over the same inventory should be preserved even though the secured party has filed only in general terms. Thus the rule subordinating a 'general filing' SI over serial-numbered goods to a subsequent SI applies only where the goods are equipment, not when they are inventory.

3.180 **We provisionally recommend that where goods are of a type that is designated by the Rules as having a unique serial number, the financing statement may include that serial number. If it does not, a buyer of the goods who does not know of the SI will normally take free of it, and, where**

[223] DR 31(7)-(8).

[224] DR 33(4).

[225] The effect of DR 29(1)(a) is that an authorised dealing will prevent the SI continuing in the collateral.

[226] See below, paras 3.257-3.259.

the goods are equipment, the SI will not be treated as perfected for the purposes of priority as against other SIs over the same goods.

3.181 Where the uniquely identifiable number has purportedly been included, but there is an error in it, a search by using the number would not reveal the existence of any SI over the collateral. In this case, there is a question: should the filing be treated as ineffective, even though the debtor's name was entered correctly; or should it be effective provided there was an adequate description of the collateral in general terms (for example, as a vehicle of a particular make, model and year)?[227] There may also be the converse question, whether a correct serial number can 'save' a filing that was made against the wrong debtor. These issues are not clearly settled by the Canadian legislation and have troubled the Canadian courts.[228] In our view,

(1) The fact that the serial number was correct should not 'save' a filing that stated the debtor's name incorrectly, except where, as previously suggested, the system would in fact reveal the filing as a 'near miss'. It would be unreasonable to expect those who are concerned with whether there are SIs over the company's property as a whole to search against individual vehicles. It is true that this might occasionally mean that an SI over a vehicle will be unperfected when a person searching on the vehicle number alone could in fact discover it; but this will rarely cause a windfall to the searcher. This is because the most usual searcher will be an intending buyer of the vehicle and, if the buyer conducts the search and discovers that there is an SI over it, the buyer will have knowledge of the SI and will not take free of it.

(2) Where the name of the debtor is correct but the serial number is incorrect, the financing statement should be treated as if it did not contain the serial number.[229] The advantages of the scheme as regards vehicles would not be fully realised unless a potential buyer of the vehicle or (where the vehicle is not inventory) a subsequent secured party can rely on a search by serial number alone. In practice there will be adequate safeguards against the secured party making a mistake. We anticipate that most SIs over vehicles will be entered by one of the existing registration organisations as agent for the secured party. Those organisations are able to check that the various items of data submitted tally - most obviously, that the registration number and VIN match, but also that these match any other details of the vehicle supplied by secured party.

[227] A similar issue can arise in the converse case in which the serial number is correct but the debtor's details are incorrect – in other words, the filing has been made against the correct vehicle but the wrong company as debtor.

[228] Eg, *Stevenson v GMAC Leaseco Ltd* 2003 NBCA 26.

[229] See DR 51(6).

PROCEEDS

Definition of proceeds

3.182 The concept of proceeds is an important and difficult one. Under the schemes we have examined and under our draft regulations, 'proceeds' refers to three different situations. The first is where the debtor receives income from the collateral (for example, dividends or interest from financial collateral) or collects on it (thus, the sums received from payment of a book debt). The second is when proceeds arise from a disposition of the collateral by the debtor. The SI will normally continue into such proceeds. The third is where the debtor has a claim arising out of damage to or interference with the collateral.[230]

Right to proceeds of disposition

3.183 The CP dealt only with proceeds in the second sense. A large majority of consultees agreed with the provisional proposals made as to the perfection of proceeds in the CP.[231] Our provisional recommendations, which we set out below, follow these with some amendments. **We provisionally recommend that where collateral is disposed of by the debtor, unless the secured party has authorised the dealing free of the SI or the case is one in which the buyer will take free of the SI, the SI should continue in the collateral and attach to the proceeds.**[232]

3.184 If a disposition of the collateral was authorised (whether by the security agreement or by a subsequent authorisation from the secured party) or, though unauthorised, it was made in circumstances in which the buyer[233] will take free of the SI,[234] the secured party will have rights to the proceeds of the collateral. In contrast, if the transferee takes subject to the SI, the secured party should have rights to both the original collateral and the proceeds of disposition. Where the secured party would be able to claim both the original collateral and the proceeds, the SPPSA (but not Article 9) contains a provision to prevent the effect being to swell the value of the collateral that is subject to the SI: where the secured party enforces an SI against both the collateral and the proceeds, the amount secured by the SI in the collateral and the proceeds is limited to the market value of the collateral at the date of the dealing.[235] We have included this for the purposes of consultation only. It may be seen as a consumer protection measure and less suitable to the more limited scope of our scheme than to the

[230] See the definition in DR 2(1), which is derived from both SPPSA s 2(1)(hh) and UCC Section 9-102(a)(62). It should be noted that the definition excludes 'products made from collateral', so that a supplier of raw materials would have to agree expressly that its SI should extend to cover the products which were made from its raw materials: this would not happen automatically. See further below, para 3.280.

[231] CP para 4.172.

[232] DR 29.

[233] Or lessee: see below, para 3.253. A secured party will not take free of the SI and, provided the first SI was perfected, the second SI will normally be subordinate to it.

[234] For example, where the collateral comprises inventory that is sold in the ordinary course of business: see below, paras 3.257-3.260.

[235] DR 29(2).

PPSAs. **We ask consultees whether the scheme should include a provision to limit the secured party's recovery from original collateral and proceeds to the market value of the collateral.**

3.185 Whether something will be proceeds will depend on it being identifiable and traceable. We do not think this should depend on there being a fiduciary relationship between whoever has the SI in the proceeds and a person having rights in, or who has dealt with, the collateral. **We provisionally recommend that whether proceeds are identifiable and traceable should not depend on the presence of a fiduciary relationship.** We have accordingly included a provision to that effect in the draft regulations.[236]

Perfection of right over proceeds

3.186 The rules just stated apply to 'proceeds' that arise on disposition of the collateral by the debtor. We consider that, as in the other schemes, it is appropriate to apply the general rules that we are about to describe to the other types of proceeds also.

3.187 At this point we are concerned with perfection of any SI in the proceeds. On this we confirm the proposal in the CP. **We provisionally recommend that an SI in proceeds should be continuously perfected if the SI in the original collateral is perfected by filing, and**

(1) the financing statement contains a description of the proceeds that would be sufficient to perfect an SI in original collateral of the same kind; or

(2) the financing statement covers the original collateral, if the proceeds are of a kind within the description of the original collateral; or

(3) the proceeds consist of money, cheques, deposits in or money credited to a bank account or insurance payments.[237]

In other cases, the secured party should have a short period in which to perfect against the proceeds.[238]

OBTAINING ADDITIONAL INFORMATION ABOUT THE SI

3.188 The filing scheme introduced by the draft regulations is intended to supply a warning that an SI may exist over the debtor's apparent property.[239] A party contemplating supplying assets or funds to a debtor may want to find out more by contacting either the debtor or any secured party revealed by a search of the register – in particular, to find out what property is covered by the financing

[236] DR 2(3).

[237] DR 29(4).

[238] DR 29(5)-(6).

[239] An SI may not actually exist at the time a filing is made: see above, para 3.138.

statement (which may contain only a broad description of the collateral) and how much is owed to the secured party. In most cases, we anticipate that the position may be much as we understand it to be at present, with such information as is commercially appropriate being supplied on a voluntary basis. Nothing prevents the debtor - or anyone else - seeking any information from the secured party. Consultees were divided on our provisional proposal in the CP that in certain circumstances the debtor and anyone with an interest in the company's property should be entitled to obtain further information about the security agreement: just over half of those who responded agreed with us.[240] Consultees did in general agree with our suggestion in the CP that the company's own register of charges fulfilled no useful function in this context, and was not worth maintaining.

3.189 To cover the case where the secured party is reluctant to release information on a voluntary basis, we have included in the draft regulations, for the purposes of consultation, provisions enabling a debtor to make a written request to its secured party to be provided with certain information in relation to a security agreement. If the secured party receiving such a request does not comply with the requirements of the draft regulation, or if it supplies inaccurate information, it could face potentially serious consequences.[241] (This right to be supplied with information is not limited just to SIs perfected by filing.)

3.190 One important issue is who should be entitled to make a request (thereby putting the secured party at risk of penalty for non-compliance). In the CP we suggested that anyone with an existing interest in the company's property should be entitled to make a request for further information.[242] This is the approach generally taken in the PPSAs. In contrast, the UCC takes the approach that the debtor, but no one else, can require the secured party to send specified information to him or a named third person.

3.191 A number of consultees expressed concerns about confidentiality issues that would be involved in allowing persons other than the debtor (for example, competing secured parties) the right to demand information without the express consent of the debtor. Balanced against this is the question of how judgment creditors can be expected to find out which of the debtor's assets are subject to an SI. Potential lenders can expect the debtor to provide the information or get it sent to them by the secured party. However judgment creditors may need information to identify what property they can safely seize. Where the debtor is nearing insolvency, it may have no incentive to respond to a request for information from a judgment creditor. In our view, however, this is a lesser concern than the confidentiality issue. There is no way at present by which judgment creditors can readily discover which of a debtor's inventory is subject to a retention of title clause, or which of its equipment is subject to a finance lease. Under our scheme, even if they are not entitled to obtain further details from the secured party, their position will be improved since they may discover the

[240] CP para 4.63.

[241] DR 18.

[242] CP para 4.63.

possible existence of such agreements from the register and may seize any goods that are subjected to an unperfected SI.

3.192 Therefore we provisionally recommend that, if the scheme is to contain a provision dealing with the obtaining of further information, only the debtor should be permitted to make an 'information request. We have drawn up the draft regulations accordingly. However, it should be noted that the right to obtain information is limited to 'in-substance' SIs; it does not apply if the SI is a 'deemed' one. This is because a potential secured party will be less interested in 'deemed SIs', as there is no question of the debtor having a right to a difference between the value of the collateral and the sums outstanding.

3.193 Adopting such an approach would mean that those interested in lending to or dealing with the debtor will have to direct their enquiries through the debtor, who can request that the information be sent directly by the secured party to a third party at a specified address. This will enable the third person to rely on the information as coming from the secured party; and if the third person does so rely, the secured party will be estopped from claiming that it was in fact owed more, or was entitled to more collateral, than it stated in the information it gave.[243]

3.194 The debtor will be able to ask how much it still owes, or ask the secured party to confirm the debtor's estimate; and to ask the secured party to confirm which personal property is subject to an SI. The debtor can be expected to have a copy of the security agreement, so this item has not been included in the list.

3.195 We think that having a provision enabling the debtor to request information in the way outlined above would be useful, but we recognise that this goes beyond what we understand the current position to be. Given that more than half of consultees who responded to the CP proposal were in favour of the wider approach that we provisionally recommended at that stage (allowing both the debtor and those with an interest in the company's property to make a demand), we think we would be justified in making a provisional recommendation that the scheme contain such a provision. However, given that this issue is controversial, we leave the matter open and seek the views of consultees.

3.196 Where, without reasonable excuse, the secured party does not comply with the information request within 10 business days of receiving it, the draft regulation provides that the debtor can apply to court for an order requiring the secured party to comply.[244] Where the court makes such an order, it may also impose sanctions for non-compliance with the order of the court, including the

[243] See also UCC Section 9-625(g).

[244] We have not thought it necessary to replicate a provision found in the SPPSA, s 18 to the effect that a secured party who receives an information request purporting to be made by a person entitled to make it may act as if the person making it is, in fact, entitled to make it unless the secured party knows the person is not entitled to make it. This provision would be more appropriate for a scheme that allows persons other than the debtor to make such a request, and would seem to weaken any duty of confidentiality between the secured party and the debtor. However, we would welcome views.

extinguishing of the SI.[245] We are not wholly convinced of the need for these additional sanctions, but have included them for consultation: the question is whether the awarding of actual damages for breach of a duty or obligation under the draft regulations would be a sufficient sanction, or whether there should also be a possible sanction of extinguishing the SI.[246] We would welcome the views of consultees.

3.197 **We conclude from the point of view of obtaining information about security that there is little point in maintaining the company's own register of charges. We ask whether the scheme should contain a provision enabling the debtor to require the secured party to supply information relating to the amount owing and the collateral subject to the SI. In particular, we seek views on whether:**

(1) only the debtor should be entitled to make an 'information request',

(2) the secured party should be obliged, at the debtor's request, to supply the information to a named third party,

(3) the court should be able to order the sanctions set out in DR 18, including extinguishing the SI.

PRIORITY BETWEEN COMPETING SIS

3.198 The establishment of a clear set of priority rules is a fundamental feature of the overall scheme we are provisionally recommending. The CP made provisional proposals or asked questions on a number of specific issues relating to priority, but did not contain a set of detailed proposals or questions on the general rules. However, the topic was the subject of a subsequent informal discussion paper, presented at one of our seminars.[247] That seminar revealed a very broad measure of agreement over the general rules; disagreements were on specific points that we will discuss as we come to them.

3.199 In this section we deal with questions of priority as between competing SIs. The rules dealing with buyers and similar transferees are for the most part treated separately,[248] though there are some rules that apply to both buyers and competing secured parties (often referred to generically as 'purchasers').[249]

[245] The UCC contains a more general provision that, in the event of the secured party not complying with Article 9, the court may order or restrain collection, enforcement or disposition of collateral on appropriate terms and conditions: Section 9-625(a).

[246] We think it unlikely that contempt of court proceedings for breach of any court order compelling compliance would be deemed to be appropriate in most cases, given the gravity of such a course and the procedural steps necessary to undertake such proceedings.

[247] Held at Norton Rose in September 2003.

[248] See below, paras 3.253-3.263.

[249] See, eg, the rules dealing with transferees of negotiable instruments, below, paras 3.229-3.236.

3.200 The draft regulations dealing with the priority of conflicting SIs take the form of a set of rules that apply in specific situations and 'residual' rules that apply otherwise. There are several specific (and important) rules that apply only to financial collateral; these are dealt with in Part 4. We start with the general, 'residual' rules.

'Residual' priority rules

3.201 There was broad agreement on the 'residual' rules that should apply in the absence of a more specific priority provision. **We provisionally recommend the following residual rules:**

(1) Perfected SIs take priority over unperfected ones.

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

(3) As between unperfected SIs, priority is determined by date of attachment.[250]

(4) The priority that an SI has under the rules above applies to all advances, including future ones (whether or not made under an obligation).[251]

3.202 The rule that, as between conflicting perfected SIs, priority is determined by the 'first to file or perfect' means that where the conflict is between two SIs that have both been perfected by filing, priority will go to the secured party who filed a financing statement first, regardless of the date that the SIs came into existence or attached. Thus if SP1 files its financing statement on 1 February and its SI attaches on 10 February, and SP2 files its financing statement on 2 February, which is also the date on which its SI attaches, as of 10 February SP1 will have priority. If SP2 had perfected by taking possession on 2 February the same result would follow.[252]

3.203 As we noted above, if collateral is of a type prescribed in the Rules as having a 'unique identifying number', this number can be included on the financing statement. If it is not included in the filing, and the collateral is equipment, whilst

[250] Some consultees argued that priority between unperfected SIs should depend on the date of creation rather than of attachment. We have considered this carefully. When the SIs have not attached when they were created because the debtor did not acquire the property until later, it is true that the date of attachment rule does not provide a helpful criterion: both will attach simultaneously. However if it does not attach because the collateral has not been identified or because the relevant party has not yet advanced credit, not only does the date of attachment rule give a clear answer but the date of attachment seems more relevant than the date of creation. We have therefore followed the other schemes in adhering to the date of attachment as the criterion. The situation is likely to be a rare one in any event.

[251] See DR 33(6).

[252] This rule applies only as between *perfected* SIs. If SP1's SI has not attached, the fact that it has filed before SP2's perfected SI will not give SP1 priority for so long as it remains unperfected. Once SP1's SI has attached, however, it will have priority.

the SI will be perfected and effective against the administrator or liquidator, the 'residual' priority rules provide that this will not be sufficient to preserve priority as against other perfected SIs.[253]

Specific priority rules

Purchase-money SIs

3.204 The most important specific rule is that giving priority to purchase-money SIs (PMSIs). In essence, a PMSI is an SI taken either by a seller to secure payment of the purchase price of the collateral, or by a lender to secure repayment of funds it has provided to enable the debtor to acquire rights in the collateral, for example, where a bank lends a sum of money to a company to buy a particular asset, securing the loan on that asset. In the CP we repeated the argument made by the Crowther committee that it would be unfair to allow the security for this additional loan to be subordinate in priority to the earlier SI:

> In this case, it is [the later creditor's] money that has led to the increase in the dealer's inventory, and it would be quite wrong that this increase should become a windfall added to the security of the original party … simply because he had filed a prior financing statement.[254]

3.205 The great majority of consultees agreed that PMSIs should, subject to certain conditions to be discussed later,[255] have priority over previously perfected SIs.[256]

DEFINITION OF PMSI

3.206 Under the draft regulations, a PMSI is an SI in collateral[257] to the extent that it secures all or part of the collateral's purchase price;[258] or an SI taken by a person who gives value for the purpose of enabling the debtor to acquire rights in the collateral, to the extent that the value is applied to acquire those rights.[259] The first limb will cover 'vendor-credit', for example where the seller seeks to secure payment for the asset by including a retention of title clause in the sale agreement, or where a hire-purchase agreement is used. The second covers 'lender-credit'.

[253] DR 33(4).

[254] CP para 4.155; Report of the Committee on Consumer Credit (1971) Cmnd 4596, para 5.7.73.

[255] See below, paras 3.211-3.219.

[256] This replicates the effects of current law. In practice the vast majority of PMSIs will be title-retention devices, and under current law the collateral in question would not be caught by an after-acquired property clause because it does not become the debtor's property.

[257] Other than investment property, which is dealt with by a specific set of priority rules: see Part 4.

[258] See DR 4(1)(a).

[259] See DR 4(1)(b).

3.207 The definition of PMSI also expressly includes the interest of a lessor of goods for a term of more than one year and the interest of a consignor who delivers goods to a consignee under a commercial consignment.[260] These are expressly included because, although they may come within the definition of an SI, in the circumstances there may be no security purpose. Thus they would otherwise fall outside the vendor- or lender-type situations discussed above and so be outside the definition of PMSI and suffer in priority as a consequence.[261]

3.208 Subject to a number of conditions to be explained below, **we provisionally recommend that an SI in collateral, to the extent that it secures all or part of the collateral's purchase price, and an SI taken by a person who gives value for the purpose of enabling the debtor to acquire rights in the collateral, to the extent that the value is applied to acquire those rights, should have priority over any other SI given by the debtor in the same collateral. Interests of lessors and consignors of goods should have the same priority.**

3.209 The UCC provides for PMSI status only in relation to goods.[262] In the Canadian and New Zealand schemes a PMSI may exist in any form of 'collateral' other than investment property; so there can be a PMSI over a licence to use a patent, for example, if the secured party has provided the funds that were used by the licensee to acquire the licence.[263] We understand that Article 9 takes the narrower approach simply because PMSI status is regarded as exceptional and there seemed to be no demand for it other than in relation to goods. For the purposes of consultation the draft regulations follow the wider approach. **We ask consultees whether our scheme should limit PMSIs to SIs over goods or whether it should include an SI over any type of collateral other than investment property.**

3.210 We have included in the definition of PMSI an element contained in the UCC, but not the PPSAs, to the effect that a PMSI does not lose its status as such even if the obligation has been renewed, refinanced, consolidated or restructured.[264] This seems to us to be a useful clarification. We have not thought it necessary to include all the other provisions of the UCC on PMSIs, such as the 'application' (appropriation) of payments, where PMSI status depends on this.

[260] See DR 4(1)(c) and (d).

[261] Our definition of PMSI is very similar to that of the SPPSA, s 2(1)(hh). It has been suggested to us that the PPSA formulation results in the possibility of a PMSI covering an advance used to buy a particular asset, when the advance was initially unsecured but later an SI was taken over the asset. We would welcome views on whether this is likely to be a concern.

[262] The UCC definition of 'goods' includes certain embedded computer programmes: see UCC Section 9-102(a)(44), and above, para 3.19. Section 9-103(c) allows a PMSI in software that is not embedded but was acquired in the same transaction as the goods and for the purpose of operating them.

[263] Under our provisional proposals, such an interest would probably fall outside the scheme: see below, paras 3.337-3.342.

[264] DR 4(4), and see UCC Section 9-103(f)(3).

CONDITIONS FOR PMSI STATUS

3.211 The CP dealt only rather briefly with the question of the conditions that must be fulfilled for an SI to achieve and retain PMSI status. Several consultees responded that they could not comment without more detail. We set out our provisional recommendations below.

3.212 When collateral is supplied subject to a PMSI, the UCC and the PPSAs draw a distinction between inventory and other collateral. In each case PMSI status will apply only if certain steps are taken, but the steps differ according to the type of collateral.

Inventory

3.213 When inventory is supplied to a company it is quite likely that other secured parties (existing or prospective) may rely on the inventory as collateral. There are, for example, stock financiers who on a regular basis advance funds on the security of the debtor's inventory, and who therefore check the value of the inventory regularly. It seems right that if such a lender has already perfected its SI by filing, it should be warned before it makes any further advances that the debtor may be receiving inventory that will be subject to a PMSI. Therefore the UCC and the PPSA require that, for an SI in inventory to have PMSI 'super-priority', as it is sometimes termed, the PMSI must be perfected and other secured parties who have filed to perfect SIs over inventory should be given notice, before the inventory is delivered.[265] We think that the notice requirement serves a useful function and we recommend adoption of the same rule.

3.214 **We provisionally recommend that for an SI over inventory to have PMSI status, it must be perfected, and a notice must have been given to any other secured party who has filed a financing statement covering the same type of collateral, before the debtor (or another person on its behalf, if earlier) obtains possession of the collateral. The notice must state that the person giving the notice expects to acquire an SI in inventory, and describe the inventory by item or kind.** [266]

Non-inventory collateral

3.215 Where the PMSI is over collateral that is equipment rather than inventory it is much less likely that other secured parties whose SIs would include the equipment will advance funds on the security of the new equipment within a short period; and they can be expected to search before doing so. Therefore the other schemes do not require notice, and there is a 'grace' period for filing of 10-15 days after delivery of the equipment.

3.216 Incorporating a period of 'invisibility' into the scheme might at first be thought to be problematical. However, we do not think in practice that this period will cause significant problems, for the following reasons. First, the PMSI priority rules only operate to give priority as against other secured parties. A buyer of the collateral

[265] UCC Section 9-324; SPPSA, s 34(3); NZPPSA, s 74.

[266] DR 42(3).

during the period before which a filing is made to perfect the PMSI will be subject to the 'usual' rules of buyers and unperfected SIs: it will take free providing it bought the collateral without knowledge of the SI.[267] Secondly, as against other secured parties, the invisibility period only exists for collateral that is not inventory. Secured parties relying on such collateral can do as they can at present and withhold funds until the grace period has passed.

3.217 We had wondered whether the 'grace' period was appropriate in the case of a wholly electronic filing system, but we understand that it has proved useful in the overseas systems where a business handles its filings centrally rather than in each of its individual offices or shops: time is needed for the dealer to inform the head office that an SI has arisen. Consequently, we see benefit in retaining the grace period.

3.218 As we explained earlier, in the draft scheme it is possible to have a PMSI over intangible property such as a licence. With intangible property the grace period could not run from the date of delivery; it therefore runs from the date the SI attaches.

3.219 **We provisionally recommend that a PMSI over goods that are not inventory should have priority over any other conflicting SI provided that it is perfected not later than 10 days after the debtor obtains possession of the collateral. In the case of a PMSI over intangibles, the 10 day period should date from attachment.**

Cross-collateralisation

3.220 The current law allows a retention of title supplier under an 'all-monies' or similar clause, if the buyer defaults in paying, to repossess any original goods supplied under retention of title, even if the particular goods seized have already been paid for. This is sometimes referred to as 'cross-collateralisation'. In practice it will be possible only if the SI has PMSI status even over the goods that have been paid for. Revised Article 9 defines a PMSI so that it applies to cross-collateral. We think this is a valuable provision; without it, there would be great practical difficulties in establishing which of several batches of identical goods all supplied by a single supplier have been paid for, and which not. **We provisionally recommend that PMSI status in one piece of inventory should extend to other inventory supplied by the same supplier, even if the particular item claimed has been paid for.**[268]

Conflicting PMSIs

3.221 A debtor may have financed the purchase of collateral partly by credit from the vendor and partly by borrowing from another secured lender. Each will have a PMSI. It seems useful to have a rule to deal with the conflict in priority. **We provisionally recommend that where two PMSIs in goods or proceeds conflict, a PMSI taken by a seller, lessor or consignor has priority over any**

[267] The PMSI will be effective in the event of the debtor's insolvency within the grace period.

[268] DR 4(2).

other PMSI, providing that it is perfected, in the case of non-inventory, within 10 days of the debtor obtaining possession of the collateral or, in the case of inventory, at the time the debtor obtains possession of the collateral.[269]

PMSIs OVER PROCEEDS AND CONFLICTING SIs

3.222 An important issue arises in respect of PMSI inventory claimants and receivables financiers. If inventory that is subject to a PMSI is sold to produce receivables, those receivables will amount to proceeds of the PMSI and the PMSI will accordingly continue over them. However, before entering into the PMSI arrangement, the debtor may also have created an SI over its receivables, for example by factoring them. The factor would want to claim the PMSI receivables as its original collateral. Who should have priority? Under the rules outlined above for inventory, the PMSI claimant would have priority. However, if the PMSI in inventory were permitted to continue into the proceeds without more, then it would be difficult for receivables financiers to secure priority over receivables arising from the sale of inventory.[270] Consequently, some of the North American systems contain specific provisions giving priority to an accounts receivable financier if it has given new value and has perfected its SI by filing prior to the supplier perfecting or filing in respect of its PMSI.[271] In contrast, the Ontario PPSA gives priority to the PMSI inventory proceeds claimant, as did, until very recently, the NZPPSA.[272] Although the Ontario rule has staunch defenders, the rule has been criticised. [273]

3.223 Policy in this area needs to reflect the relative commercial importance of receivables financing as against supplier-financing (for example, by sale on retention of title clause). Receivables financing is a very significant method of raising finance within the UK economy[274] and appears to be a more established and efficient method of financing than supply of inventory on credit under a

[269] DR 42(5).

[270] We will see that under the scheme we recommend, this applies only to inventory that is resold in its original form. If material subject to an SI is made into 'new goods', the supplier may reserve an SI over these but it will not have PMSI status. This differs from the UCC and PPSA schemes. See further below, para 3.282.

[271] SPPSA, s 34(6). UCC Article 9 achieves the same result by excluding PMSIs over most forms of proceeds, so priority over receivables that are proceeds will depend on the normal 'first to file or perfect' rule.

[272] The New Zealand Personal Property Securities Amendment Act 2004, which came into force on the 15 April 2004, inserts a new s 75A into the NZPPSA effectively giving the receivables financier priority.

[273] Commentators have also noted the potential uncertainty of the former New Zealand position for factors, with the risk of restitutionary claims (where the proceeds are no longer identifiable) being brought against the factors who had collected debts by inventory suppliers who had priority, with factors possibly having to pay over receipts years after the relevant debts had been collected: see M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 74.3 (pp 293-294).

[274] We are told by the Factors and Discounters Association that they fund receivables and inventory in excess of £100 billion a year.

retention of title clause.[275] To prefer the receivables financier would also better replicate the current situation: retention of title suppliers that seek proceeds are usually held to have unregistered floating charges and would thus generally lose to factors. Moreover, the factor is likely to give notice to the account debtor first and thus obtain priority under the rule in *Dearle v Hall*.[276] **We provisionally recommend that a secured party claiming an account as original collateral should have priority over a secured party claiming the account as the proceeds of a PMSI, provided that the receivables financier perfected its SI by filing before the PMSI secured party supplied the goods in question or filed in respect of its SI.[277]**

PRIORITY RULES FOR FARMING?

3.224 Some of the other schemes contain additional PMSI provisions relating to the farming industry. For the purposes of this consultation, we have not replicated these in the draft regulations, but we would welcome the advice of consultees as to whether equivalent provisions would be appropriate for our scheme.

3.225 The first issue concerns livestock. It may be hard to determine whether livestock should be treated as 'equipment' or as 'inventory' for the purposes of the PMSI priority rules. The UCC treats a PMSI in livestock in the same way as it does a PMSI in inventory, requiring notice to be given to other holders of conflicting SIs within a certain time before the debtor receives possession of the livestock.[278] We would welcome views on whether we should replicate this provision.

3.226 **For the purposes of the priority rules, should the scheme provide that a PMSI in livestock be treated in the same way as a PMSI in inventory?**

3.227 The second issue relates to those who finance the production of crops, for example by supplying fertiliser on credit. The SPPSA contains a provision that a perfected SI in crops or their proceeds that is given for value to enable the debtor to produce the crops, and that is given while the crops are growing or within the six months prior to their planting, has priority over any other SI in the same collateral.[279] In the US, a 'model' section of the UCC contains a similar rule in relation to such 'production-money' SIs.[280] Again, we would welcome views on whether our scheme should contain similar provisions.

[275] This dates only from the late 1970s: see CP para 6.16.

[276] (1828) 3 Russ 1; see above, para 2.146. This was held to be the position in *Pfeiffer (E) Weinkellerei-Weineinkauf GmbH & Co v Arbuthnot Factors Ltd* [1988] 1 WLR 150.

[277] See DR 42(6).

[278] Although the period is reduced from five years to six months: UCC Section 9-324(d).

[279] SPPSA, s 34(11). (Section 34(11) contains an equivalent provision relating to those who fund the acquisition of feed, drugs or hormones relating to SIs in fowl, cattle or fish.)

[280] Model Section 9-324A, which requires notification to others before the 'production-money' party gives new value. Official Comment 2 to UCC Section 9-324 notes that '[model section 9-324A] is a model, not uniform provision. The sponsors of the UCC have taken no position as to whether it should be enacted, instead leaving the matter for state legislatures to consider if they are so inclined.'

3.228 **We ask whether the scheme should provide that an SI taken by a secured party who effectively enables a crop to be produced should have priority over competing SIs in the resulting crop or its proceeds. If so, should there be time limits or notice requirements in relation to this?**

Protection of transferees of 'negotiable' collateral

3.229 In the CP we made the provisional proposal that the priority rules of a notice-filing system should not disturb the protection currently given to a holder in due course.[281] Those consultees who addressed the question agreed unanimously.

3.230 This is a matter that affects any transferee of a negotiable instrument, whether a buyer or a person who takes an SI over it. The draft regulations deal with several situations involving negotiable collateral together in one provision. At this point it is important to note the way in which the terms 'buyer' and 'purchaser' are used in the draft regulations. The definition of 'purchaser' is drawn widely – it includes someone who takes by sale, lease, discount, assignment, mortgage, pledge and gift. The term will thus cover both a buyer and other secured parties, and any provision in the draft regulations that applies to 'purchasers' will apply to both these types of person, whereas some of the provisions are expressly limited to 'buyers' (or lessees).[282] The rules discussed the following paragraphs apply to 'purchasers' or, where another form of outright transfer is in question, 'holders' or 'transferees'.

3.231 **We provisionally recommend that a purchaser of an instrument for value, without knowledge of the SI, and who takes possession of the instrument should have priority over any SI in the instrument, whether or not the SI was perfected, unless the purchaser not only knew of the SI but knew that the transaction would violate the terms of the security agreement.**[283] Where the purchaser acquired the instrument in the ordinary course of the transferor's business, the purchaser only has 'knowledge' if it knew that the transaction violates the terms of the security agreement. 'Instrument' is a defined term.[284]

TRANSFEREES OF MONEY

3.232 Transferees of money should also be protected, as should those who receive payment in some other form.[285]

3.233 Where a creditor has received payment of a debt owing by the debtor through an electronic funds transfer or certain types of written payment mechanisms (via a 'debtor-initiated payment'), it will take priority over an SI in the funds paid, the

[281] CP para 12.48.

[282] See DR 31.

[283] DR 38(4) and (6).

[284] DR 2(1).

[285] The term 'cash' or 'non-cash proceeds' appears on several occasions in the draft regulations. 'Cash' is a wider term than 'money' (although colloquially they are sometimes used interchangeably): cash means money, cheques and bank accounts, whereas money is defined as coins and notes: DR 2(1).

intangible which was the source or the instrument used to effect the payment, whether or not it knew of the SI at the time of payment.[286] We did not deal specifically with this provision in the CP, but it is an important one for the purposes of businesses being able to trade and raise funds. Commentators on some of the equivalent provisions in the overseas schemes have noted that the importance of this provision lies in its being the equivalent of the 'old' power of the debtor to pay creditors where the debtor's assets were subject to a floating charge. Without such a provision, it would be difficult to carry on business where a general SI - the 'replacement' to the old floating charge - had been given.[287]

3.234 We think that, for holders of money, protection should extend to a holder who either receives the money without knowledge of the SI or who, though knowing of it, gives value.

3.235 **We provisionally recommend that:**

(1) holders of money (that is, notes and coins in any currency[288]) which is subject to an SI, whether perfected or not, should have priority over that SI if the holder acquired the money without knowledge that it was subject to an SI, or is a holder for value, whether or not the holder acquires the money without knowledge of the SI;[289]

(2) a creditor who has received payment of a debt owing to it by the debtor other than by payment in cash,[290] should have priority over an SI in the funds, intangible or instrument used to effect the payment, whether or not it knew of the SI at the time of payment.[291]

TRANSFEREES OF NEGOTIABLE DOCUMENTS OF TITLE

3.236 **We provisionally recommend that a holder to whom a negotiable document of title is negotiated, and who gave value, should have priority over an SI in the document of title, whether or not the SI was perfected, unless the holder not only knew of the SI but knew that the transaction would violate its terms.[292]**

[286] DR 38(2).

[287] M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 95.1 (p 344).

[288] DR 2(1).

[289] DR 38(1).

[290] The payment has to have been received through a 'debtor-initiated payment': see DR 38(2)-(3).

[291] DR 38(2).

[292] DR 38(5)-(6).

Priority in transferred collateral

TRANSFERS BY THE SECURED PARTY

3.237 An SI may be assigned by the secured party to a new secured party. We have said that, if the SI was perfected by filing, no new filing will be required.[293] However the new secured party may wish to change the register to reflect its interest, in particular so that any notices are sent to it rather than to the old secured party (such as the notice needed to secure PMSI status over inventory, as discussed earlier). It will be possible to achieve this by filing a financing change statement.

TRANSFER BY THE DEBTOR

3.238 In contrast, if the debtor company transfers the collateral, the SI will continue in the collateral unless the transfer is authorised or the situation is one in which the buyer will take free.[294] There may be implications for perfection and priority of the SI.

3.239 One question of priority arises where, for example, the debtor receiving the transfer (the transferee) has already created a general SI over all its present and future assets, or subsequently creates one. The other systems have a series of priority rules relating to this scenario, which we think we will have to address. The difficulty is that the three schemes we have looked at differ in substance and in drafting.

3.240 Let us assume that Company A has created an SI over a machine in favour of SP1, and Company B either has created one or (before SP1 has filed against Company B or taken possession of the collateral) creates one over collateral of the same type (or a broader description, for example, all goods) in favour of SP2. Company A transfers the machine to Company B, without SP1's authority and not in the ordinary course of business (that is, it does not normally sell machines of that kind[295]), so that Company B takes subject to SP1's SI.

3.241 Another priority issue arises if Company B subsequently creates an SI over its property. Parties who carry out a search to find out what of the transferee's property may be subject to SIs will not discover the SI over the property that was transferred because the relevant financing statement will have been filed against the transferor.

3.242 The UCC rule is simple: provided SP1's interest was perfected at the time of transfer and has remained so, SP2's interest is subordinate, so SP1 has priority over SP2. This is so whether SP2's interest was created or filed before or after SP1's.[296]

[293] See above, para 3.161.

[294] See below, para 3.253.

[295] See below, para 3.258.

[296] See UCC Section 9-325, Official Comment 3, Example 1.

3.243 The SPPSA and NZPPSA take a different approach. In essence, once SP1 knows that the machine has been transferred to SP2, it has a limited period of time in which to file against SP2. If it does not do so within the time, its SI will lose its priority as against any SI subsequently created by SP2 and perfected first.

3.244 The PPSAs have a further provision dealing with advances made by SP2 under an already perfected SI.[297] SP1 will lose its priority against further advances being made or contracted for under the existing SI, unless within 15 days it acts to protect its priority. Once it knows of the transfer and who the transferee is, it has 15 days in which to file or take possession. It will have priority over any advance that is made or contracted for within the 15-day period. After that period has expired, it will have priority only if it takes possession or files against the transferee before the advance is made or contracted for.

3.245 Consultees expressed a wide variety of views on this question, some of which did not take into account the nature of the notice-filing system. We think that SP1's interest should have priority when it did not know of the transfer; that is common to all the schemes and seems incontestable. The policy question is whether SP1 should always retain priority over SP2's SI, whenever filed (as in the UCC), or should it lose priority to SIs perfected after it knows and has had 15 days in which to file against Company B but does not do so (as in the PPSAs)? After further consideration we provisionally recommend the UCC's approach. It seems an unnecessary burden on the secured party to have to file a second time. The PPSA rule does not offer SP2 much greater practical protection. Since SP2 will be bound by SP1's interest if SP2 did not know of the transfer, SP2 will, before it takes a new SI over a used machine, have to check its provenance and search against prior owners in any event.[298] This should safeguard it. To adopt the PPSA rule, qualifying SP1's rights when it knew, seems to us to invite litigation over whether or not, or at what point in time, SP1 had notice of the transfer.

3.246 **We provisionally recommend that if collateral is transferred by the debtor to a party who takes subject to the SI, then provided the secured party's interest was perfected at the time of transfer and has remained so, it should have priority over any SI created by the transferee. This is so whether the SI created by the transferee was created or filed before or after the SI created by the transferor.**[299]

CHANGES IN THE DEBTOR'S NAME

3.247 There are also issues if the debtor company changes its name. Under the current provisions of the Companies Act 1985 a company can change its name by special resolution. However, the change of name does not have effect until the

[297] SPPSA, s 35(8).

[298] Except if the machine is within the special category of uniquely serial-numbered goods for which registration by serial number will be prescribed: see above, paras 3.176-3.181.

[299] DR 37.

Registrar has entered the new name on the register and issued an altered certificate of incorporation.[300]

3.248 Some of the other systems have rules relating to the priority position of SIs when the debtor changes its name.[301] In our system however (at this stage at least), we are dealing solely with corporate debtors. We think it should be possible for Companies House to amend automatically the registry entry once it received notification of the name change from the company in the usual way. Presumably it would be possible for the software to recognise when a search by a previous name was being used and to bring up a 'warning box' with the new name. (This could be coupled with Companies House notifying any secured parties who had filed of the change in debtor name.) There would need to be a more detailed rule were our proposed system to apply to all debtors, when there would be a certainty of name changes outside the knowledge of Companies House, but this is something that can be developed at a later stage. However, we recognise that even at this stage there might be problems where an overseas company - one that Companies House has no existing record of - changes its name. It may be necessary for the draft regulations to include provisions addressing this issue, although they do not at the moment.

Liens

3.249 Although interests arising by operation of law, such as liens, are generally excluded from the scope of the draft regulations,[302] there may be a conflict between a lien and an SI over the collateral that is the subject of the lien. **We provisionally recommend that where a person in the ordinary course of business supplies materials or services with respect to goods which are subject to an SI, a lien that that person has with respect to those services and materials has priority over the SI (unless the lien is a statutory lien which expressly provides otherwise).**[303]

PRIORITY AS AGAINST EXECUTION CREDITORS

3.250 The 'residual' rules discussed above also contain provisions concerning the priority advances as against execution creditors. In essence an execution creditor will be subject to any SI that is perfected when the creditor attempts execution.[304] We have explained that this will be a change from the present situation under a floating charge. Whereas in principle[305] an execution creditor takes free of a floating charge if it has completed execution before crystallisation of the charge, under our scheme SIs will normally have attached to collateral that has been

[300] Companies Act 1985, s 28(1) and (6).

[301] See, eg, NZPPSA, s 90(1)(b).

[302] See above, para 3.61(1).

[303] DR 39.

[304] See above, para 3.153(3).

[305] The attempted execution may trigger an automatic crystallisation clause in the floating charge; see above, para 3.71.

acquired by the debtor. The execution creditor will not have priority over the SI unless the SI has not been perfected.[306]

3.251 However, we think that the 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.

3.252 **We provisionally recommend that execution creditors should have priority over unperfected SIs[307] and over a perfected SI in respect of further advances made after the secured party knows of the execution creditor's interest, unless the secured party was under an obligation to make the advance.**[308]

PRIORITY AS AGAINST BUYERS OR LESSEES

3.253 Earlier, we noted that if collateral is disposed of by the debtor, the SI continues in the collateral unless either the dealing was authorised by the secured party, in the agreement or otherwise, or the case is one in which the scheme provides that the transferee of the collateral takes free of the SI.[309] The scheme contains a number of rules about when a buyer or lessee of other collateral will take free of an SI, even where the dealing was unauthorised.

3.254 It should be recalled that the scheme distinguishes between buyers and purchasers: the latter includes both buyers and those who merely take an SI in the collateral.[310] In this section we deal with the separate provisions affecting only buyers and similar disponees of the collateral.

Unperfected SIs

3.255 In the CP we provisionally proposed that an unperfected SI should be ineffective against any person who for value acquires an interest in or right over property subject to the charge even if the buyer had actual knowledge of the SI.[311] Although a large proportion of consultees agreed with this, we have since reconsidered it in part. We think that a buyer who has actual knowledge of an SI should take subject to it even if it was unperfected. As a number of consultees have pointed out, the rule we proposed in the CP 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 SI. We therefore provisionally recommend that a buyer of collateral subject to an unperfected SI will take free of it, providing value is given and the buyer was without knowledge

[306] DR 33(7).

[307] DR 20(3). It has been suggested to us that it would be sufficient that execution was initiated by delivering a writ of execution, although we would welcome views on this point.

[308] DR 33(7).

[309] See above 3.183.

[310] See above, para 3.230.

[311] CP para 4.177.

of the SI.[312] As with the other rules, we would apply the same approach to a disposition by way of lease.

3.256 **We provisionally recommend that a buyer or lessee of collateral should take free of an unperfected SI unless it had knowledge of the existence of the SI.**

Sales of goods in the ordinary course of business

3.257 A buyer or lessee who deals with a company whose normal business is selling or leasing the kind of goods in question should not be expected to search to see if the seller or lessor has created an SI over the goods. The other schemes provide that where goods are sold or leased in the ordinary course of business, a buyer or lessee will take free of any perfected or unperfected SI unless it knew not just of the existence of the SI but that the sale or lease constituted a breach of the security agreement under which the SI was created. In the CP we explained that, in this context, 'ordinary course of business' must be interpreted more narrowly than, for example, under current law in relation to dispositions under a floating charge or even under the Sale of Goods Act 1979. In those contexts it seems to mean no more than that the sale must not be 'suspect' in some way; whereas under the UCC and PPSAs it means that the sale is one of goods of a type that the seller normally sells. Thus a buyer who buys a stock item from a dealer will take free of any SI created by the seller, and therefore does not need to search; but the person who buys, say, a used press from a printing company will be bound by any perfected SI over the press and thus should search the register before agreeing to purchase it.

3.258 In response to the CP, consultees expressed a wide variety of views on this proposal.[313] In subsequent discussion, however, a consensus seemed to emerge that this is an appropriate rule. Therefore the provision in the draft regulations is worded so that it is different from the current English law on sales in the ordinary course of business. Under the draft regulations, the rule applies if the sale is both in 'the ordinary course of business' and the seller's business normally involves selling goods (or the lessor's business normally involves leasing goods) of the type in question. This will normally be confined to sales of inventory, though it may occasionally include goods that at one time were equipment, for example if company regularly sells off its stock of equipment.[314]

3.259 It should be noted that under this rule the buyer will only take free of SIs created by the immediate seller. If the goods are second-hand it is possible that they may be subject to an SI created by a previous seller, for example, if the previous seller held them under a hire-purchase agreement that has not been paid off. Under the general rules, if the earlier SI was perfected it will be binding on the buyer. (We have already noted the special rules for uniquely numbered goods such as motor

[312] DR 20(4).

[313] CP para 12.40.

[314] DR 31(2)-(3).

vehicles[315]). In the CP we provisionally proposed, as had the Crowther and Diamond reports, that a person who buys from a dealer should take free of all SIs, since there would be no way for the buyer to discover the SI.[316] A small majority of consultees supported the proposal but the minority who disagreed made a telling point: this would constitute a major inroad into the principle that a seller cannot transfer a title it does not have, and one that is not necessary to our scheme.[317] Moreover it would have a considerable impact on those who supply equipment on retention of title terms. It should not be adopted without a full review of the law of transfer of title. We have therefore abandoned this proposal as a general rule.

3.260 **We provisionally recommend that a buyer of goods from a seller who normally sells goods of that kind, or a lessee from a lessor who normally leases goods of that kind, should take free of any perfected SI created by the seller or lessor unless the buyer or lessee knows that the sale or lease is in violation of the security agreement.**[318]

Low price goods bought for private purposes

3.261 In the CP we also asked whether a person who buys goods for private purposes, whether buying from a dealer or someone else, should take free of all SIs. This question divided consultees. Most of the other schemes have a similar provision, applicable to goods bought for less than a modest sum such as $1000. In other words, private buyers of low value second-hand equipment[319] need not search or worry about SIs over the equipment. We think it might be useful to include such a provision and for the purposes of consultation have included one in the draft regulations.

3.262 **We ask consultees whether a person who**

(1) buys goods for a purchase price of, say, £1000 or less (or leases them where they have that market value),

(2) does so primarily for personal, family or household purposes,

(3) and does not know that the goods are subject to an SI,

should take free of any perfected or unperfected SI in the goods. If so, is the figure of £1000 appropriate?

[315] See above, paras 3.176-3.181.

[316] CP paras 4.185–4-185.

[317] None of the other schemes we have considered applies this as a general rule.

[318] DR 31(2)-(3). The provisions are limited to buyers or lessees who have taken delivery or possession, compare the Sale of Goods Act 1979, s 25.

[319] Buyers of inventory will take free of the seller's SI under the rules outlined above.

Motor vehicles and other serial-numbered goods

3.263 We noted earlier that where the collateral consists of what are prescribed by the rules to be uniquely identifiable goods, it is possible for the unique number to be included on the financing statement.[320] A buyer or lessee without knowledge of the SI will take goods that are equipment free of any SI that has been perfected by filing where the goods are uniquely identifiable but where the unique number was omitted from the filing.[321]

OTHER PRIORITY SITUATIONS

3.264 There are several other areas where the UCC and PPSAs have rules addressing specific priority situations. In a number of cases we have decided not to replicate these.

Fixtures

3.265 Interests over land are excluded from the application of the draft regulations, as they generally are from the UCC and PPSAs.[322] However, on the related question of fixtures, the North American schemes have complex provisions dealing with questions of priority as between the secured party and those with interests in the land. These seem to reflect a different background in terms of the rules about fixtures. The NZPPSA does not include such rules. We think that we also can avoid complex rules on the continuation of an SI over goods that become fixtures and its priority.

3.266 Under our proposals, an SI covering the goods that ultimately become fixtures would be within the scheme, until the point that they become fixtures.[323] The SI will continue in the collateral even if it becomes a fixture, but the secured party will have no right to enforce its rights against the landowner unless the landowner has consented to the removal of the fixture (for example, by agreeing to a right of re-entry on default).

3.267 In order for the secured party to protect itself against purchasers of the land to which the goods have become affixed, it will have to take steps to register the right of entry at the Land Registry, as under the current law. Should the goods later be detached from the land, the SI in them will in revive. Whether it will be effective will depend on the usual rules of perfection. We have not thought it necessary to include specific provisions this effect.

3.268 **We ask whether consultees agree that specific rules dealing with fixtures are not needed.**

[320] See above, para 3.180. Where the collateral was equipment, and where such a unique number could have been, but was not, included, the SI would be at risk of loss of priority to subsequent SIs.

[321] See above, para 3.178, and DR 31(7)-(8).

[322] See below, paras 3.309.

[323] The question of whether goods have become a fixture is left to the current law.

Crops

3.269 We have also included provisions to deal with growing crops. We would welcome the views of consultees on whether the approach we provisionally propose is an appropriate one.

3.270 We think that an SI over growing crops should fall within the scope of our proposed scheme, so that the crop can be secured separately from the land on which it is growing. However, under current land law, a mortgagee in possession could also claim growing crops within the scope of its mortgage over the farmland. The draft regulations therefore include a priority rule designed to address this potential conflict, by providing that a perfected SI in 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.[324] This approach is similar to that taken in the UCC. It is simpler than that taken in the PPSAs, which make priority dependent upon registration of an interest in the local Land Registry Office.

3.271 This rule seems appropriate both to crops that have been planted (that is, what are sometimes referred to as *fructus industriales*: for example, a cereal crop) and to those naturally grown (*fructus naturales*: for example, fruit growing on trees). The definition however excludes trees other than crops forming part of trees, so that growing trees are neither crops nor goods, and interests over a growing stock of trees would fall outside our scheme. On this the overseas schemes vary, and we would welcome advice, particularly where the trees were planted as a crop.

3.272 **We provisionally recommend that a perfected SI 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.**

3.273 **We ask consultees whether growing trees should be treated like other crops or should be left outside the scheme.**

Accessions and commingled/processed goods

3.274 The draft regulations - as with the PPSAs - provide that an SI can continue into the proceeds of goods.[325] However, where accessions and processed/commingled goods are concerned, these may not fall within the definition of 'proceeds'. The North American and New Zealand schemes include specific provisions dealing with accessions and processed/commingled goods (particularly as to priority). In the CP we asked whether any 'restatement' should set out rules on accessions and processed/commingled goods.[326] We had only five responses to this question, but all were in favour of having such rules, principally because it would help to avoid confusion. Since the consultation process we have had the opportunity to consider this area in further detail. In the light of further comments we have received, we have come to the conclusion that

[324] DR 40.

[325] DR 29(1).

[326] CP para B.77.

the draft regulations do not need to contain specific provisions dealing with these issues; they will be covered by the general provisions of the scheme.

Accessions

3.275 When a supplier retains an SI in components that it has delivered to a buyer, a question may arise whether the supplier's interest in a component continues after it has been installed in or fixed to other goods. Under the current law, where an article is added to another article but is easily removable, without serious injury or destruction to the whole that has been formed, the proprietary rights of the supplier are unaffected.[327] If it is not easily removable, and the other article is the 'dominant chattel', the supplier's interest disappears by 'accession' to the dominant chattel. Another supplier may have an SI in the dominant chattel. The value of this interest would be increased by the value of the accession.

3.276 This is different from the rule laid down in the other schemes, which we understand represent pre-UCC law, at least in the US. These permit the secured party to remove any item that has become an accession provided that it compensates the owner of the dominant article for the damage caused (other than the mere loss in value to the dominant article). The right to remove an accession is formally unlimited; but in practice it is limited by a cost-benefit test, in that a secured party will not seek to remove an accession if the accession is worth less than the damage that will be caused. We think that this difference in the pre-scheme law explains, at least in part, why the North American treat accessions in the way that they do.

3.277 When we discussed this in one of our informal seminars, those who spoke saw no reason to adopt this approach, nor to provide that a secured party whose goods have become an accession to other, dominant goods should have an automatic SI in the dominant goods. It suffices that it is possible - as we explain below - for the supplier and the buyer to agree that the supplier should have an SI in the goods to which the component has become an accession. Therefore the draft regulations do not contain a definition of 'accessions'; this question is left to the existing law. Nor do the draft regulations set out specific rules dealing with the priority of SIs over accessions as against SIs over the dominant goods. **We provisionally recommend that specific rules on accessions are not needed.**

Commingled goods

3.278 At common law, where goods belonging to one party are mixed with similar goods belonging to another (for example, if two parcels of loose grain are stored in a single silo), the two become co-owners of the bulk. Thus if two creditors each had an SI in one of the two parcels, they would each continue to have an SI over the owner's share of the bulk. The goods have not changed in their nature, so no new filing is needed; and any SI over the share in the commingled goods will have the same priority that it had before the goods were mixed. If, for example, grain that is subject to a PMSI is mixed into a mass of other grain that is subject to an 'all assets' SI in favour of a bank, the SI over the proportion that represents

[327] See *Hendy Lennox (Industrial Engines) Ltd v Grahame Puttick Ltd* [1984] 1 WLR 485.

the 'PMSI' grain will continue to have PMSI status as against the general SI over the mass. **We provisionally recommend that there is no need for our scheme to include special rules to deal with commingled goods.**

'Processed' goods

3.279 Where goods of different natures are combined into a new article, for example resin and wood chips are combined into chipboard, it seems that any SI in the ingredients would disappear along with the identity of the ingredient.[328] The UCC and the PPSAs expressly provide that an SI continues into the new goods, and that the secured party does not need to file a new financing statement: perfection of the SI over the original goods being treated as perfection over the product or mass.[329] There are then complex rules dealing with the priority of the various competing claims, both as against each other and as against any SI over the goods as a whole.

3.280 Again, at the informal session the general view was that we should not change the common law rule that when the new product is made, the original goods and any SI over them disappear. It should be for the parties to agree expressly that the secured party should have an SI in the new goods as well as the original goods supplied.[330] This comes close to replicating the current law, save that in practice the supplier is unlikely to have an effective SI over the new goods under current law. It would be a floating charge and it is most unlikely that the supplier will register it as such. If such an arrangement were to be agreed under our proposed scheme, the SI over the new goods could be perfected by an appropriate filing, which could of course be made in advance of the transaction. No special provisions are required to achieve this result.[331]

3.281 Nor do we consider it necessary to have special priority rules for competing SIs that continue into the product; this can be left to the general priority rules. In what is probably the most common case – where several suppliers each have an SI over different ingredients and each secured party also takes an SI over the 'new goods', but the goods will have to be sold at an insolvency sale and fetch less than the unpaid prices of the ingredients – the secured parties would have priority according to the order of filing.

3.282 It should be noted that while the supplier will have a PMSI over the goods in their original state (assuming it has fulfilled the necessary conditions as to notice and filing[332]), under our proposals any SI over the 'new' goods will not be a PMSI. It will therefore be subordinate to any previously filed or perfected SI over the new

[328] *Clough Mill Ltd v Martin* [1985] 1 WLR 111, CA.

[329] UCC Section 9-336; SPPSA, s 39(3); NZPPSA, s 83.

[330] Allowing the SI to continue by agreement can be seen as a necessary quid pro quo for a system that subjects retention of title clauses to the rules of the scheme, including perfection requirements.

[331] An alternative that has been suggested to us is to extend the definition of 'proceeds', so that processed goods would be held to be the proceeds of the SI in the component part, up to its proportional share. We have not followed this approach, but would welcome views.

[332] See above, paras 3.213-3.214.

goods, such as an SI in favour of a 'stock' financier or a general SI in favour of the debtor's bank. The same would be true of any claim to the proceeds of sale or disposition of the new goods; but we have already proposed that, to protect receivables financing, the relative priority of a PMSI claim to receivables as proceeds and of an SI over them as original collateral should be governed by the order of filing.[333] **We provisionally recommend that there is no need for our scheme to include specific provisions on processed goods.**

LIABILITY IN DAMAGES

3.283 In the CP we asked whether there should be a provision to the effect that a person failing to discharge any duty or obligation imposed by the system should be liable for reasonably foreseeable loss caused to those who could reasonably be expected to rely on performance of that duty or obligation.[334] This type of provision features in the overseas schemes, although the schemes vary as to whether this is limited to the person to whom the duty/obligation was owed, or whether it is also extended to any other person who can reasonably be expected to rely on performance of it. Of those who commented, a bare majority were in favour of having such a provision, although several thought that it would be necessary to see the nature of the scheme in more detail before deciding whether such a provision was necessary. The draft regulations contain a provision that extends liability to any person who can reasonably be expected to rely on performance of the duty. We would welcome views on it.[335]

3.284 There are several provisions in the draft regulations non-compliance with which might lead to an award of damages. These include:

(1) DR 17 (secured party's obligation to use reasonable care in the custody and preservation of collateral in its possession);

(2) DR 18 (secured party's obligation to send information about a security agreement to the debtor or someone named by the debtor);

(3) DR 47 (filing a financing statement without the debtor's consent);[336]

(4) Part 5 (secured party's obligations relating to the giving of notices, disposal and distribution of the proceeds of disposal of collateral following default).

[333] See above, para 3.201.

[334] CP para 4.221.

[335] DR 71.

[336] The provision on damages is drafted with a qualification that the person filing did not have an honest belief that the debtor has consented. This is intended to catch malicious rather than mistaken filing. A person who files genuinely (but mistakenly) believing that there is consent by the debtor (including consent through entering into a security agreement) should not be liable under this provision. For example, a supplier of goods might file thinking it has won the battle of the forms to have its retention of title clause included in the contract, but in fact that clause was never incorporated, so that there is no security agreement. We do not think damages would be appropriate in this case; instead, the debtor's remedy would be to seek the removal of the financing statement under the procedure provided for in DR 55.

3.285 However, unlike some of the overseas schemes, there are no provisions awarding fixed-sum damages ('statutory damages') for breach of particular provisions. The damages provisions are also expressly without limitation to or effect on any other liability which may exist.

3.286 **Do consultees agree with the approach we have set out in DR 71 of permitting damages for reasonably foreseeable loss? If not, what sanctions should exist for failing to carry out any obligation imposed by the draft regulations? Should the availability of damages be limited to those to whom the duty or obligation is owed? If damages are an appropriate sanction, should there be provision for fixed-sum awards for breach of particular provisions?**

3.287 We would welcome views on whether the draft regulations should contain an equivalent to a provision found in the UCC, which in effect expressly provides that a secured party does not owe a duty based on its status as secured party:

(1) to a debtor, unless the secured party knows:

(a) that the person is a debtor,

(b) the identity of the person, and

(c) how to communicate with the person; or

(2) to another secured party that has filed a financing statement, unless the secured party knows:

(a) that the person is a debtor, and

(b) the identity of the person.

3.288 **Should there be a provision effectively limiting any duty of a secured party towards debtors and other secured parties unless the secured party knows that the person is a debtor or secured party as appropriate, and their identities?**

SIs and the 'specialist' registries

3.289 Under current law there are statutory provisions for the registration of certain assets at what are sometimes called 'specialist registries'. The assets concerned are land, ships, aircraft and certain forms of intellectual property, and the relevant legislative schemes allow for registration of an asset itself and, in some cases, of an interest affecting that asset (such as a charge, mortgage or assignment). A charge created by a company over such an asset must also be registered at Companies House, regardless of any other registration provisions relating to the specialist registry. Failure to comply with the company charge registration requirements will render the charge invalid against third parties on insolvency, even if the specialist registry registration provisions have been complied with.[337]

[337] For a fuller account see CP paras 2.49-2.55.

Thus a charge may need to be registered in two places. The priority of securities registered in the specialist register will depend on the rules of the particular scheme; it will not necessarily be affected by any 'constructive notice' of an earlier charge registered only at Companies House.

3.290 In the CP we noted that the Company Law Review Steering Group had proposed that neither the validity nor the priority of charges over land should depend on registration in the Companies Register, though it suggested that there should still be a penalty if the charge were not registered there, in order to ensure that the register gave a more accurate position. We suggested that the latter was unnecessary since the existence of a charge that is on a specialist register is readily discoverable from that register. We therefore made the provisional proposal that the validity and priority of charges over land, and over other assets if the charge is registrable in a specialist register, should not depend on filing a financing statement at Companies House.[338] We suggested that it would be useful, however, if the specialist registry could forward information about registered charges to Companies House so that it would also appear on the Companies House register.[339]

3.291 The responses from consultees fell into three groups. Some, including the Land Registry, welcomed the proposal without reservation. A small group were wholly opposed, on the ground that it was important that the Companies Register should have complete information about charges over the company's property. Much the largest group agreed with the proposal that validity and priority should not depend on registration at Companies House on condition that information from the specialist registry were forwarded to Companies House and included on the register for information purposes. There was particular concern about this in relation to charges over land.

3.292 Since the CP we have developed our proposals in more detail. We have considered the relationship between the Companies Register and the specialist registers, in particular the ship and aircraft registers, if the scheme is to be extended to include quasi-securities. This aspect has caused us to rethink the policy issues, because it became apparent that simply to exclude *charges* that had been registered in the specialist registry from a scheme that includes quasi-securities would cause difficulties. There would be the confusing possibility of some SIs dropping in and out of the scheme, or interests over the asset being covered by two different schemes.[340] Consequently, as we go on to explain, our

[338] CP para 4.211.

[339] Para 4.210.

[340] For example, if an exclusion were based just on the registration of a mortgage, this would mean that a finance lease would need to be perfected (invariably by filing) under our scheme, yet a mortgage over that same asset, which was registered in the specialist registry, would be outside it. There also seems little incentive for a secured party to register its mortgage at the specialist registry, when it could achieve all it wants – and arguably more – by perfecting under our scheme. Moreover, where one secured party chose not to register its mortgage at the specialist registry but another party did so choose to register, this would give rise to a clash of two priority schemes and a need to check two registers as a matter of course.

policy now is not just to exclude charges that are registered in a specialist register but to exclude any form of SI (whether charge or quasi-security) over an asset for which there is a specialist charges register.[341]

3.293 We have approached the question of aircraft, ships and intellectual property – for which there are, in most cases, specialist registries and mortgage registration provisions – on the basis that if a lender is really serious about taking security over such an asset, as opposed to just 'sweeping it up' together with the rest of the company's assets in general, it will ensure that all the necessary steps are taken to comply with any specialised 'asset' registration or mortgage registration requirements.[342] We have been told that this is the case by those involved in specialised finance in some of these areas.

3.294 Although our general policy approach to the specialist registers is similar there are differences, so we deal with each in turn. We deal first with land, and then turn to the specialist registers involving personal property.

Land

3.295 We continue to think that our scheme should exclude the creation or transfer of an interest in land, including a lease, from its scope, whether the land is registered or unregistered.[343] Neither the validity nor the priority of charges over land would depend on registration at Companies House. Matters of attachment, perfection and priority of such interests should be governed solely by land law. However we think that arrangements should be made to enable a search of the Companies Register to show registered charges over land.

3.296 We think there are two reasons for requiring all charges over a company's land to be registered at Companies House. One is to avoid the need to search two registers. The other is that the land register might not reveal every SI.

3.297 Under current law, a search at Companies House will reveal a charge over land. The land registry will not register the charge without a certificate of registration from Companies House, though a notice or caution may be entered. The exclusion of the creation or transfer of interests in land, without more, would mean that a search of the 'notice-filing' register at Companies House would no longer have this effect. A potential lender contemplating taking security from a company over its land would need to search at the Land Registry rather than at Companies House. If it were proposing to take security over both personal property and land it would have to search both registers.

[341] We still think that it would be desirable to link the various registries, although in most cases this would simply be a question of establishing a 'hyperlink' from one website to another (which would depend on the other registries being accessible in this way to conduct a search, which currently they are not).

[342] Eg, ensuring, where possible, that the asset is registered at the appropriate specialist registry, and registering any necessary mortgage or interest that can be registered there (in addition to complying with any other requirements under the Companies Act 1985 or the Bills of Sale Acts 1878-1891).

[343] The overseas schemes all exclude the creation or transfer of an interest in land: eg, SPPSA, s 4; NZPPSA, s 23.

3.298 We have been told by practitioners that it is common practice to search only the Companies Register, on the basis that the absence of any entry there of a charge over land will invalidate the charge against third parties on insolvency.[344] If it were no longer possible to search in this manner, additional work would need to be done by the lender to establish whether land was subject to a charge.

3.299 Moreover, the absence of a Companies House registration might mean that an equitable interest over land that had not been registered at the Land Registry would not be revealed at all. We have also been told that sometimes where fixed charges are taken over a portfolio of real property, those charges are only registered at Companies House and not at the Land Registry. We understand that they are not registered at the Land Registry for commercial reasons, to avoid complications where it is anticipated that the property might be sold. We do not know how common this practice is, nor whether it relates to registered land, unregistered land or both. But they raise the question, how serious a risk is presented by charges that have not been registered at the Land Registry? How many parties dealing with companies might be put at risk if the link with Companies House were broken?

3.300 If the land is unregistered, a puisne mortgage or a general equitable charge will be void as against a purchaser of the land charged with it, or of any interest in such land, unless the land charge is registered in the appropriate register before the completion of the purchase.[345] Priority of registered land charges is dealt with by the Law of Property Act 1925. Section 97 provides that that '[every] mortgage affecting a legal estate in land…whether legal or equitable…shall rank according to its date of registration as a land charge pursuant to the Land Charges Act'.[346] Therefore purchasers of unregistered land will not be affected by charges that have been registered only at Companies House and removing a requirement to register there will not affect them. It would affect principally unsecured creditors, because, if it were no longer necessary to register there, wholly unregistered charges would no longer be void as against the liquidator.

3.301 If the land is registered, a legal charge is registrable at the Land Registry. Equitable interests can be protected by notice (under the old Land Registration Act 1925, as a 'minor interest' by notice or caution), but such a notice does not affect their priority, this being determined by the first in time to create, rather than being linked to any date of notice being entered. Failure to protect by notice does not affect priority. Consequently, under current law, an equitable mortgage created by a *non*-corporate person that has not been protected by notice or caution can have priority over a second equitable mortgage,[347] even though the

[344] We would have thought that a search would be made of the land register in any event for other purposes, eg, to confirm title, but from what we are told this is not the case.

[345] Land Charges Act 1972, s 4(5). (The charge has to have been created after 1926.)

[346] 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 s 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 876-877.

[347] But not a purchaser of a legal estate.

second mortgagee could not find out about the existence of the first.[348] In the case of such a charge created by a company, even if a notice is not entered at the Land Registry, the current requirement to register the equitable mortgage at Companies House will mean its existence is discoverable. Removing this requirement would, without more, result in the priority position of equitable mortgages created by companies being the same as for individuals (that is, a potentially undiscoverable interest might have priority). Unsecured creditors would face the same problems as with unregistered land.

3.302 However, we think that the dangers of 'invisible' equitable mortgages over registered land may soon be over. The Land Registration Act 2002 contains a provision allowing rules to be made allowing for electronic conveyancing, whereby 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.[349] At present, the Land Registry is consulting on proposals for the introduction of 'e-conveyancing'.[350] Assuming that provisions along the lines of those anticipated in the Land Registration Act 2002 are introduced, the result should be that all mortgages or charges over registered land will have to be registered electronically in order to have effect. We consider it likely that any e-conveyancing proposals will be implemented before our system is operational, and that consequently the risk of 'invisibility' caused by our 'de-linking' the land register from the company charges register will no longer be a problem in respect of registered land.

3.303 E-conveyancing would solve the problem of invisible mortgages over registered land. With unregistered land there remains a risk for unsecured creditors, but we wonder how serious the risk is. First, we do not have information that many lenders rely on charges over unregistered land that are not registered under the Land Charges Act 1972. Secondly, the 'risk' faced by unsecured creditors depends not just on whether the charge is valid but on whether they can find out about it. This relates to the next point to be discussed.

3.304 In the CP we asked whether the specialist registry should forward information about charges created by a company to Companies House 'for public notice'. Most consultees who responded on the issue seemed to favour establishing some form of electronic link, and some even made support for notice-filing conditional on there being a link between the registries. It would clearly remove the need for dual searching, and would thus reduce the risk to unsecured creditors in particular, if the land registry could forward information to Companies

[348] For a discussion of this point, see Law Com No 254, *Land Registration for the Twenty-First Century: A Consultative Document*, para 7.17.

[349] Land Registration Act 2002, s 93.

[350] See *E-conveyancing: A Land Registry Consultation*; *E-conveyancing: A Land Registry Consultation Report*, and *E-conveyancing: The Strategy for the Implementation of e-conveyancing in England and Wales*. The Land Registry's *Defining the Service* received Ministerial Approval in July 2004, Written Ministerial Statement, *Hansard* (HC) 16 July 2004, col 92WS.

House and the latter could display it on, or make it available through, the register of SIs.

3.305 For so long as the system of land law permits unregistered equitable interests to have priority over subsequent equitable interests, the usefulness of forwarding information to Companies House would be limited, in that it would reveal those charges and mortgages that had been registered, but not those that had not; and there would be no reason to register an equitable mortgage in order to preserve its priority.[351] Once e-conveyancing is introduced, with the effect that all charges and mortgages will now have to appear at the Land Registry in order to be effective, a link between the registries would be more effective, as all charges and mortgages over registered land should appear. There may be some unregistered charges over unregistered land but we suspect they would be few.

3.306 There are two ways in which information that is on the land registers could be made available to those searching the Companies House register.

(1) One would be by the Land Registry forwarding information to Companies House for display on the register. Under the Land Registration Act 2002 the Lord Chancellor already has power to make rules to provide for this.[352]

(2) The other would be by establishing a 'hyper-link' between the on-screen information presented by Companies House and the electronic register of the Land Registry. This would depend on the Land Registry's e-conveyancing register being searchable by company name rather than the identity of the land, but we see no reason why this should not be technically possible.[353] It would also depend on the Land Registry marking in some electronic fashion charges over land, so that the hyperlink would give access only to charges and not to all entries (for example, holdings of land that are not subject to a charge) in a company's name. We are sure that if this is not done already it would be possible.[354]

Which system should be used seems to be a purely technical question.

3.307 We therefore think that the combination of e-conveyancing and establishing a link between two electronic registries will be sufficient to overcome the potential problems of removing the need to file charges over land at Companies House.

[351] See above, para 3.01. At present, of course, those latter charges would be required to be registered under the Companies Act 1985.

[352] The 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).

[353] A provision would be needed to take into account a change in the company name.

[354] It would only be necessary for post-commencement charges. Pre-commencement charges will already be registered and it will be possible to find them by a standard search: see below, para 3.390.

3.308 It is possible that, theoretically at least, another consequence of excluding the creation or transfer of interests over land would be that a floating charge over land would continue to be governed by the existing law rather than our scheme. However, we understand that it is far more usual to take fixed charges over land and floating charges over any property not covered by such fixed charges. We have not heard of problems arising in the PPSA schemes because of this theoretical possibility. [355]

3.309 **We provisionally recommend that the creation and transfer of interests in land should be excluded from the scope of the draft regulations. Arrangements should be made to make available on or via the Companies House register information about charges over a company's land that are registered at the Land Registry.**

Rights to payment arising in connection with land

3.310 Although the creation or transfer of interests in land are excluded from the scope of a personal property security scheme, it is very important to note that there is a distinction between interests in land and interests in any *debt* that that interest itself creates. The former is outside the scheme, the latter inside it. Thus if A grants a mortgage over Blackacre to B, the mortgage will be outside our scheme, and will be subject to the rules of land law relating to matters such as validity, registration and priority. However, if B then factors the income stream due to it as repayments under that mortgage to C, or otherwise creates a charge over its receivables, that arrangement between B and C *will* fall within our scheme.

3.311 We make this point because some of the PPSAs, in addition to excluding the creation or transfer of interests over land, also exclude transfers of rights to payment arising in connection with an interest in land, unless evidenced by a security or an instrument.[356] We prefer the approach of the UCC and the Ontario PPSA, which do not have such an exclusion.[357] Otherwise factors would have to operate under two different regimes, as would those taking security by way of a general SI (which under current law would be a floating charge).

[355] However, in respect of unregistered land, our proposals may mean that the Land Charges Act 1972 will need to be amended to remove the 'deemed' registration provision contained in s 3(7), whereby registration of floating charges under the Companies Act 1985 is sufficient in place of registration under the Land Charges Act, and that once registered under the 1985 Act the charge has effect as though it had been registered under the Land Charges Act 1972.

[356] SPPSA, s 4(f); NZPPSA, s 23(e)(ii). The OPPSA, s 4(1)(e)(ii) seems to include such interests, although commentators have suggested clarification is needed: J Ziegel and D Denomme, *The Ontario Personal Property Security Act Commentary and Analysis* (2nd ed 2000) para 4.6 (pp 84-85).

[357] The UCC Section 9-109(b) states that:

> The application of this article to a security interest in a secured obligation is not affected by the fact that the obligation is itself secured by a transaction or interest to which this article does not apply.

We have not thought it necessary to replicate this provision in the draft regulations.

3.312 **We provisionally recommend that interests over rights to payment arising from an interest in land should not be excluded from the scheme.**

Aircraft

3.313 As a general rule, an aircraft cannot fly in or over the UK unless it is registered in some part of the Commonwealth (which includes the UK[358]), a 'Contracting State' (one that is party to the 1944 Chicago Convention), or any other country with which the UK has an agreement which makes provision for the flight over the UK of aircraft registered in that country.[359] (There are some exceptions to the general rule, although they are unlikely to be of great significance in relation to company SIs.[360]) The practical effect of the legislation is that virtually all commercially-flown aircraft operated by companies in the UK will have to be registered.[361]

3.314 The UK Register of Civil Aircraft is administered by the Civil Aviation Authority (CAA) and is governed by the provisions of the Air Navigation Order 2000, as amended.[362] The legislation contains detailed registration requirements which we do not discuss here. The registration and priority of aircraft mortgages is governed by the Mortgaging of Aircraft Order 1972 (MAO).[363] The MAO provides that an aircraft registered in the UK nationality register, or such an aircraft together with any store of spare parts for that aircraft, may be made security for a loan or other valuable consideration.[364] Registered mortgages[365] have priority over unregistered mortgages and charges, and priority between registered mortgages is decided by reference to the date of registration, although nothing in the priority rules is to be construed as giving a registered mortgage any priority over any possessory lien for work done to the aircraft or statutory right of detention.[366] Priority notices may also be entered in the mortgage register.[367]

3.315 Leasing is also extremely significant in the airline financing industry. We understand that in the late 1990's, in the world as a whole, about half of the more

[358] Air Navigation Order 2000 (ANO), art 129(1).

[359] ANO, art 3(1).

[360] See ANO, art 3(2).

[361] The types of aircraft that are unlikely to be registered in the UK are mainly those that are still being built, vintage aircraft (eg, those in museums and not flying) and certain small, unmanned aircraft. In addition, those that have been de-registered from a non-UK aircraft registry and are 'between registers' may also not appear.

[362] SI 2000 No 1562.

[363] SI 1972 No 1268. For a detailed treatment of this topic, see, eg, McBain, *Aircraft Finance: Registration, Security & Enforcement* (1988 with updates).

[364] MAO, art 3.

[365] Mortgage includes a mortgage which extends to any store of spare parts for that aircraft but does not otherwise include a mortgage created as a floating charge: MAO, art 2(2).

[366] MAO, art 14.

[367] MAO, art 5(1).

modern jet aircraft were owned, but about 30% were on finance lease and about 20% on operating lease.[368]

3.316 Bearing in mind that the scheme we provisionally recommend is one that covers quasi-securities and well as mortgages, we have considered three possible options:

(1) bringing all SIs over aircraft within our scheme and taking over the mortgage registration function from the CAA (effectively closing the aircraft mortgage register),

(2) excluding mortgages that have been registered in the aircraft mortgage register, but otherwise bringing all SIs within our scheme (which would be the effect of the provisional proposal we made in the CP); or

(3) excluding *all* interests over aircraft, where that aircraft - as opposed to any mortgage - has been registered at an aircraft registry (whether in the UK registry or elsewhere).

3.317 The first option, taking over the security registration function of the aircraft registry, is unlikely to be acceptable three reasons. First, the system of aircraft registration and registration of aircraft mortgages is well-established and accepted. There seems no reason to disturb it.[369] Secondly, such a move might be seen as premature, given the work being done in relation to SIs over airframes under the Mobile Equipment Convention.[370] Thirdly, our scheme is just for companies. The existing aircraft mortgage scheme would have to continue at the CAA for unincorporated persons, and we doubt whether presenting the international aviation financing world with such a split system would prove to be attractive, even though there are already differences in the treatment of charges created by companies and unincorporated persons.

3.318 The second option, bringing all SIs within our scheme save for mortgages registered on the aircraft mortgage registry, is likely to cause problems or confusion when quasi-securities are considered. A mortgage over an aircraft would be governed by the MAO, a finance lease by our scheme. Which would have priority? It would be possible to devise rules of priority to deal with the conflict, but since title-retention devices over aircraft do not seem to cause any

[368] See *Aircraft Financing* (ed Littlejohns and McGairl, 3rd ed 1998) p 8, citing GE Capital Aviation Services.

[369] Although logically there seems no clear need for a specialist registry for aircraft mortgages, the 1944 Geneva Convention and the Mobile Equipment Convention both uphold the principle of the registration of SIs in the same register as the aircraft register. The Canadian provinces and New Zealand have chosen a different solution: although all have separate aircraft registers, the SI aspects have been taken over by the PPSAs, with aircraft being identifiable by unique serial number.

[370] The Aircraft Protocol of the Mobile Equipment Convention is intended to establish an international scheme for SIs over aircraft, with an 'international interest', which would be registered on an international registry, with priority based on date of registration. The Protocol takes a functional approach, including quasi-securities within the definition of international interest (art 2).

difficulty (because aircraft are sufficiently expensive that few will be bought or mortgaged without a careful investigation of the title to them) there seems little point in trying to include them in our scheme at the cost of introducing avoidable complications.

3.319 We think that it would be preferable to follow the third option, and exclude all SIs over registered aircraft. The existing law relating to security and quasi-security would continue to apply to interests over such aircraft. This would avoid any conflict between registered aircraft mortgages and SIs under our scheme. Materials and parts that become accessions will be governed by our scheme until they become accessions.[371]

3.320 Our scheme will apply to any SIs over aircraft that are not registered because they are in the course of construction. When the aircraft is registered, the SI over it will no longer be perfected under our scheme, nor its priority protected. If it amounts to a mortgage, the secured party will have to ensure that it is registered as soon as the aircraft is registered. We do not see that this will be unduly burdensome.

3.321 We would apply this exclusion whether the aircraft is registered in the UK registry or elsewhere in the world. It is true that not every aircraft registration system provides for the registration of mortgages and charges over the aircraft. To this extent our proposal would mean that if a company registered in England and Wales owns an aircraft registered in such a system and creates a charge over the aircraft, the charge will not be registrable. We have consulted experts in aviation finance and have been told that aircraft financing is so specialised that this will cause no problem. General lenders are most unlikely to think that they will be able to have recourse to an aircraft owned by a company if they have not taken a specific SI over it.

3.322 **We provisionally recommend that SIs over aircraft registered in the UK or anywhere else in the world should be excluded from our scheme.**

Ships

3.323 The 'ship registry' is administered in the UK by the Registry of Shipping and Seamen. As with aircraft, there are registration provisions for the asset itself, and a system of registering mortgages over ships, together with priority rules for such registered mortgages, based on date of registration. However, the mortgage provisions do not apply to all types of registered ship.[372]

3.324 The Merchant Shipping Act 1995 (MSA) and the Merchant Shipping (Registration of Ships) Regulations 1993[373] (MSR) provide for a single centralised register for

[371] Interests arising from transactions involving such aircraft, such as factoring of the income streams related to their use, would fall within our scheme.

[372] The governing legislation for registration of ships and of mortgages is the Merchant Shipping Act 1995 and the Merchant Shipping (Registration of Ships) Regulations 1993 (SI 1993 No 3138, as amended).

[373] SI 1993 No 3138.

ships, which is divided into separate Parts for different kinds of ship.[374] The registration provisions are not mandatory, although in practice ships will be registered in order to gain the benefits of establishing a nationality and to assist in proving or transferring ownership.[375] The legislation also contains what it calls 'private law provisions' (MSA, Schedule 1), which govern both transfers and mortgages of ships. However, the private law provisions do not apply to certain ships even though they have been registered.[376] Where the private law provisions do not apply, it is not possible to register any mortgage that may exist at the ship registry.[377]

3.325 In addition to providing for a prescribed form of mortgage, the legislation also sets out a priority rule between two or more registered mortgages, based on the order of registration (although there is power to allow priority notices[378]).

3.326 As with aircraft, we considered the three possible policy options of:

(1) bringing all SIs over ships within our scheme and taking over the mortgage registration function from the ship registry (effectively closing the ship mortgage register);

(2) excluding mortgages that are registrable at the ship registry, but otherwise bringing all SIs within our scheme (the CP proposal), and

(3) excluding *all* interests over ships, where that ship - as opposed to any mortgage - has been registered at a ship registry (whether in the UK registry or elsewhere).

[374] These are: Part I for ships owned by qualified persons which are neither fishing vessels nor registered as small ships; Part II for fishing vessels; Part III for small ships (ie, less than 24 metres), and Part IV for ships which are 'bareboat charter ships'. MSR, reg 2(1). The provisions relating to bareboat charters are covered in MSA, s 17, although we do not go into detail on this point here.

[375] If a ship is registered, any transfer must be effected by a 'bill of sale' satisfying the prescribed requirements, unless the transfer will result in the ship ceasing to have a British connection: MSA, Sched 1, para 2 . Where this is done, the transferee will not be registered as owner unless it has made the prescribed application to the registrar, and the registrar is satisfied that the ship retains a British connection. Where there is any transfer of a registered ship, the person ceasing to own the ship has to notify the Registrar and surrender the certificate of registry. The Registrar will then cancel the certificate of registry and 'freeze' the register pending the application for the registration of the transfer or transmission by the new owner: MSR, reg 50(1). The new owner has to apply to transfer the registration within 30 days. If this is not done, the Registrar may cancel the registration of the ship and the certificate of registry.

[376] The private law provisions do not apply to those registered as small ships (Part III) or to bareboat charter ships (Part IV). Registration of fishing vessels (Part II) can be either 'simple', in which case the private law provisions relating to transfers and the registration of mortgages do not apply, or 'full', in which case they do.

[377] Although registration at Companies House will of course be necessary in the case of companies.

[378] MSA, Sched 1, para 8. We understand that, where further advances are concerned, a second registered mortgage may rank ahead of a further advance secured by a first registered mortgage, on the ground that registration counts as notice to the first mortgagee of the second mortgagee's interest.

3.327 The first option we again reject as being unlikely to be acceptable. The system of registration of ship mortgages is very well-established[379] and we have not heard of dissatisfaction with it. Moreover, because our scheme could deal only with ships that are mortgaged by companies, the existing scheme would have to continue for unincorporated persons.

3.328 The second option (that provisionally proposed in the CP[380]) suffers from similar problems to those identified in relation to aircraft, when viewed in the light of a scheme that applies to all SIs and not just charges. There would be a real risk of competing interests over the same ship being governed by two different schemes, and hence confusion.

3.329 We therefore provisionally recommend taking a similar approach to that taken for aircraft, but with an additional qualification. Since a mortgage cannot be registered over every type of registered vessel, the exclusion should be limited to those where under English (or Scots) law registration of the mortgage is possible. Otherwise mortgages over those types of ships would be 'invisible.'[381] We have not, however, seen the need to introduce this qualification as regards overseas ship registers, for the same reasons as with aircraft.[382]

3.330 Thus we provisionally recommend that we should exclude from our scheme all interests in ships where the ship has been registered at the UK ship registry (or an equivalent one anywhere else in the world), provided that a mortgage is capable of being registered at the ship registry (that is, registrable), but otherwise bringing all SI's within our scheme.[383]

[379] It pre-dates registration of company charges by many years.

[380] Para 4.211.

[381] There only seems to be one reported case of such a situation, *The Shizelle* [1992] 2 Lloyd's Rep 444. This involved unincorporated parties. Thus we are probably not dealing with a common situation.

[382] See above, para 3.321.

[383] The relationship with the specialist registries is not an area where we have been able to derive particular assistance from the overseas schemes, given the different natures of the different national registers. The NZPPSA, s 23(e)(xi) excludes:

> A transfer, assignment, mortgage, or assignment of a mortgage of a ship (within the meaning of the Ship Registration Act 1992) that exceeds 24 metres register length (within the meaning of that Act), or any share of such a ship.

This exclusion is based on ship length, rather than the fact or otherwise of registration, and commentators suggest that this leads to an 'unsatisfactory' position with regards to ships shorter than 24 metres, as they are not excluded from the PPSA but are also potentially subject to the Ship Registration Act 1992 (SRA), in that registration is possible but not mandatory. Consequently, if such a ship were to be registered, both the NZPPSA and the SRA could apply, giving rise to potential priority conflicts: see M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 23.15 (pp 113-115).

The position in Canada varies. Neither the Saskatchewan nor the Ontario PPSAs have any exclusion for ships, based on length, fact of registration, or otherwise. However, other provinces do have an exclusion: British Columbia and New Brunswick both exclude mortgages under the Canada Shipping Act, although these exclusions seem to be based on the fact of registration rather than ship length or any other factor: BCPPSA, s 4(b)(i)

3.331 It follows that where the ship has been registered at the ship registry, and the registration is one to which the 'private law provisions' apply, so that a mortgage over the ship could (but does not have to) be registered, then any interest in the ship – whether by way of mortgage or quasi-security – is excluded from our scheme. Where such a ship has been registered, the current law will continue to exist more or less as it does at the moment (save that there would be no dual registration requirement), both for charges and for quasi-securities. We return to the point we made earlier that any lender serious about using a registered or registrable ship as security should ensure that the ship and mortgage registration provisions are complied with. Conversely, where the ship itself is not registrable either in the UK or elsewhere, or it has been registered where the mortgage registration provisions do not apply (for example, because the ship is a 'small' ship), then there is no way a lender can protect itself by registering a mortgage at the ship registry, or others find out about it. SIs over such ships fall within our scheme.[384]

3.332 It is possible that an SI could be perfected under our scheme whilst a registrable ship had not actually been registered, but then the ship becomes registered. In this case the interest over the ship 'drops out' of our scheme and is then governed by what is the 'current' law (under which the court will look to the form of the security agreement and see what sort of security or quasi-security exists outside our scheme). Hence there should never be a conflict between the priority rules of our scheme and the rules in relation to the 'excluded' interests. However, we do not think this situation will be common, and in any event it can be avoided by the lender insisting that all that can be done to register the ship is done before it takes its security.

3.333 **We provisionally recommend that any SI over a ship that is registered in the UK and to which the 'private law provisions' apply, or over a ship registered anywhere else in the world, should be outside our scheme.**[385]

Enforcement of ship mortgages

3.334 There is an additional matter to consider regarding the enforcement of mortgages. Under current law, it is probable that matters relating to the enforcement of ship mortgages will be dealt with by the Admiralty jurisdiction of the High Court, which applies to all mortgages or charges, whether registered or not, including those created under foreign law.[386] Admiralty jurisdiction in respect of claims in respect of mortgages or charges can be brought *in personam*, or *in rem* against the ship or property in connection with which the claim arises.[387] The

excludes 'a mortgage under' the Act; NBPPSA, s 4(k) excludes 'a mortgage registered under' the Act.

[384] It is possible that ships bearing an International Maritime Organisation number could be treated in the same way as we propose for vehicles, by using that unique registration number as part of the filing process.

[385] DR 12(1)(h) and (2).

[386] Supreme Court Act 1981, s 20(2)(c) and (7)(c).

[387] Supreme Court Act 1981, s 21(1)-(2).

in rem action, allowing the creditor to arrest the ship and have it sold by the Admiralty marshal, is seen by some commentators as having advantages over traditional mortgage remedies.[388] We are cautious about disturbing established practice in this specialised area, particularly if it would result in a different enforcement regime for an SI created by a company and a mortgage created by a partnership or individual. At present, there is a consistent dedicated remedial scheme that can be used for all ships, and we are cautious about altering this unless consultees advise us to the contrary.

3.335 Although the effect of our provisionally recommended policy in this area is that most company-owned or operated ships are likely to fall outside our scheme, the draft regulations contain a provision that the statement of rights and remedies is without prejudice to Admiralty practice relating to the enforcement of mortgages or charges on ships and interests in ships. We would welcome the views of consultees as to whether such a provision is necessary for those SIs over ships that fall within our scheme.

3.336 **For those SIs in ships that fall within the scope of the draft regulations, we provisionally recommend that the statement of rights and remedies contained in Part 5 of the draft regulations should be made without prejudice to current Admiralty practice relating to the enforcement of charges and mortgages in ships.[389]**

Intellectual Property

3.337 The position for interests over intellectual property is complicated by the fact that it does not comprise one particular type of asset, such as an aircraft or a ship, but rather takes several forms, each subject to its own statutory and common law provisions.[390] In some cases registration of the asset at a specialist registry (and interests in it) is possible, but in other cases there are no registration provisions.

3.338 The approach we provisionally recommend for SIs over the various forms of intellectual property follows the approach we took for aircraft and ships. We suggest that where the intellectual property right has been registered at an appropriate registry, either in the UK or anywhere else in the world, and where a mortgage or charge over that intellectual property is also capable of registration in that register (whether or not it actually has been) then *any* interest over that registered intellectual property will fall outside our scheme.

3.339 There are no legislative provisions affecting goodwill, and SIs over this will thus fall within our scheme. There are legislative provisions covering copyright and design rights, but no separate registration provisions with respect to either of

[388] See, eg, A Clarke in *Interests in Goods* (eds N Palmer and E McKendrick 2nd ed 1998) p 665.

[389] DR 56(4).

[390] The Companies Act 1985 makes a charge on goodwill or intellectual property registrable, and defines intellectual property for these purposes as comprising patents, trade marks, registered designs, copyright or design rights, and any licence under or in respect of such rights: s 396(3A).

them, or for the registration of any security affecting them (other than the Companies Act 1985 requirements).[391] Interests over copyright and design rights will thus also fall within our scheme (unless an overseas jurisdiction allows for registration).[392]

3.340 There are registration provisions with respect to registered designs, under the Registered Designs Act 1949, which also allow for notices of interests such as assignments and mortgages of registered designs to be entered in the register.[393] Interests in registered designs will thus be excluded from our scheme. Interests in registered patents and in registered trademarks will also be excluded from our scheme, as the Patents Act 1977 and the Trade Marks Act 1994 provide for both registration of a patent/trade mark and of transactions affecting registered patents and trade marks.[394]

3.341 At the moment the draft regulations refer to patents, trademarks and designs, as our understanding is that these are the only forms of IP that can be registered (all currently registrable at the Patents Office) and over which charges, mortgages (and other interests) are also capable of being registered. We have not referred to copyright in the draft regulations, as this is not subject to registration in the UK, although this would be necessary if copyright and charges over copyright can be registered elsewhere in the world. We would welcome the advice of consultees on this point.

3.342 **We provisionally recommend that SIs over registered designs, patents and trade marks should be excluded from our scheme.**

SIs OVER ASSETS ABROAD OR CREATED BY 'FOREIGN' COMPANIES

3.343 Determining policy for whether and how the draft regulations should apply to SIs created by companies registered in England Wales over collateral outside the jurisdiction, and SIs created by companies incorporated or registered elsewhere over assets in England Wales, proved to be a difficult task. The CP considered some of the issues that arise,[395] but it focussed on registration, and not all the issues were fully explored. The CP did not refer to the Regulation on Insolvency Proceedings.[396] We have also to consider that under European law – as recently

[391] See the Copyright, Designs and Patents Act 1988.

[392] Copyright and design rights are transmissible by assignment as personal property, although an assignment is not effective unless it is in writing signed by or on behalf of the assignor: our scheme will not affect this requirement of writing.

[393] There is an overlap here with unregistered design rights: where a national unregistered design right subsists in a registered design, the Registrar shall not register an interest unless satisfied that the person entitled to that interest is also entitled to a corresponding interest in the national unregistered design right. Moreover, where a national unregistered design right subsists in a registered design and the proprietor of the registered design is also the design right owner, an assignment of the national unregistered design right is taken to be also an assignment of the right in the registered design, unless a contrary intention appears: Registered Designs Act 1949, s 19.

[394] Patents Act 1977, s 32; Trade Marks Act 1994, s 63(1).

[395] CP paras 5.87-5.120.

[396] Council Regulation (EC) No 1346/2000 of 29 May 2000, OJ L160/1, June 30, 2000.

made clear by the *Inspire Art*[397] case – companies may be registered in one Member State but have their entire operation in another. Consultees' responses were helpful but also left many of the issues untouched. We are fortunate that subsequently we have received valuable advice from a number of academic and practitioner experts.

3.344 Space precludes a full discussion of all the issues we have had to consider in reaching our conclusions. In a paper for an informal seminar[398] we considered following the North American and New Zealand models,[399] 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 SIs. For example, we suggested that there would be advantages if the validity and perfection of non-possessory SIs over intangibles in general were governed by the jurisdiction in which the debtor company is registered. We also explored the relative advantages of different approaches: for example, with non-possessory SIs over goods, whether it would be better to follow the PPSA approach of leaving questions of perfection to the law of the jurisdiction where the goods are located (the '*lex situs*') at the date of attachment, save with 'mobile' equipment, where perfection is governed by the law of the place of the debtor's incorporation; or the approach of Revised Article 9, which refers to the latter law in all cases of non-possessory SIs over goods.

3.345 After discussion at the seminar and with experts subsequently, we have concluded that it would not be sensible for us to try to regulate such issues of private international law. 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 serious difficulty in practice. 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 context, in 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.

3.346 Therefore we have reverted to a minimalist approach. We deal only with questions of how the scheme will apply to SIs created by companies registered in England and Wales over their assets outside the jurisdiction, and to SIs created by companies incorporated elsewhere, or registered in Scotland, over assets here.

[397] Case C-167/01, *Kamer von Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd*.

[398] Held at Allen & Overy on October 22, 2003.

[399] See, eg, SPPSA, ss 5-8.

Companies registered in England and Wales

3.347 In relation to SIs created by 'English' companies[400] over assets outside the UK,[401] it will be seen that the draft regulations provide that in general the scheme is to apply to all types of collateral,[402] wherever the collateral is located in the world.

3.348 In practice, the effect of the scheme in relation to assets overseas will be limited. We illustrate this point by considering first possessory SIs and then non-possessory SIs over goods.

Possessory SIs

3.349 Questions of validity, priority and (so far as it can be separated from the issue of validity) perfection of possessory securities is traditionally left to the *lex situs*. In practice most issues relating to a possessory security created by an English company over its assets located in another jurisdiction will be determined in the local jurisdiction, which will apply the *lex situs*. Our scheme will not normally be relevant.

Non-possessory SIs over goods

3.350 Current law requires an English company to register at Companies House charges over its goods wherever the goods are located;[403] issues over the law governing validity and priority are left to the general law. In practice 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'[404] - is likely to be of limited effect in relation to goods that are overseas. This is because in many cases the issue will be between the secured party and another creditor who claims to have acquired rights according to the *lex situs*, and it is very unlikely that the *lex situs* will treat a security device that it recognises as valid, but which under English law amounts to a registrable charge, as invalid for want of registration under English law.

3.351 The problem may be illustrated by considering the operation of the Regulation on Insolvency Proceedings.[405] An English company may have its Centre of Main Interest in another country. Where this is another Member State, the Regulation

[400] In using the shorthand term 'English' companies, we mean companies and LLPs registered in England and Wales: see above, para 3.7.

[401] SIs over assets in Scotland are considered below, para 3.380. It will be seen that we recommend that the same rules should apply as with assets outside the UK.

[402] Thus this will include goods, accounts, intangibles, investment property and bank accounts.

[403] We take this to mean both any of the charges listed in Companies Act 1985, s 396 when created under English law and also 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. Under our proposals any transaction that had a security purpose would have to be perfected (by filing or otherwise) to be effective on the debtor's insolvency.

[404] Companies Act 1985, s 395(1).

[405] Council Regulation (EC) No 1346/2000 of 29 May 2000, OJ L160/1, June 30, 2000.

provides that on an insolvency the principal proceedings will be conducted under the law of that State.[406] The same applies if the company merely has an establishment and some assets in the State and the proceedings there are secondary ones. Thus the *lex situs* will be applied.

3.352 Even if the only proceedings are in a Member State other than that where the goods are located, under article 5 of the Insolvency Regulation the rights *in rem* of the creditor must be respected. Normally these rights will be governed by the *lex situs*.

3.353 Thus in many cases the relevant question will be decided by the *lex situs*. Whether or not the SI had been perfected according to English law would only be relevant if the law of the relevant Member State required non-possessory SIs created by companies registered in other Member States to be perfected by filing in their jurisdiction of company registration. This is unlikely to be common, particularly as regards quasi-securities.

3.354 Thus the Insolvency Regulation creates some weakness even in the current scheme of registration: the company is required to register charges wherever the goods are located but, provided that the charge is valid under the *lex situs*, the 'real' sanction that an unregistered charge will be invalid against other creditors is lost. This also has implications for our proposed scheme under which filing is voluntary. If the 'usual' sanctions of possible loss of priority and of ineffectiveness in the event of the company's insolvency do not apply, secured parties taking non-possessory SIs over goods outside England and Wales may not think it worthwhile to file under our scheme. Perfection under our scheme would really matter only if the goods (or their proceeds) were subsequently brought into England and Wales.

3.355 Where the non-possessory interest created by the English company is valid under the *lex situs*, and is one that would amount to an SI under our scheme, it might be thought that there is little point in applying the draft regulations. First, the secured party might need to perfect its SI under the local law, and so could not rely on filing in England and Wales to perfect its SI. To apply our scheme might result in a need for 'dual registration', a concept which we are trying to avoid if possible.[407] Secondly, the argument that applying our scheme so that perfection is needed in England and Wales, in order to enable creditors or others to find out what SIs the company has created over its overseas assets, is undermined if in practice the secured party would choose not to perfect under our scheme. The local law may treat the SI as perfected provided that the secured party complies with local requirements alone. If the goods are not likely to be brought into England and Wales, the secured party may take the view that the goods will never become subject to English law, and not bother to file under our scheme as well.

[406] *Ibid*, art 4(1).

[407] This is of course already the case under the current law, but if our scheme includes title-retention devices this might increase the number of cases in which dual registration would be needed, if the *lex situs* required registration of such devices.

3.356 This might suggest that the draft regulations should take the approach of the Canadian and New Zealand PPSAs, which is that an SI over goods in general should be perfected in a jurisdiction only if the goods are in the jurisdiction at the time, or are brought into it subsequently.

3.357 In fact this is not an end of the matter. The SI 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 SIs over that type of asset[408]). This would initially appear to give the secured party no rights at all, and if a second secured party took an SI that is recognised by the *lex situs*, or if the goods are validly seized by way of execution under that law, the first secured party would be unable to claim the goods against the other creditor, since that would involve an action under the *lex situs*.

3.358 However, where there are no competing secured parties or creditors who have yet levied execution, the outcome under current law seems to depend on whether the English company has an establishment in the jurisdiction where the goods are.

(1) If it does, then under the Insolvency Regulation secondary proceedings may be opened there in relation to the assets in the jurisdiction, and the proceedings will be governed by the law of the same jurisdiction.[409] Again, perfection under English law is irrelevant since the *lex situs* will not recognise it.

(2) If it does not have an establishment where the goods are, the liquidator may be able to get hold of the assets for the benefit of the unsecured creditors, but it appears that secured party will be able to enforce its SI even though it is not recognised by the *lex situs*. The English court may exercise its jurisdiction *in personam* over the liquidator to enforce the contract between the secured party and the company, and may require the liquidator to pay the proceeds to the secured party, as it did in *Re Anchor Line*.[410] This outcome under current law depends upon the charge being properly registered in England and Wales. We think that for

[408] Eg, Scots law does not recognise fixed non-possessory charges over goods.

[409] Arts 3(1) and 4.

[410] *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 did not consult on that question, but our impression is that the rule in fact serves the needs of practical justice. An English company may well have assets abroad and English creditors, secured or unsecured, may look to these as security or as assets that, if need be, may be taken to satisfy the company's debts. They may well be unaware that the assets are overseas. If they are aware of that fact and choose to rely on forms of security that are not recognised in other jurisdictions, they take the risk that they will be ousted by secured parties who take SIs of a kind that are recognised there, and also of unsecured creditors having the goods seized under local procedures; but that does not seem to be any reason to deny the rights of a party who has taken an SI that is valid under English law as against the claims of unsecured creditors or competing secured parties under the same law – provided that the SI has been publicised in the normal way by filing.

> our scheme to change this would be to risk misleading unsecured creditors and possibly subsequent secured parties.

3.359 We have concluded that the best course would be for the draft regulations to maintain the current approach, and accordingly they have the effect that non-possessory SIs created by English companies over their personal property must be perfected (by filing in the case of goods) wherever the assets are. We accept that secured parties who take SIs that they are confident will be enforceable in the *lex situs*, or who are dealing with companies that have an establishment where the goods are, will have little incentive to file. This means that other parties must realise that they will need to investigate whether or not there are SIs over the goods under local law, rather than rely merely on the register established under our scheme.

3.360 We think that it is not just the registration requirement that should apply in respect of assets overseas but the scheme as a whole. In a case like *Re Anchor Line* (admittedly a rare situation) a question may arise as to whether it was necessary for the secured party to file in order to perfect its SI, or whether it was perfected by possession or, in the case of financial collateral, 'control'. Questions of priority might also arise between competing secured parties neither of whom had an SI recognised by the *lex situs*. We think that in principle such issues should be governed by the rules of our scheme. This is so even though in practice the vast majority of issues involving assets outside England and Wales will fall to be decided by the *lex situs* and any provision of our scheme that purports to apply will be ignored.

3.361 We have considered whether it should be provided explicitly that where the collateral is located outside England and Wales, the application of the scheme is without prejudice to proprietary rights of a secured party or third parties under the law of that jurisdiction. We have been advised that this is unnecessary. However, we have provided that the application of the scheme is without prejudice to regulation 19 of the Financial Collateral Arrangements (No 2) Regulations 2003[411] (which is concerned with collateral comprising investment property).[412] This is because for book entry securities collateral in accounts within the EU Member States it appears that questions of perfection will always be governed by the law of the place in which the account is maintained. Article 9 of the Financial Collateral Directive provides that:

> the requirements for perfecting a financial collateral arrangement relating to book entry securities collateral ... and the completion of the steps necessary to render such an arrangement and provision effective against third parties shall be governed by the law of the country where the account is maintained.

3.362 We have provided that our scheme should be without prejudice to regulation 19 of the Financial Collateral Arrangements (No 2) Regulations 2003, which implement the Directive, to avoid our provisions being misleading.

[411] SI 2003 No 3226.

3.363 **We provisionally recommend that the scheme should apply to SIs created by companies registered in England and Wales over assets outside the UK.**[413]

Companies incorporated outside the UK

3.364 For companies incorporated outside the UK ('oversea', or as they are termed in the draft regulations, 'foreign' companies) the draft regulations apply only to SIs over assets that are in England and Wales or to which the law of England and Wales would apply for the purposes of determining questions of perfection and priority (for example, when financial collateral is held in an account that has no physical location but is governed by English law). We think it is appropriate that the scheme should apply as the *lex situs*. This applies to any foreign company, not just one that has a place of business in England and Wales.[414]

3.365 We consider this approach to have advantages for all concerned. First, whether the company is a UK one or a foreign one, parties who are thinking of buying or taking SIs 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 think that secured parties taking SIs over the 'English' assets of foreign companies will appreciate the certainty of knowing that if they have perfected, their interest will be valid and (subject to the normal rules) its priority will be protected. Thirdly, this should help the debtor company, as it will be able to offer better security to creditors.

3.366 Revised Article 9 provides, in effect, that filing should take place in the jurisdiction in which the debtor company is registered. That approach has great attractions; a secured party will only have to file in that jurisdiction, and searchers will only have to search there. However, it is not a workable approach in our context in which most relevant jurisdictions have no directly equivalent registers and in which the relevant jurisdiction may also require other forms of registration of certain types of SI.

3.367 We think that our scheme, including the perfection rules, should apply to SIs created by any foreign company, not just one that has a place of business in England and Wales. We do not think that a scheme that applied only to companies with places of business here would offer sufficient protection to buyers or potential secured parties.[415] We also suspect that modern business methods may enable companies to operate in the UK on quite a large scale without having a 'place of business' here, for example, if their goods are stored with third parties.

[412] DR 13(2).

[413] See DR 13(1). (Assets in Scotland are discussed below.)

[414] In the CP we suggested – at para 5.93 – limiting the scheme to those companies that had registered a place of business. Whilst all 17 consultees who responded on this point agreed with this approach, we now think that limiting the scheme in this way would not offer sufficient protection to buyers or potential secured parties. See below, para 3.367.

[415] Certainly not where motor vehicles and the like are concerned, for which we provisionally recommend filing in all cases.

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. We understand that Companies House would be able to deal with filings against foreign companies that are not registered here.[416]

3.368 Where an SI has been created by a foreign company over goods that are subsequently brought into England and Wales, it would be harsh to require that it has to be perfected immediately if it is to be valid in the company's insolvency or to retain its priority as against other secured parties. Instead, the draft regulations adopt the Canadian approach of giving the secured party a 'grace' period[417] in which to perfect its SI in accordance with the draft regulations. During that time the SI is treated as perfected, provided that it was perfected under the law of the previous jurisdiction, and continues to be so during the grace period, although it will be subordinate to the interest of a buyer or lessee who acquires its interest without knowledge of the SI and before it is perfected by possession or control.[418]

3.369 In the case of SIs over receivables where the *lex situs* of the receivable is English law, the draft regulations apply to the SI even though the debtor under the security agreement is a foreign company. Without this, those looking to buy or take security over English debts, or to take garnishee proceedings, would find it difficult to know whether there is an existing SI over them. The scheme will also apply to SIs created by foreign companies over investment property and bank accounts that are governed by English law.[419]

3.370 We note that our proposal fits with the EC Insolvency Regulation. We have said that article 5 of the Regulation requires that, whatever the law of the proceedings, as regards assets in another jurisdiction the creditor's rights under the *lex situs* must be respected.[420] For this purpose:

[416] If it is not possible, then we would expect secured parties to require oversea companies to open a place of business here and register accordingly. We assume that opening a place of business here need only be nominal (perhaps merely registering a postal box?) and therefore not burdensome; but there seems little point in making the law depend on such an empty formality.

[417] 60 days, or 15 days from when the secured party knows that the goods have been brought into England and Wales, or before perfection ceases under the law of the first jurisdiction, whichever is earlier.

[418] DR 13(5)-(6).

[419] For 'immobilised' shares held in the books of an intermediary, the current rule is that proprietary effects are governed by the domestic law of the country in which the relevant account is maintained: See the Directive on Financial Collateral Arrangements, 2002/47/EC of 6 June 2002, OJ L168/43, June 27, 2003, art 9. If the Hague Convention on the Law Applicable to Certain Rights in respect of securities held with an Intermediary (2002) comes into force it will in effect allow the parties to choose the law governing the proprietary aspects of the holding: art 4 of the Convention provides that the law applicable shall be that of the account agreement or such other law as is provided for in that agreement, provided that the relevant intermediary has an office of the designated type in the State whose law is so designated.

[420] See above, para 3.352.

> The right, recorded in a public register and enforceable against third parties, under which a right *in rem* within the meaning of paragraph 1 may be obtained, shall be considered a right *in rem*.[421]

The meaning of this provision is not completely transparent but we believe its effect to be that the right *in rem* may be subject to local registration requirements. It does not appear to be limited to rules that require registration for the right *in rem* to come into existence (for example, in Scots law a real security cannot exist without registration). The words 'may be obtained' seem to us to include registration that must be made for the right to be enforceable by the third party, which would be the case under our scheme.

3.371 We also note that the nature of our scheme, which may require the secured party to file if it wishes to perfect a non-possessory SI, appears wholly compatible with European Community company law. EC company law limits the restrictions that may be imposed on a company that is established in another Member State. Articles 43 and 46 of the EC Treaty prohibit restrictions on the freedom of establishment, including restrictions on the setting up of branches by nationals of one Member State in the territory of another Member State, unless the restriction can be justified on the grounds of public policy, public security or public health. In the *Inspire Art* case[422] it was held by the ECJ that, when a company was properly incorporated in England, the Dutch authorities could not impose on it capital adequacy requirements, nor requirements that its directors be jointly and severally liability with the company, equivalent to those required by Dutch law for domestic companies, even though the company was trading exclusively in the Netherlands. But the scheme that we propose, though it applies to SIs created by companies, does not affect the company itself.[423] There is no requirement on the company to file. It affects secured parties who deal with the company. Any restrictive effect on the company is at most very indirect and it is arguable that the effect will be to make it easier for the company to raise finance on the strength of its assets in England. As we have seen, the Insolvency Regulation seems to require that such requirements be given effect.[424]

3.372 **We provisionally recommend that SIs created by foreign companies over their assets in England and Wales, or to which the law of England and**

[421] Art 5(3).

[422] Case C-167/01, *Kamer von Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd*.

[423] For similar reasons Eleventh Council Directive 89/666/EEC of 21 December 1989 is not an obstacle. Art 1 provides that if 'a branch [is] opened in a Member State by a company which is governed by the law of another Member State' the company must disclose various pieces of information. It has been held that Member States may not impose additional disclosure requirements unless these are authorised by the Directive, 'since these may interfere with the exercise of the right to establishment and must therefore be eliminated': Case C-167/01, *Kamer von Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd*, at para 68. The perfection requirement of our scheme is imposed on the secured party not the company.

[424] Further, it is hard to see that a rule that SIs must be perfected is a restriction on freedom of establishment. The *Inspire Art* case involved what may be called an *ex-ante* restriction. The perfection requirement, even if can be said to affect the company, is a rule affecting its operation not its establishment.

Wales would apply for the purposes of determining questions of perfection and priority, should be subject to the scheme.

Scotland

3.373 Issues parallel to those just discussed arise in relation to SIs created by companies registered in England and Wales over assets in Scotland and by companies registered in Scotland over assets in England and Wales.

3.374 The current position was described briefly in the CP.[425] 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.[426] Very briefly, the law of security in Scotland is different to that in England and Wales. For example, Scots law does not recognise fixed non-possessory charges over goods, nor can a debt be assigned without notification to the debtor.[427] Scots law recognises the floating charge. Particulars of charges created by companies registered in Scotland are registrable at Companies House in Edinburgh. It appears that a floating charge created by an Scottish company will be treated as effective in England and Wales provided that it was properly registered in Scotland, and vice versa with a floating charge created by an English company over assets in Scotland.

3.375 The SLC has not yet presented its report.[428] However, if the provisional proposals made in the discussion paper are confirmed as recommendations and are brought into effect, it seems likely that the 'mutual recognition of registration' of floating charges just described would no longer apply. This is because it was proposed that under Scots law, in accordance with its general tradition, registration of the floating charge should be regarded as necessary to constitute the floating charge; and suggested that the charge document itself, not just particulars of the charge, might have to be registered.[429] Other charges would cease to be registrable.

3.376 This would seem to mean that even if English law remained unchanged, Scots law would no longer recognise a floating charge over assets in Scotland merely because particulars of it had been registered in Cardiff; the charge itself would have to be registered (presumably in Scotland since there is no facility for this in England and Wales). A change to a system of notice-filing would certainly mean the end of 'mutual recognition'; the filing of a financing statement would definitely not satisfy the proposed requirements for the charge to be constituted in Scotland. However, if Scots law were to be changed but not English law, there seems no reason why an English court should not enforce a floating charge created by a Scottish-registered company over its assets in England, provided that the requirements of Scots law as to 'constitutive registration' had been met.

[425] CP paras 5.95ff.

[426] DP No 121.

[427] DP No 121, para 4.5.

[428] We understand that it is expected shortly.

[429] DP No 121, para 2.11.

3.377 Were Scots law to remain unchanged, so that particulars of charges created by Scottish companies remain registrable in Edinburgh, but our scheme adopted for England and Wales, Scots law would be faced with the questions (1) whether to recognise 'new style' SIs created by companies registered in England and Wales over assets in Scotland as forms of security recognised by Scots law, or otherwise valid transactions;[430] and (2) whether to take into account whether the perfection requirements of English law have been satisfied.

3.378 In effect, if there is to be change on either side of the border, it may have the result predicted by the SLC in its discussion paper:[431] the two jurisdictions may revert to the position before 1982 when each regarded a company registered in the other jurisdiction as an oversea company.

3.379 In the light of this, we think that the approach we outlined above in relation to SIs created by companies registered in England and Wales over their assets outside the UK, and by companies incorporated outside the UK over their assets here, should in general terms be applied as between Scotland and England and Wales.

3.380 Thus an SI created by an English company over assets in Scotland should be subject to the scheme, including the normal rules of perfection. Whether the scheme will 'bite' will depend on what takes place. If the contest is between a party claiming rights under Scots law – for example, a judgment creditor or a buyer of the goods – and a party claiming an SI, the dispute will normally come before a Scottish court, which will apply Scots law. As we indicated earlier, it will be for Scots law to decide whether the SI is to be recognised and treated as enforceable. If the changes provisionally proposed by the SLC were to be implemented at the same time as our scheme, and the SI were to be the equivalent of a floating charge under Scots law, the secured party would presumably need to ensure that the charge document had been registered in Scotland. If, however, the contest were to be between two parties claiming interests under English law, and were to come before an English court, the English court would presumably apply the rules of our scheme even though the assets were in Scotland.[432]

3.381 Conversely, we think that a Scottish-registered company with assets in England and Wales should be able to create over them any of the full range of SIs recognised here, but should be subject to the normal rules of the scheme just like a foreign company. In other words, it should be possible for the Scottish company to file and the normal sanctions for not filing should apply. As the SLC suggested in its discussion paper, if it were not possible for the Scottish company to offer its

[430] Eg, Scots law would presumably continue to recognise title-retention arrangements such as finance leases, and might recognise SIs over goods.

[431] DP No 121, para 6.19.

[432] Compare *Re Anchor Line*, above, para 3.358 n 410.

English creditors the advantages of the notice-filing scheme, it might find itself at a competitive disadvantage.[433]

3.382 However, it should be possible to make administrative arrangements that may simplify the position for Scottish companies slightly. We understand that though companies registered in England and Wales are required to register particulars of charges in Cardiff and Scottish companies in Edinburgh, the information is in fact kept on the same computer database. Thus if charges created by Scottish companies (or, under the SLC's provisional proposals, floating charges) continue to be registered with Companies House in Edinburgh, there seems no reason why the system should not be configured so that a search of the 'English' register would reveal the 'Scottish' floating charge. The registration could be treated as perfection by filing for the purposes of our scheme, so as to save the need to register also in Cardiff.

3.383 **We provisionally recommend that an SI created by an English company over assets in Scotland should be subject to the scheme, including the normal rules of perfection. An SI created by a company registered in Scotland over assets in England and Wales, or to which the law of England and Wales would apply for the purposes of determining questions of perfection and priority, should also be subject to the scheme.**

TRANSITIONAL PROVISIONS

3.384 Two periods of time need to be considered: a period before commencement and a transitional period affecting both pre-commencement charges that are not currently registered and pre-commencement quasi-security transactions.

Commencement

3.385 There will have to be a period before commencement of the draft regulations for the electronic register to be commissioned, constructed and tested. During the course of this project we have worked on the basis that Companies House would administer the registry functions, building to some extent on its existing records, rather than a new registry being created (at least for so long as the draft regulations do not apply to non-corporate debtors). Even so, the time taken to construct the register is likely to be heavily influenced by factors outside our control, and this task should not be underestimated. We do note, however, that electronic registers of the type we envisage already exist, so it may be possible to 'buy in' at least the beginnings of a system. Nonetheless, it is likely that commissioning, constructing and bringing an electronic system to operational readiness would take at least two years.

3.386 The regime introduced by the draft regulations would effect a number of significant changes to existing law and practice. Whilst the register is being constructed we think that the registry or responsible government department would need to undertake a significant programme of 'education' for potential

[433] DP No 121, paras 6.20-6.21; compare our remarks in relation to foreign companies, above, para 3.365.

users, such as financial and legal practitioners, trade associations and representative organisations. This may also require something in the order of two years, although at least some of this education could be done concurrently with the construction of the register.

A transitional period?

3.387 The second possible period of time would be a transitional period, starting from the commencement of the draft regulations once the register is brought into operation. Any new SI created after commencement will be fully subject to the new scheme. The more difficult issue is how pre-existing interests - whether charges or quasi-securities created under the 'old' law - should be treated. In the following paragraphs we consider the position of (1) pre-commencement charges that have been registered at Companies House in accordance with the Companies Act 1985, (2) pre-commencement charges that are not registrable, and (3) pre-commencement quasi-securities.

Pre-commencement registered charges

3.388 For charges that have been registered under the Companies Act 1985 before the commencement of the draft regulations ('pre-commencement charges') there need be no transitional period.

3.389 At an earlier stage in this project we thought that it would be necessary for pre-commencement charges to be perfected by filing by the end of a transitional period if they were to remain effective thereafter. We received several representations that this would have had significant cost implications. We now think that this will not be necessary.

3.390 During our discussions with the Registrar's staff at Companies House, they indicated that they considered it feasible to establish an electronic link between the new register introduced under our scheme and their existing charge/mortgage records, which are held in electronic format. Previously we had thought this would not be possible. This would allow for the electronic system to be configured so that a search of the notice-filing register could locate the information currently held on the Companies House mortgage database and present it as a search result. The current mortgage details held at Companies House will contain most, if not all, the information that would be contained on a financing statement - indeed, somewhat more information, for example about the 'collateral description', than would be found on most financing statements. If a search of the notice-filing register can indeed locate and present the existing information held about company charges, it would make unnecessary any requirement that there be a transfer of information from one register to another, or that pre-commencement charges be re-registered (that is, perfected by filing) by the end of any transitional period. In effect, the existing registration will be treated as perfection by filing and therefore existing charges that were registered before commencement will continue to have effect indefinitely. The search result should carry an indication that it relates to a pre-commencement charge, so as to warn searchers that they should make enquiries on the point. We think that the Registrar's Rules could deal with this, and so it does not appear in the draft regulations.

3.391 In terms of priority, pre-commencement fixed charges that were properly registered before commencement will retain their existing priority as against other pre-existing charges. As against post-commencement SIs their priority will depend on the normal rules of priority of the new scheme. (In other words, if priority depends on date of filing they will have priority by virtue of having filed first, but they will not have priority over later-filed PMSIs.)

3.392 Pre-commencement floating charges will also retain their existing priority against other pre-commencement charges. In practice this priority will depend on the date of crystallisation and whether competing chargees had notice of any negative pledge clause in the agreement. From the moment of commencement the old floating charge will be treated as a 'new-style' SI: that is, it will be treated as attaching (and since it is already 'filed', being perfected) at the moment of commencement. The only exception would be if the provisions of the charge indicate that the SI is not to attach until some future event; but a mere description of the charge as 'a floating charge' will not have this effect.[434]

3.393 **We provisionally recommend 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 SIs. As against post-commencement SIs their priority should depend on the normal rules of priority of the new scheme.**

Pre-commencement unregistrable charges

3.394 Those charges that are currently not registrable at Companies House will also become subject to the new scheme on commencement and will retain their existing priority position. However, with unregistrable charges there is a question whether the chargee should have to file a financing statement in order to perfect (or perfect their SIs in some other way under the draft regulations) before the end of a transitional period; or whether the charge should simply continue to be effective indefinitely without filing.

3.395 Our initial thought was that previously unregistrable charges should have to be registered within a transitional period. Without this, there would continue to exist a set of invisible but effective charges. In order to preserve the charge's priority for the future, the date and time of filing would be deemed to be the date of original creation of the charge. Again, the financing statement should make this clear.

3.396 It has been put to us, however, that this would have significant cost implications for secured parties, not so much in the filing itself but in determining whether financial institutions have previously unregistrable charges that need to be perfected. We are told that the records of many secured parties are incomplete or not in a form that makes it easy to determine such a question. Given that we expect the number of such unregistrable charges to be relatively small, as there are few types of charge that are currently not registrable that will need to be perfected by filing under the new scheme, it may be more cost-effective *not* to

[434] See DR 15(6); above, para 3.74.

require filing. Users of the register would have to be warned that it will not reveal pre-commencement unregistrable charges; and these will have priority as from the date of creation, as under existing law.

3.397 **We ask consultees whether there should be a transitional period during which pre-commencement charges that are not registrable under current law should have to be registered.**

Pre-commencement quasi-securities

3.398 A similar question needs to be asked in relation to the much larger category of pre-commencement quasi-securities, including both title-retention devices that have a security purpose and the 'deemed' SIs such as sales of accounts. Quasi-securities that are created after commencement will of course be fully subject to the new scheme. Should there be a transitional period during which existing quasi-securities should retain their effectiveness and priority but after which they should have to be perfected (typically by filing) in order to do so? We will return to this question after describing how the two alternatives - a transitional period and no such period - would work.

A transitional period

3.399 If there were to be a transitional period we think it should be of at least five years. Just as we sought to reduce the need to 're-register' existing company charges (in effect requiring it, if at all, only for currently unregistrable charges), so we would like to reduce the inconvenience and cost of having to re-register existing quasi-securities. We understand that many typical title-retention agreements (such as finance leases or hire-purchase agreements) are in the order of three to five years. Quasi-securities over aircraft and ships can be much longer, but these will generally be outside the scope of the draft regulations.[435] We think that if there is a long transitional period – of at least five years – this would allow most 'standard' finance leases and hire-purchase agreements created before commencement to run their course before the end of the transitional period. At the end of the transitional period, those pre-commencement quasi-securities that are still in existence (for example, factoring and block discounting agreements, which we assume are less likely to be limited to a set term) would become subject to the rules of our scheme, including the perfection requirements.

3.400 In terms of priority, pre-commencement quasi-securities would continue to have the same priority, both among themselves and as against charges, as under existing law until the end of the transitional period. At the end of the period the new law would apply to them and, if they had not been perfected, the normal consequences would result. However, with a long transitional period most pre-commencement title-retention transactions would have expired before it ends, so that no action will be required. Where the quasi-security is older than this (for example, a long-term factoring agreement or a long equipment lease) and is duly perfected by filing within the period, its priority would continue to date from when the agreement was made. Again, when a financing statement was filed it should

[435] See above, paras 3.313-3.336.

indicate that the SI dates from before commencement. Again, this is something for the Rules, and does not appear in the draft regulations.

3.401 As between conflicting pre-commencement quasi-securities and subsequent SIs over the same asset, the pre-commencement quasi-security would have priority over any post commencement SI, but would be at risk of losing any priority if not perfected by filing before the end of the transitional period.

No transitional period

3.402 The alternative is not to have a transitional period for some or all types of quasi-security. Pre-commencement quasi-securities would simply continue to be effective in insolvency, and to enjoy their existing priority position as against other-pre-commencement SIs, without any filing being made.

3.403 As against any post commencement SI, the rule for pre-commencement title-retention devices would be simple: they would have priority. They would also bind any buyer of the goods.

3.404 Pre-commencement sales of accounts would be more tricky. We think that their priority as against post-commencement purchasers (buyers or secured parties) should probably depend on whether the buyer had notified the account debtor before the date of filing for the post-commencement SI. The other possibility would be that it would depend on which party first notified the account debtor, but that would mean that post-commencement purchasers would have to notify the account debtor to protect the priority of their SI. That would not be consistent with our general scheme.

Conclusion on quasi-securities

3.405 Although it was put to us that the cost of identifying and filing for long-term pre-commencement quasi-securities would outweigh the benefits, as was argued also for pre-commencement unregistrable charges, we think there is a substantial difference between the two cases.

3.406 On the one hand, with quasi-securities the benefit of applying the normal perfection rules after the transitional period would be much greater. They are far more likely to occur. Requiring perfection by the end of the period would mean that those dealing with the debtor – whether potential buyers, secured lenders, unsecured creditors or (if things go badly) an administrator or liquidator – would not have to worry about 'hidden' pre-commencement quasi-securities.

3.407 On the other, while there would be many more long-term quasi-securities, the cost of identifying them should be lower than for charges. The cost is not in the registration itself, which is cheap and easy. We were told that the cost of identifying existing charges would be high because many financial institutions have inadequate records of their charges. We think that existing quasi-securities will be much simpler to track, if only because from each one there would normally be an income stream. It should also be borne in mind that it will not be necessary to identify every agreement precisely in order to file. The secured party can perfect any number of agreements with a debtor by a single filing in general terms. Even a party that is not sure whether it has any security agreement with a

particular company can make a precautionary filing if it gets the other party's consent.

3.408 We think that there should definitely be a transitional period after which pre-existing sales of receivables should be filed, since such agreements may last for an indefinite period. On balance we think that the same should apply to title-retention devices; the potential benefits seem to us to outweigh the costs, at least if the transitional period is long enough (say five years) that the vast bulk of agreements will expire before the end of the period. We have therefore drawn up the draft regulations to include a transitional period for quasi-security devices.

3.409 **We provisionally recommend that:**

(1) Pre-commencement sales of receivables should retain their existing effectiveness and priority for a transitional period of [five] years. If they are perfected by filing within that period they will retain their priority (as from the date of creation). If by the end of that period they have not been perfected by filing they will cease to be effective in insolvency and will lose their priority as against other post-commencement SIs.

(2) We ask consultees whether they agree with our conclusion that a similar scheme should apply to post-commencement title-retention transactions and, if so, how long the transitional period should be.

INSOLVENCY ISSUES

3.410 As we noted in Part 2, the effect of our scheme on the 'floating' charge will have a number of consequences for the insolvency legislation, which at present treats fixed and floating charges differently.[436] We also noted that, although determining policy in this area was not a matter for the Law Commission, we considered that we should suggest possible solutions to the issues that arise as a result of our provisional proposals.

3.411 We are aware that our provisional recommendations will require consequential amendments to primary and secondary legislation dealing with insolvency matters. However, it has not been possible to include a list of the necessary amendments in the draft regulations at this stage. It is our intention that the draft regulations should be substantially neutral in their effect on insolvency (although clearly aspects such as the improved priority position under our scheme of what would currently be floating charges will mean the effect will not be entirely neutral). The Insolvency Act 1986 - and other pieces of insolvency legislation - contain references to a number of words, phrases or concepts that will or may be affected by our proposals, and which in turn will need to be considered for amendment. One obvious amendment that will be needed is in relation to references to the floating charge (and the knock-on effects for preferential creditors, for example). We note in passing that the determination of whether a charge is fixed or floating for the purposes of insolvency continues to trouble the

[436] See above, para 2.60.

courts. In *National Westminster Bank PLC v Spectrum Plus Ltd and others*,[437] Lord Phillips MR said:

> Priorities in the event of insolvency should not turn upon the technical skill with which the bank accounting arrangements have been set up. Professor Goode recommends 'structured personal property security legislation' of a type to be found in other common law jurisdictions. This appeal may underline the desirability of such legislation.

3.412 However, the need for amendments will go far beyond references to fixed or floating charges. For example, the terms 'secured creditor' and 'security' appear in the legislation; the definitions of these terms, and the instances of where they are used will need to be amended as appropriate (for example, the power of an administrator to deal with property of a company that is 'subject to a security').[438] 'Hire-purchase agreements', 'chattel leasing agreements', and 'retention of title agreements' are all defined terms, and amendments will need to be considered to these definitions and the circumstances in which the terms appear.[439] The provisions dealing with receivers will be affected. We do not underestimate the task of identifying all necessary consequential amendments. We have been in contact with the Insolvency Service and will continue to work with them and others on this issue. We hope to be able to include consequential amendments by the time we publish our Final Report.

[437] [2004] EWCA Civ 670.

[438] See, eg, Insolvency Act 1986, ss 15 and 248.

[439] See, eg, Insolvency Act 1986, s 251.

PART 4
FINANCIAL COLLATERAL AND PROCEEDS OF LETTERS OF CREDIT

INTRODUCTION

4.1 In Part 2 we explained that in the CP we had proposed that it should be possible to perfect SIs over investment securities and bank accounts by taking 'control' of the collateral.[1] Though the immediate responses to the CP were not easy to interpret, subsequent discussion has suggested that there is strong support for special provisions for collateral of this type, allowing control as an alternative form of perfection to filing. We have concluded that the proposed introduction of notice-filing presents an opportunity to provide a legal underpinning to the provisions of the Financial Collateral Arrangements (No 2) Regulations 2003[2] (FCAR), which apply to financial collateral arrangements under which the 'collateral taker' has 'control' but leave 'control' undefined, and to provide a sound and clear scheme of priorities for this very important form of collateral.

4.2 In this Part we explain in detail how our proposed scheme would work, and refer to the relevant draft regulations contained in Appendix A. The scheme is derived from the UCC (Articles 8 and 9 in their revised form). The draft regulations follow both this and the recommendations of a working group of the Uniform Law Conference of Canada, Civil Law Section, which proposed amendments to the Canadian Conference on Personal Property Security Law Model PPSA.[3] The Canadian proposals follow the UCC provisions very closely but are adapted to the structure of the PPSA, which is rather different from that of Revised Article 9 of the UCC. The Canadian proposals do not cover security over bank accounts; our proposed provisions for this are drawn from Revised Article 9.[4]

1 See above, para 2.138.

2 SI 2003 No 3226, which implement Directive 2002/47 EC of 6 June 2002 on financial collateral arrangements.

3 The working group's report was in response to a proposal by the Canadian Securities Administrators (CSA) of a draft Uniform Securities Transfer Act (USTA) and proposed amendments to the Ontario PPSA and the Alberta PPSA (as representative of the CCPPSL Act in force in all common law jurisdictions other than Yukon and Ontario). The working group comments on the draft prepared by the CSA Task Force, and makes some counter-proposals. A consultation paper, *Proposal for a Modernized Uniform Law in Canada Governing the Holding, Transfer and Pledging of Securities,* and revised consultative draft of USTA were published in May 2004. The documents are available on the website of the Ontario Securities Commission: http://www.osc.gov.on.ca/HotTopics/ht_usta_index.jsp#expanded.

4 In New Zealand and Saskatchewan, perfection of SIs over indirectly held investment securities is by an extended notion of possession. Possession is defined as covering the taking of physical possession of a certificate or the recording of the interest of the person in the records of the issuer or intermediary, as the case may be: NZPPSA, s 18; SPPSA, s 2(5). The priority is the same as that given to buyers of documentary intangibles: that is, the purchaser (whether a subsequent secured party or buyer) will gain priority by taking control only if it gave value and acquired the investment security without (actual) knowledge of the SI. If the purchaser acquired the investment security under a transaction

4.3 Financial collateral within the meaning of the FCAR comprises various forms of financial instrument, such as shares or bonds, and also cash held in an account. This is why this section also covers bank accounts, though the draft regulations dealing with these are separate. We think that our scheme should also cover other forms of collateral that are not financial instruments but that are held in book entry form and traded on markets: commodity contracts and commodity accounts. The UCC and the proposed Canadian scheme cover these, sometimes treating them together with investment securities as 'investment property' and sometimes separately, though the rules for the two are largely identical.[5] We understand that they were separated only because in the US commodity trading is regulated separately from investment securities. For our purposes we could refer simply to 'investment property'. However, for the time being we too have treated the two separately in the draft regulations because that makes it easier to compare our draft to what may be called the 'UCC model' and to see what the effect of it would be. In our account of the scheme, however, we will often refer simply to 'investment property' as covering both securities and commodity contracts and commodity accounts.

4.4 In the UCC not all the relevant provisions dealing with investment property are contained in Revised Article 9; many provisions on investment securities, and particularly some crucial definitions, are in Article 8 (Investment Securities).[6] Similarly the proposed Canadian amendments involve the PPSA but rest on a proposed Uniform Securities Transfer Act (USTA). Because English law has no equivalent legislation,[7] we will need to incorporate into our scheme several provisions found in Article 8 and USTA. References in the footnotes of this paper are to UCC Articles 8 and 9, to the proposed USTA and the working group's proposed amendments to the Model PPSA (WG).[8]

4.5 We have found each of these documents to be of great assistance. The provisions seem to us, for the most part, to represent current understandings and good practice on this side of the Atlantic; they also seem to fit well with the provisions of the FCAR. Therefore we have followed the 'UCC model' fairly

entered into in the ordinary course of the transferor's business, the purchaser will take free unless it knows that the transaction is in breach of the security agreement. We think the 'control agreement' and the priority rules of the UCC scheme (see in particular below, paras 4.18 and 4.46-4.47) are an improvement on this and therefore we have not adopted the NZPPSA/SPPSA approach.

5 For an exception, see below, para 4.90.

6 1994 Revision.

7 The Financial Markets and Law Committee has established a working group to consider the need for legislation on indirectly held investment securities. The working group has recently published *Property Interests in Investment Securities: Analysis of the need for and nature of legislation relating to property interests in indirectly held investment securities, with a statement of principles for an investment securities statute*. The report recommends enactment of a legislative scheme. The report and a number of background papers are available from the Financial Markets and Law Committee's website, http://www.fmlc.org. We are very grateful to the group for providing us with a copy of their draft report as well as advice.

8 The working group in fact refers to the relevant sections of the Alberta PPSA. This is very similar to the SPPSA on which we have based our draft regulations.

closely, departing from it only where we are aware that the legal context or practices in this country are different, and therefore different rules may be appropriate.

Types of investment securities

4.6 In what follows we will refer to different ways in which investment securities[9] such as shares or debt obligations (for example, 'bonds') may be held. It may help the reader who is not familiar with this area if we outline them.

4.7 First, securities may be represented by a certificate. Certificated securities may be in 'bearer form' (a type of negotiable instrument) or 'registered form' (where entitlement depends on being entered on the issuer's books as the holder).

4.8 Secondly, particularly in the UK, many shares are wholly dematerialised ('uncertificated'). All settlement takes place electronically (through CREST) and those entitled are entered as the holders on the operator's and the issuer's registers. For UK companies it is the entry in the operator's (CREST) register that confers legal title.[10]

4.9 A person who holds a bearer certificate, a person who holds a share certificate and is registered on the issuer's books and a person who is entered as the holder on the issuer's register (or, for UK shares, the register of the settlement system (CREST)[11]) each holds *directly* of the issuer. Investment securities may also be held *indirectly*. For example, frequently paper certificates are 'immobilised' by being deposited with a custodian. All settlement of trades in them takes place electronically and all entitlements consist merely of an entry in the accounts of either the custodian or a person who holds 'under' the custodian (both are 'intermediaries').[12] The ultimate investor holds a security entitlement in an account maintained for it in the books of the intermediary with which it deals. In turn the intermediary holds an entitlement in the books of a higher tier intermediary or the custodian. Equally, an intermediary may be registered with CREST as the holder of uncertificated securities but the securities are kept in a securities account maintained in the books of the intermediary for entitlement holders.

4.10 There are thus three classes of investment security:

(1) certificated negotiable securities;

(2) certificated, registered (non-negotiable) securities; and

[9] In the draft regulations we use the term 'security' rather than 'investment security'.

[10] Uncertificated Securities Regulations 2001, SI 2001 No 3755 (USR), reg 24(6). CREST covers Irish, Manx, Guernsey and Jersey securities. For these, the pre-2001 system still operates and legal title is transferred when the entry is made in the issuer's register.

[11] As the result of changes introduced by the USR.

[12] The UCC also contemplates a person who has a bearer share depositing it with an intermediary and thereafter having a 'security entitlement' credited to its account in the intermediary's books. See Official Comment to Section 8-501.

(3) uncertificated securities.

4.11 Each class of security may be held by the investor directly or indirectly. Examples of indirect holding occur when shares are certificated but immobilised; or if the intermediary who holds for the investor, or an intermediary higher up the chain, is registered as the holder in the issuer's or operator's register, or holds a negotiable security, but holds for the person (the investor or a lower-tier intermediary) shown in its books as the entitlement holder.

4.12 We will see that the scheme is not confined to investment securities. Other forms of property, in particular commodities and commodity contracts, may also be held indirectly and are included.[13] We have said that security over bank accounts is also treated in this section, since bank accounts are a form of financial collateral within the meaning of the Financial Collateral Directive (FCD)[14] and the FCAR, and also are covered by the control provisions of the UCC. They are considered separately.[15]

4.13 The UCC also applies its notion of 'perfection by control' to the proceeds of letters of credit. At the end of this Part we provisionally suggest that we should do likewise.

BASIC PRINCIPLES

4.14 Four basic ideas underlie the UCC model that we provisionally recommend our scheme should follow. We explain each in turn.

'Control' means a right to realise or appropriate the collateral

4.15 The first is that a secured party, or with investment property an outright purchaser, is treated as having sufficient 'control' to perfect its SI if it has taken all the steps that it reasonably can 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.[16]

4.16 There are three ways for the secured party to gain this type of control:

(1) To have the financial collateral transferred into its own name.

[13] See further below, paras 4.88-4.92.

[14] Directive 2002/47 EC of 6 June 2002 on financial collateral arrangements.

[15] See paras 4.93-4.132.

[16] It is worth pointing out at this stage that the notion of 'control' as used here and 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: compare the distinction between fixed and floating charges over book debts, see CP para 2.18 and *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. As we will see below, paras 4.62-4.65, a secured party may have control in the UCC sense even though the debtor also has the right to dispose of the collateral free of the SI.

(2) Where the collateral is represented by a certificate, to take possession of the certificate and any signed forms that are necessary to enable him to transfer the security. (This is termed 'delivery'.)

(3) Where the financial collateral is held on the books of an issuer or of an intermediary, or is in a bank account, to enter a 'control agreement' with the issuer or intermediary that it will accept its instructions to transfer or redeem the collateral without further reference to the debtor.

It should be noted that more than one secured party may have 'control' in the third sense.

4.17 When a party has gained control in one of these ways it will usually[17] also be the case that any other party seeking to take security over the same financial collateral, or to buy it, will inevitably discover the existence of the SI. The general principle that we adopted in the CP, that there should be no need to file when the existence of an SI will be readily discoverable,[18] suggests that in such a case it should be unnecessary to file in order to perfect the SI. Besides, as we explained in Part 2, we have now realised that the policy stated in the CP cannot always be achieved in a pure way without unjustifiably impairing the operation of the relevant market. In any event, for many forms of financial collateral the FCD prevents us requiring registration if the 'collateral taker' has control of the collateral.[19]

4.18 It may not be necessary to follow the UCC model of control precisely. Below we will discuss a situation involving certificated securities in which it might be thought that the SI will inevitably be obvious to enquirers even though the secured party does not have an immediate power of disposal.[20] We also ask whether with indirectly held securities it should be necessary that the parties have reached a 'control' agreement or whether notice of assignment should suffice.[21] The question is, in one sense, whether it should suffice that the secured party has control in a merely negative sense that what it has done will normally be sufficient to alert others of its interest, or whether we should follow the UCC in saying that control should be in the positive sense that the secured party has put itself in a position to realise or appropriate the collateral without more. We return to these questions later, but in the light of discussion with experts it is our provisional view that we should define control in the 'positive' sense.

[17] For exceptions see below, paras 4.49 n 60 and 4.109.

[18] See CP para 4.15.

[19] See above, para 2.142.

[20] See below, para 4.44.

[21] See below, paras 4.51-4.54.

Control trumps other forms of perfection

4.19 The second principle is that a secured party who perfects by control will take priority over an SI perfected by any other method (or that is unperfected).[22] The most obvious application of this is that an SI perfected by control has priority over one perfected only by filing. However it applies also where the SI is for one reason or another 'temporarily perfected'; where an SI that has attached is regarded as perfected without more ('automatic perfection');[23] and where an SI over an investment security may be perfected by taking delivery of the certificate.

4.20 The policy underlying this rule is to enable financial collateral to be taken without the need to search or make enquiries about other possible SIs.

A bona fide purchaser for value who takes control of investment property in such a way that no one else can also have control of it takes free of other interests

4.21 Under the UCC this third principle is expressed in two rules, one for certificated or uncertificated securities and the other for indirectly held investments. A secured party or other purchaser[24] who takes control of a certificated or uncertificated security, who gives value (which includes existing indebtedness[25]) and who takes without notice[26] of an earlier SI or other adverse claim, will take free of it. (Such a person is known as a 'protected purchaser'.) With indirectly held securities ('security entitlements'), the purchaser will take free only if the financial asset is credited to its account (rather than a control agreement being made that the intermediary will accept its instructions without further reference to the debtor).

4.22 The aim of these provisions is to protect the transferability of investment property. A secured party or other purchaser who obtains control or, in the case of a security entitlement, has it transferred into its own name, for value and without knowledge of competing interests, has an indisputable title like that of a holder in due course. (Bank accounts do not have or need the same transferability[27] and there is no equivalent rule for these.)

4.23 On their face, the rules seem to apply different standards according to the nature of the investment property. Under the third principle, stated above, a secured party who obtains control will take free of interests not perfected by control. What about other interests that have been protected by control, for example by an

[22] Note that as between competing secured parties, knowledge of an existing SI is irrelevant; compare the position of buyers, below. This is a general feature of the UCC and PPSA priority schemes: see above, para 3.201. We are told the UCC adopted this rule 'to protect the security of financing'.

[23] For an example of automatic perfection, see below, para 4.59.

[24] Thus this principle applies to buyers as well as secured parties. See further, paras 4.77-4.81.

[25] See DR 2(1); UCC Section 1-201(44).

[26] Consistently with the general approach of the scheme, this means actual knowledge, not constructive knowledge or notice.

[27] We would welcome confirmation of our understanding of this.

earlier secured party reaching a control agreement with the issuer or intermediary? It is not immediately obvious why a later secured party who enters a control agreement with the issuer of uncertificated securities should take free of even a similar agreement made previously by the issuer with the earlier secured party,[28] whereas to achieve that result with indirectly held investments the second secured party must take the security entitlement into its own name.

4.24 When this is applied to English law, however, the rule does make sense because CREST, which acts as the agent for issuers of uncertificated securities, will only enter what amounts to a control agreement (placing the securities into an escrow account controlled by the secured party) with one person at a time. Thus a party cannot obtain control if someone else has already done so. Nor under the CREST rules will any party be able to have securities that are held in escrow transferred into its name without the consent of the party who controls the escrow account.[29] (However, whereas the UCC rules on 'protected purchasers' deal with all 'adverse claims', our scheme can only deal with when a buyer or subsequent secured party will take free of an earlier SI.[30])

As between SIs perfected by control, priority is in the order in which control is obtained

4.25 The fourth principle is that, as between SIs perfected by control, priority will (unless agreed otherwise) be in the order that the secured parties obtained control. In practice, for the reasons just explained, this rule will apply only to indirectly held investment property and to bank accounts.

4.26 There are exceptions to this rule. Under Revised Article 9, an SI taken by an investment intermediary over an entitlement or account with itself will have priority over SIs in favour of other parties.[31] Similarly, an SI taken over a bank account by the bank itself will have priority over any other interest. However neither exception will apply if the account is transferred into the secured party's or other purchaser's name.

Provisional recommendation on basic principles

4.27 The four basic principles that we have identified as underlying the concept of control that is used in the UCC to govern the perfection and priority of SIs in investment property make taking control into a powerful mechanism. A party with control is in a very favourable position both to enforce its SI and in relation to other interests.

[28] This seems to be possible under Section 8-106(c)(2).

[29] In some legal systems it is still the issuer's register that is evidence of the holder's right. See para 4.8 n 10 above. If a company registered in England holds shares in this way, for example, if it holds shares in a Guernsey company, the issuer may not be permitted take note of any SI: compare Companies Act 1985, s 360. Again, the secured party's only option would be to have them transferred into its own name. This would also prevent anyone else gaining control of them.

[30] The circumstances in which a purchaser should take free of some other form of 'adverse claim' are outside the scope of this project.

4.28 The principles underlying the UCC seem to us, from discussion that we have held with experts in this country, to reflect the common understanding of what is meant by 'control' under the FCAR and also good practice and reasonable commercial expectations here.

4.29 **We provisionally recommend that our scheme for financial collateral should adopt as basic principles that:**

(1) a secured party, or with investment property an outright buyer, should be treated as having sufficient 'control' to perfect its SI if it has taken all the steps that it reasonably can 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;[32]

(2) a secured party who perfects by control should take priority over an SI perfected by any other method (or that is unperfected);

(3) a bona fide purchaser for value who takes control of investment property in such a way that no one else can also have control of it should take free of other SIs; and

(4) otherwise, as between SIs perfected by control, priority should (unless agreed otherwise) be in the order that the secured parties obtained control.

INVESTMENT PROPERTY

4.30 We now turn to the details of the rules on investment property. Bank accounts will be dealt with later.[33] These are the two forms of property over which SIs may be perfected by control.[34]

Definition of investment property

4.31 There is a series of interlinked definitions. Unless otherwise stated these will be found in DR 2. The first is 'investment property' itself. This covers a 'security, whether certificated or uncertificated' (typically, shares and bonds), 'security entitlement', 'securities account', 'commodity contract' and 'commodity account'. Each element of that definition is also defined.

4.32 'Security' is defined broadly to cover both shares and obligations that are 'represented by a certificate in bearer or registered form', and those

[31] For the reasons see below, paras 4.55 and 4.74.

[32] This is subject to the points to be discussed in paras 4.72 and 4.124 below.

[33] See below, paras 4.92-4.132.

[34] UCC Revised Article 9 also provides for 'control' over the proceeds of a letter of credit. We discuss whether we should include similar provisions below, paras 4.133-4.150.

> the transfer of which may be registered in books maintained for that purpose by or on behalf of the issuer, or, where the primary record of entitlement to the asset as against the issuer is the register of the operator of a settlement system, on the operator's register… and…
>
> …which - (i) is, or is of a type, dealt in or traded on securities exchanges or securities markets, or (ii) is a medium for investment and by its terms expressly provides that it is a security governed by these Regulations.

The definition used in the draft regulations is taken from the UCC.[35] It would be possible to substitute the definition of 'financial instrument' used in the FCAR if that were thought to be more appropriate because of its familiarity; the two appear to us to cover the same ground.[36]

4.33 Thus 'a security, whether certificated or uncertificated' includes 'certificated securities' that are represented by a certificate and 'uncertificated securities' that are represented by an entry on an issuer's or operator's register. In effect, for our purposes we are talking here of *directly* held securities; *indirectly* held securities will be held as 'security entitlements'[37] in a 'securities account' through the intermediary, or a higher tier intermediary, which will hold a corresponding security directly.

4.34 'Securities accounts' are accounts with intermediaries in which 'financial assets' (which include securities) are credited, the intermediary maintaining the account treating the person for whom the account is maintained (the 'entitlement holder') as entitled to exercise the rights that constitute the financial asset.[38] (Thus the

[35] Section 8-102(15).

[36] FCAR, reg 3 provides that:

> 'financial instruments' means -
>
> (a) shares in companies and other securities equivalent to shares in companies;
>
> (b) bonds and other forms of instruments giving rise to or acknowledging indebtedness if these are tradeable on the capital market; and
>
> (c) any other securities which are normally dealt in and which give the right to acquire any such shares, bonds, instruments or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payment);
>
> and includes units of a collective investment scheme within the meaning of the Financial Services and Markets Act 2000, eligible debt securities within the meaning of the Uncertificated Securities Regulations 2001, money market instruments, claims relating to or rights in or in respect of any of the financial instruments included in this definition and any rights, privileges or benefits attached to or arising from any such financial instruments;

[37] The principles developed by the Financial Markets and Law Committee's working group (see above, para 4.4 n 7) refer to what we term a 'security entitlement' as 'an interest in securities' (pr. 2(a)); but that scheme deals only with indirectly held securities (pr. 1(a)).

[38] The 'securities account' is in reality a shorthand way of referring to the assets held in the account; in that sense it is not an asset in itself but an SI can be taken over 'the securities account' so as to create an SI over the entitlements held in the account from time to time.

'entitlement holder' is the person identified in the records of the intermediary as having a security entitlement against the intermediary. A 'security entitlement' means the rights and property interest of an entitlement holder with respect to a 'financial asset'.)

4.35 'Financial assets' is a wider class than investment property. It includes (i) securities; (ii) obligations and shares that are traded or used as a medium for investment and (iii) anything else held in a securities account if the intermediary and holder have agreed to treat it as a financial asset. Class (ii) and, by definition, class (iii) are investment property for our purposes only when held in a securities account. The definition of financial assets is included to make it clear that investment property is not limited to securities.[39] (In addition, a credit balance in a securities account will be a 'financial asset'.)

4.36 But for the reference to a 'securities account', the definition of 'financial asset' would be wide enough to cover commodity contracts and commodity accounts, but these are separately defined for the reasons explained earlier.[40] So too are 'commodity customer' (the equivalent of the security entitlement holder) and 'commodity intermediary'. We deal with commodities below.[41]

4.37 **We provisionally recommend the definitions explained in the paragraphs shown of:**

(1) investment property (para 4.31);

(2) security (para 4.32);

(3) securities accounts (para 4.34); and

(4) financial assets (para 4.35).

Investment securities

'Control'

4.38 We have explained that, for investment property,[42] an SI may be perfected by the secured party obtaining control as alternative to any other form of perfection, for example by filing; and that an SI perfected by control will take priority over one perfected in any other manner. What amounts to 'control' varies according to the nature of the investment property and, in some cases, who is the secured party.

4.39 Control is not only relevant to secured parties. Under the fourth of the general principles described above, a buyer of investment property who has taken control

[39] Or to 'financial instruments' within the meaning of the FCAR, reg 3.

[40] See above, para 4.12.

[41] See paras 4.88-4.92.

[42] And bank accounts, see below, para 4.110.

of it will often take free of any other SI. For this reason the draft regulations refer to a 'purchaser' taking control rather than a secured party doing so.[43]

CERTIFICATED SECURITIES

Certificated securities in bearer form

4.40 If the certificated security is in bearer form, a person has control of it if it merely has possession of the certificate.[44] Such a person will thus obtain priority over those perfected by other means.[45] This preserves the negotiability and the efficient transfer of bearer securities.

4.41 The UCC scheme however seems to go slightly beyond preserving what we currently understand by 'negotiability' in English law. The special characteristic of negotiable instruments that is relevant here is that the holder in due course takes free of any defect in title of its transferor. A holder is only 'in due course' if it gives value (which would be the case in the situations we are considering) and takes without notice of the defect. We will see that the UCC applies this rule to buyers;[46] but a secured party who obtains control of an investment security will have priority over any previous SI irrespective of its knowledge of it. We consider this further below.[47]

Certificated securities in registered form

4.42 If the certificated security is in registered form, the secured party has two methods of perfecting by control. One is to be registered with the issuer as the holder.[48] The other is to take delivery[49] of the certificate and a signed transfer form made out to him or in blank.[50]

4.43 At this point the UCC scheme contains a complication that we may need to replicate in our scheme. A secured party who takes delivery of the certificate but without a signed transfer form is treated as having perfected, but not by control. Perfection by taking delivery will mean that the SI will be effective in the event of

[43] DR 6.

[44] DR 6(2). Section 8-106 refers to the 'purchaser' taking 'delivery'. 'Delivery' is then defined in Section 8-301. As (with one exception that will be discussed below, para 4.46) delivery seems to mean no more than that the purchaser gets possession or is registered as the holder, this seems to add an unnecessary layer of complexity and our draft regulations use delivery only in relation to certificated securities in registered form.

[45] See above, para 4.19.

[46] See below, paras 4.77-4.81.

[47] Para 4.72. This is an application of the general rule of the scheme: see para 4.19 n 22 above.

[48] DR 6(3)(b).

[49] Taking delivery in this case is simply another way of saying that the secured party has obtained possession, or that someone else has possession but holds the certificate for him: see DR 26(3). We will see that a person who obtains possession of a certificate does not always take delivery in the relevant sense: below, para 4.46.

[50] DR 6(3)(a). The UCC refers to the certificate being 'endorsed'. We understand that US share certificates commonly have a transfer form on the back of certificate itself.

the debtor's insolvency. Moreover, there is an explicit rule, creating an exception to the normal 'first to file or perfect' rule, to the effect that an SI over a certificated investment security in registered form which is perfected in this way (that is, by taking delivery of the certificate without obtaining the signed transfer form) will have priority over conflicting SIs perfected by any method other than control.[51] The question is, why not treat possession of the certificates alone as a case of 'control'?

4.44 The answer seems to be that this is an application of the UCC's principle that a secured party should be treated as having control only when it has done all it can to put itself into a position to dispose of the securities without any further proceedings:[52] thus, only if it has a transfer form signed by the debtor, rather than merely having the certificates. Since in practice no one else will be able to obtain control while the secured party has the certificate, this rule does not seem to be strictly necessary; we might treat the secured party as having sufficient control even though it is only control in a 'negative' sense rather than in the 'positive' sense required under the UCC.[53] We have decided for the time being to keep to the UCC scheme but we would welcome advice on whether a party who has taken delivery of the certificate but without a signed transfer form should also be treated as having control. To some extent the answer may depend on what is thought to be good practice in this country. We are told that when an equitable mortgage or charge over certificated, registered shares has been agreed with the debtor, some lenders will merely take possession of the share certificates[54] while others will insist on a transfer form in addition.[55]

4.45 It will be noted that we have followed the UCC and the Canadian model in referring to the secured party taking 'delivery' of the certificate rather than 'obtaining possession' of it. In most cases a person who takes delivery is simply one who obtains possession, either itself or through a third person who holds the certificate on its behalf. This sounds like using two words where one would do, and we were tempted to try to simplify the draft regulations by referring only to 'obtaining possession'. However we now think that is necessary to use a concept akin to what the UCC terms 'delivery' of a certificated security in registered form in order to avoid a difficulty that arises when a certificate comes into the possession of a securities intermediary.

4.46 The difficulty arises because a person who is the holder of a registered, certificated security (in the words of the relevant sections, a purchaser) may deliver the certificate to a securities intermediary for either of two purposes. One

[51] Section 9-328(5): see Official Comment 6; WG s 35.1(3). Again this applies irrespective of SP2's knowledge of the existing SI.

[52] See above, para 4.15.

[53] See above, para 4.18.

[54] *Gower and Davies, Principles of Modern Company Law* (7th ed 2003) p 695 n 91.

[55] A number of consultees pointed out that this is not a safe way of taking security because a duplicate certificate may be obtained. We do not see that this should prevent the SI from being treated as perfected by possession, and the risk seems equally great whether or not a transfer form is also demanded or delivered.

is so that the intermediary may re-register itself as the holder so that it can, for example, deal with the security. In this case the 'purchaser' now merely has an indirect holding – a security entitlement. The other is for safekeeping; the purchaser is to remain the direct holder. The UCC is careful to provide that when a certificated security comes into the possession of a securities intermediary who holds it for the purchaser, the latter has 'control' only if the certificate is still in the purchaser's name and has not been endorsed over to the intermediary (or in blank)[56] – for if it has, the intermediary will be able to transfer it and the purchaser will only have a security entitlement. The UCC achieves this result by providing that there is 'control' of the certificate only if there is delivery and by defining delivery so as to require that the certificate is still in the purchaser's name and has not been endorsed over to the intermediary (or in blank).

4.47 The UCC also uses the word 'delivery' to describe the transfer of an uncertificated security into the name of the purchaser or someone who holds on its behalf. The Official Comments to the UCC note that this seems 'a bit solecistic' but follows routine usage.[57] It seems to us to be unnecessarily confusing and the draft regulations refer simply to the uncertificated security being registered in the name of the purchaser.[58]

4.48 **Do consultees agree that it is unnecessary for the draft regulation dealing with control to refer to someone 'holding on behalf of' the purchaser?**

UNCERTIFICATED SECURITIES

Uncertificated securities held through CREST

4.49 As we explained earlier, title to uncertificated securities in UK companies depends on the entry in the register maintained by CREST. A secured party may take control of an uncertificated security of this kind by having the security transferred into its own name[59] or by getting the registered holder to transfer it into an escrow account in the holder's own name over which the secured party has a power of attorney.[60]

[56] Section 8-301(a)(3).

[57] Section 8-301, Official Comment 3.

[58] DR 6(5)(a).

[59] See DR 6(5)(a); compare Section 8-106(c)(1) and 8-301(b)(1).

[60] See DR 6(5)(a); compare Section 8-106(c)(2), which is the nearest equivalent. (On 'control agreements' see further below, para 4.51.) CREST will act only on a properly authenticated dematerialised instruction (PADI); in this case the PADI is known as a TTE (Transfer To Escrow) and will mean that only the person nominated - the secured party or its nominee - may issue the instruction (a TFE – Transfer From Escrow) to release the holding from the escrow account. In the past, doubts have been expressed as to whether putting the shares in an escrow account is of itself enough to confer a proprietary interest (see CP para 2.71) but it seems to us that a security agreement could be implied from the circumstances and that there is no reason why, under the new scheme, an escrow should not amount to a security agreement. (Note that CREST will not reveal the existence of an escrow to a third party even at the registered holder's request. We consider that this would create only a minor exception to the 'publicity principle'. A secured party who is seriously concerned to

Uncertificated securities where title depends on the issuer's register

4.50 Title to uncertificated securities issued by companies outside the UK may depend on registration of the holder in the issuer's register. Since a company registered in England and Wales might own such shares, and SIs over them will need to be perfected under our scheme,[61] we need to provide that these also may be perfected by control as an alternative to filing. Here the secured party may perfect by control by being registered as the holder.[62] The draft regulations also allow for control agreements in this situation. UK issuers are not permitted to make such agreements, but it seems from the UCC that US issuers may be permitted to do so. Since companies registered in England and Wales may hold securities issued in the US, we need to provide for these too.

SECURITIES HELD THROUGH AN INTERMEDIARY

4.51 With indirectly held securities there are two methods by which the secured party (or a buyer) may obtain control. The first is, again, to have the security entitlement transferred into its name.[63] The other is to obtain the agreement of the intermediary that the intermediary will comply with instructions from the secured party on the transfer or redemption of the property in question without further consent from the entitlement holder. This is known as a 'control agreement'.[64]

4.52 The requirement that the intermediary must have agreed to the arrangement before there will be control may go further than is required by current law. It will be recalled that under the FCAR, 'control' is not defined. Under current law it seems that there are three ways in which a creditor may perfect a security over indirectly held investments. One is by an agreement between debtor, intermediary and creditor that the security entitlement will be transferred into the name of the creditor (a novation; this is the equivalent of our first method). Secondly, without the entitlement being nominally transferred, the intermediary may agree to hold for the creditor (an 'attornment').[65] Thirdly, the intermediary may be given notice that the investments have been assigned. The current view is that any of these three methods may be used.[66] However, it seems to be accepted to be good practice for the secured party to seek an attornment, because the secured party who relies on a mere notice of assignment will take

have uncertificated shares as security can itself seek to escrow; it will then discover the existing escrow quickly enough.)

61 See above, para 2.148.

62 DR 6(5)(b).

63 DR 6(6).

64 DR 6(6) and (8). Note that a securities intermediary is required to confirm the existence of a control agreement to a third party if so directed by the entitlement holder: below, para 4.55.

65 Attornment is not often thought of as a form of perfection because in many contexts, for example, receivables financing, little is to be gained by framing a security as an attornment rather than an assignment. See F Oditah, *Legal Aspects of Receivables Financing* (1991) p 90; R Goode, *Legal Problems of Credit and Security* (3rd ed 2003) para 1.54 (p 38).

66 R Goode, *Legal Problems of Credit and Security* (3rd ed 2003) para 6-28 (p 224).

subject to any rights of set-off the intermediary may already have against the debtor.[67]

4.53 The reason that the UCC requires an agreement between the intermediary and the secured party is to ensure that the intermediary has agreed to accept the secured party's instructions to transfer or dispose of the security entitlement if necessary. Thus the secured party has taken all the steps that it reasonably can 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, as required by the first of the principles underlying the UCC.[68] We think that it is not essential to require agreement, rather than a notice of assignment. It would be possible to treat a secured party who has merely given a notice of assignment as having not only a perfected SI but as having sufficient 'control' that the secured party should have priority over a subsequent secured party who gives notice or obtains an attornment. This would be 'control' in a 'negative' sense.[69] However we understand that a well-advised secured party in this country will seek control in the 'positive' sense by obtaining an agreement with the intermediary that it will accept the secured party's instructions to transfer or dispose of the security entitlement. It seems sensible to require it as a condition of 'control', and the draft regulations so provide. We would welcome views on the point.

4.54 **Do consultees agree that an agreement between the intermediary and the secured party, rather than simply a notice of assignment, should be a condition of 'control' and its consequences?**

SECURITY TAKEN BY INTERMEDIARIES

4.55 It will frequently happen that an intermediary lends money to a client to purchase investment securities that are then held as an entry in the institution's own books, and are subject to an SI in the intermediary's favour. Many intermediaries are also ready to advance funds to their clients for other purposes against the security of the client's account. This is an efficient way to borrow at least in the short term and we do not wish to put any impediment in its way. In any event there is no need to require filing in order to alert enquirers. If the intermediary volunteers information or is required by the debtor to give it, the intermediary has an obvious interest in informing the enquirer of its own interest, since if it was asked to give information and failed to mention its own SI, the intermediary might be estopped from enforcing its interest. Thus the intermediary's SI is treated as perfected by control.[70]

[67] *Ibid*.

[68] See above, para 4.15.

[69] See above, para 4.18.

[70] DR 6(9); compare Section 8-106(e).

SECURITIES ACCOUNTS

4.56 With indirectly held securities, the control may be over a particular entitlement;[71] or it may be over the debtor's account with the intermediary.[72] The draft regulations, like the UCC, provide that:

(1) The attachment of an SI in a securities account is also attachment of an SI in the security entitlements carried in the securities account.[73]

(2) Perfection of an SI in a securities account also perfects an SI in the security entitlements carried in the securities account.[74]

(3) A person who has control of all security entitlements held in a securities account has control over the securities account.[75]

CONTROL OF INVESTMENT SECURITIES: A SUMMARY

4.57 **We provisionally recommend that with investment securities, a secured party or other purchaser will have control:**

(1) With a certificated security in bearer form, if it takes possession of the certificate;

(2) With a certificated security which is in registered form if it:

(a) takes delivery of the certificate with a signed transfer form made out to him or in blank, or

(b) is registered with the issuer as the holder;

(3) With an uncertificated security if:

(a) in systems in which it is entry in the register of the operator of the settlement system that determines legal title, either-

(i) the purchaser is entered in the register of the operator as the holder, or

(ii) the operator, on the instructions of the registered holder, has placed the security into a sub-account in the holder's own name but has given the purchaser a power of attorney over the security, or

[71] In practice this will be no more than an entitlement to a proportion of the shares of that type held in the books of the intermediary; there will be no entitlement to particular shares.

[72] See above, para 4.34 n 38.

[73] DR 15(12); compare UCC Section 9-203(h); WG s 12(4).

[74] DR 21(1).

[75] DR 6(13).

(b) in systems in which it is entry in the register of the issuer that determines legal title, either –

(i) the purchaser is entered in the register of the issuer as the holder, or

(ii) the issuer has entered into a control agreement with the purchaser;

(4) With a security entitlement, if it-

(a) becomes the entitlement holder; or

(b) has entered into a control agreement with the intermediary; or

(c) is the entitlement holder's own securities intermediary, to whom the entitlement holder has granted an SI.

Control over a securities account amounts to control over the security entitlements carried in the securities account.

Disclosure of the control agreement

4.58 The existence of a control agreement is information that is confidential to the client and that the intermediary would normally refuse to disclose. However a subsequent potential lender may reasonably require a confirmation from the intermediary as to what, if any, control agreements already exist in relation to the account. For consultation purposes we have included a provision to that effect in the draft regulations.[76] **We ask whether the issuer or intermediary should be obliged to disclose what control agreements exist if required to do so by the registered holder or entitlement holder.**

SECURITY GIVEN BY INTERMEDIARIES

4.59 It can also happen that an intermediary creates an SI in favour of a third party over security entitlements. (It should do this, of course, only with the client's consent, or with entitlements that it holds 'in excess' in the sense that they do not represent holdings of its own clients but are held for itself.) As when dealing with any other debtor, the secured party may require that it becomes the entitlement holder. However, in this case the UCC permits an alternative. An SI in investment property created by a securities intermediary or by a broker is 'automatically perfected' on attachment.[77] In other words, the secured party need do nothing specific in order to perfect the SI.

4.60 We understand that the two methods of perfection are designed to reflect two different market practices. The secured party taking an SI from an intermediary

[76] DR 6(10); UCC Section 8-106(g); USTA s 34(2). CREST would not at present respond to any such enquiry even on the request of the holder.

[77] Section 9-309(10).

may require what the UCC refers to as a 'hard pledge' – for example, that the entitlements are placed into a special pledge account. That would be a form of 'control'. Alternatively, the secured party may rely simply on an agreement that it can treat the investment securities as its own when necessary. This is referred to as a 'soft pledge' and there is 'automatic' perfection without control or filing.[78] This seems convenient and it presents little danger to other purchasers, because if the intermediary subsequently creates another SI over the same investment property, or the party entitled does so, and the second SI is perfected by the secured party taking control, SP2 will have priority, as perfection by control gives priority over SIs perfected by other means.[79]

4.61 **We provisionally recommend that an SI in investment property created by a securities intermediary is treated as perfected when it attaches, without further steps being required.**[80]

DEBTOR MAY RETAIN RIGHT TO DEAL WITH SECURITY ENTITLEMENT

4.62 In the case of indirectly held securities, if the secured party makes a control agreement with the intermediary, it has control whether or not the entitlement holder retains the right to deal with the entitlement.[81]

4.63 When we first learned of this provision of the UCC,[82] we were worried by it. We could envisage a scheme that allowed the debtor to substitute other investment securities for those originally subject to the SI; but if the debtor retained complete freedom to deal with the entitlement, what security would the secured party have? Again after informal consultation we have realised that this was a misconception. We had been thinking in terms of the old, fixed security: the debtor's freedom to trade in the securities would indeed be inconsistent with that. However, the floating charge allows a debtor to dispose of assets subject to the charge so long as the charge had not crystallised (and, depending on the terms of the charge, there is no guarantee that the proceeds of such activities will fall within the charge). Thus there is nothing incompatible between allowing the debtor to deal with the entitlement and having an SI, though obviously it will provide the secured party with less certain security than if it can prevent the debtor dealing.

[78] See Section 9-309, Official Comment 6. We are told that this rule was adopted simply to make the market more efficient.

[79] Whereas if the first SI were treated as perfected by control, it would retain priority even though the investment intermediary had failed to warn SP2 of the existence of the earlier interest.

[80] See DR 21(4).

[81] DR 6(6); compare UCC Section 8-106(f).

[82] This goes further than the FCAR: under the FCD and the FCAR the collateral is to be regarded as in the possession or control of the collateral taker despite any right of the collateral-provider to substitute equivalent financial collateral or to withdraw excess collateral. We think such an arrangement would not prevent the charge being by a fixed charge under current law.

4.64 **We provisionally recommend that a secured party may have control of indirectly held securities whether or not the entitlement holder retains the right to deal with the entitlement.**

4.65 The UCC applies the same rule to control agreements with the issuer of uncertificated securities.[83] However, CREST does not allow the debtor to deal with securities placed in escrow. Under our scheme it would be possible for a secured party to allow the debtor the right to continue to deal with uncertificated securities held on the CREST register but only if the holding remained in the debtor's name and was not placed in escrow. The SI would then not be perfected by control. It would have to be perfected by filing and it would be vulnerable to losing priority to a later one that was perfected by control.

SECURITY AGREEMENT IN WRITING

4.66 We have explained that, unlike the other schemes, our proposals do not require that a security agreement be in writing. With indirectly held securities, since the interests being transferred will always be equitable, arguably a signed writing would be currently required by the Law of Property Act 1925, section 53(1)(c) but, in cases covered by the FCAR section 53(1)(c) is disapplied and we have recommended that it be disapplied in any case covered by our scheme.[84]

4.67 The disapplication of section 53(1)(c) by the FCAR has the result that where the collateral-provider and taker are both non-natural persons, no signature is required, but it seems that an unsigned writing is still needed. Article 3(2) of the FCD states that its prohibition on formality, referred to above, is without prejudice to the FCD's application to financial collateral 'only once it has been provided and if that provision can be evidenced in writing and where the financial collateral arrangement can be evidenced in writing or in a legally equivalent manner'. We do not find this easy to interpret; it is not clear whether this imposes a requirement of writing, either as to the control or as to the security agreement, or merely allows Member States to require one. But in any event the FCAR disapply section 53(1)(c) only when there are 'security' or 'title-transfer' financial collateral arrangements, and each of these is defined in terms that require the arrangement to be 'evidenced in writing',[85] so writing (but not a 'signed writing') will continue to be required in any event. (This is so whether the SI is legal or equitable, which under our scheme will be of no importance.) These provisions apply to indirectly held securities and to holdings under CREST. We have doubts as to the usefulness of this requirement. However, as under the FCD 'writing' includes recording by electronic means and any other durable medium, it is most unlikely that there will not be some written evidence of a security agreement[86] over

[83] UCC Section 8-106(f).

[84] DR 14(3). See above, para 3.80.

[85] FCAR, reg 3.

[86] Under FCAR, reg 3 it is not wholly clear whether the evidence in writing requirement refers only to the security agreement, only to the arrangement with the operator, issuer or intermediary or to both. We think reg 3 should be interpreted in the light of the FCD, art 1(5), which only requires that the financial collateral arrangement (ie, the security agreement) be evidenced in writing.

investment property. In any event, it seems sensible to keep our scheme in line with the FCD. **Therefore we provisionally recommend that control over uncertificated securities or indirectly held securities (that is, those covered by the FCAR) should not be effective to perfect an SI unless the security agreement is evidenced in writing.**[87]

RIGHT OF USE/ON-PLEDGING

4.68 We understand that it is common for a secured party who takes security over investment property to 'on-pledge'; that is, to use the collateral to create further SIs. This is certainly true of a 'repo';[88] the title is transferred to the secured party who can use its title for that purpose. With a traditional security like a mortgage there may be a right at common law to on-pledge.[89] In any event, the FCD requires Member States to ensure that collateral takers have a right of use if one has been agreed between the parties. The FCAR, regulation 16 states that:

> If a security financial collateral arrangement provides for the collateral taker to use and dispose of any financial collateral provided under the arrangement, as the owner of it, the collateral taker may do so in accordance with the terms of the agreement.

Revised Article 9 provides that a secured party who has possession or control of collateral may create an SI in it.[90] At least in relation to investment property[91] we think it would be sensible to have a similar provision but one that explicitly allows the secured party to dispose of the collateral if that has been agreed between the parties.[92] **We provisionally recommend that a secured party that has control of investment property should have the right to create a further SI in it and, if agreed, to sell it.**[93]

[87] See DR 6(7).

[88] For a discussion of 'repos', see CP paras 6.38-6.45.

[89] *Donald v Suckling* (1866) 1 LRQB 585, though there may be residual doubts in some quarters: eg, J Benjamin & M Yates, *Law of Global Custody* (2nd ed 2002) para 4.22.

[90] Section 9-207(c)(3). Further, Section 9-207(b)(4)(C) permits the secured party to use collateral of any kind 'in the manner and to the extent agreed by the debtor.'

[91] We consider the right to use other forms of collateral below, paras 5.44-5.46.

[92] The Canadian proposals include such a right but it is limited: 'not sell, create a security interest in or otherwise deal with the collateral on terms which might impair the debtor's right to redeem it': WG s 17.1(c). A similar limitation had been found in former Section 9-207. The CSA had proposed a right like that in Revised Section 9-207. At least in relation to investment property, which is normally fungible (or merely a right to a proportion of a particular issue), the debtor may not be at all concerned if the secured party has, for example, on-pledged the securities the debtor transferred for a greater sum or a longer period than covered by the security agreement between the debtor and the secured party; the debtor will expect the secured party to return equivalent securities. If it is willing to trust the secured party to do this we see no reason to prevent it, even if the FCAR did not dictate that the parties' agreement must be respected.

[93] See DR 17(5)(b) and (c). In Part 5 of this consultative report we discuss having a statement of rights and remedies in the draft regulations, and we explain that where collateral is in the secured party's possession or control, in addition to having a right of use the draft regulation also provides that the secured party may hold as additional collateral

4.69 An on-pledge will normally result in the 'on-pledgee' being given 'control', for example, by the intermediary entering the 'on-pledgee' in its records as the entitlement holder, or an intermediary accepting a control agreement. It follows that the first secured party (the 'on-pledgor') will no longer have control in the normal sense. This is why it is provided that an SI that is perfected by control will remain perfected even though the secured party itself relinquishes control, until such time as the debtor recovers the equivalent of control – that is, gets back the certificate, is registered with the issuer or is entered once more as entitled to the security.[94] **We provisionally recommend that an SI that is perfected by control should remain perfected even though the secured party itself relinquishes control, until such time as the debtor recovers the equivalent of control.**

Priority as between competing SIs over investment securities

CONTROL TRUMPS OTHER FORMS OF PERFECTION

4.70 The general rule is that an SI perfected by control has priority over any other SI (that is, an unperfected one or one perfected by some other means).[95] It should be noted that SP2 who takes control will gain priority over SP1 who perfected by filing whether or not SP2 knew of the prior interest. It has been described as 'a structural rule, based on the principle that a lender should be able to rely on the collateral without question if the lender has taken the necessary steps to assure itself that it is in a position to foreclose on the collateral without further action by the debtor.'[96] We have already provisionally recommended following this approach.[97]

RULES OF PRIORITY FOR COMPETING SIS OVER INVESTMENT SECURITIES WHERE BOTH THE SIS ARE PERFECTED BY CONTROL

4.71 As mentioned above, more than one secured party may have control over a security entitlement with an intermediary because the intermediary has made two 'control agreements'. The UCC provides that priority is in order of control.[98] We have replicated this rule.[99]

any increase or profits (except money) received from the collateral. In the case of money received, the secured party must either remit it to the debtor or apply it to reduce the amount of the secured obligation. See UCC Section 9-207(c), and see below, para 5.43.

94 DR 27(2).

95 See above, para 4.19; DR 34 rule 1; compare UCC Section 9-328(1).

96 See Section 9-328(1), Official Comment 3.

97 See above, para 4.29.

98 See UCC Section 9-328(2). Because an SI perfected by control will trump one perfected only by filing, there is no need for a special rule for PMSIs over investment securities. A lender who finances the purchase of the investment security, and then takes an SI over it, can ensure priority by the simple expedient of taking control. See Section 9-328, Official Comment 2. Indeed the UCC limits PMSIs by definition to SIs over goods and software: Section 9-103. (To similar effect, WG s 1(jj) excludes investment property from its definition of PMSI. Our draft regulations do likewise: see DR 4(1)). (In fact this may not fully answer why there are no PMSIs with investment property. First, we have seen that in effect the intermediary who creates a PMSI has priority for it, and more (above, para 4.59). But what

PROTECTED PURCHASERS

4.72 As we explained earlier, under the UCC scheme a purchaser (who of course includes a secured party) who takes control by having the security or security entitlement transferred into its own name, for value and without knowledge of competing interests, has an indisputable title like that of a holder in due course.[100] Thus this reduces the effect of the 'order of control' rule. A secured party who is allowed to take the asset into its own name can be confident of its position. We consider this rule to be fundamental in ensuring that financial assets can readily be used as collateral. We have therefore replicated it, so far as SIs are concerned,[101] in our scheme.[102]

4.73 **We provisionally recommend that a secured party[103] who takes control of a certificated or uncertificated security or, in the case of a security entitlement, has the entitlement transferred into its own name, for value and without knowledge that the sale or acquisition constitutes a breach of the security agreement creating or providing for a competing SI, should take free of that SI.**

SIS CREATED IN FAVOUR OF INTERMEDIARIES

4.74 Article 9 contains an exception to the general rule of priority according to date of control: an SI held by an intermediary in an entitlement or account maintained by the intermediary has priority over any other SI over the same assets.[104] We are told that intermediaries insisted that other secured parties seeking SIs in the same security entitlements should, if they wanted priority, negotiate a subordination agreement with the intermediary. We would welcome advice on whether this rule is also appropriate for our scheme.[105] For the time being we have included it.[106]

about the third party who provides the purchase-money for investment securities which are ordered through the debtor's regular broker and placed in the debtor's securities account, over which the purchase-money provider takes 'control' via a control agreement, only to find that SP1 has a control agreement already? We presume the answer to be (i) that such transactions will be rare – the broker will be as cheap a source of finance as anyone; and (ii) that the purchase-money provider should know better than to let the debtor hold the investments in its own name; the purchase-money provider should insist that the investments are in its own name, or obtain a subordination agreement with the intermediary.)

[99] See above, para 4.25 and DR 34 rule 3. UCC Section 9-328(2) appears complex but this seems to be the result of repeating much of the wording of the Article that defines control, Section 8-106. We have avoided this.

[100] See above, paras 3.229-3.236.

[101] The question of when a purchaser should take free of other kinds of 'adverse interests' is outside the scope of this project.

[102] See DR 32.

[103] For other purchasers see below, paras 4.77-4.81.

[104] UCC Section 9-328(3).

[105] It is not easy to divine the purpose of the rule from the Official Comment, since in the example given the result stated would follow simply from the order in which the competing secured parties took control. It therefore does not tell us why a subsequent SI in favour of

4.75 **Do consultees agree that an SI held by an intermediary in an entitlement or account maintained by the intermediary should have priority over any other SI over the same assets?**

SIs CREATED BY INTERMEDIARIES

4.76 We saw earlier that an SI created by an intermediary over investment securities is treated as automatically perfected. It is conceivable that the intermediary might create more than one such SI, and the UCC has a priority rule for this case: they rank equally.[107] **We provisionally recommend that where competing SIs granted by securities intermediaries are perfected otherwise than by control they should rank equally.**[108]

Buyers of investment securities

4.77 Under the general rules of our scheme, a buyer of assets that are subject to a perfected SI will normally take subject to it unless the disposition free of the SI was authorised or one of the exceptions applies (for example, the buyer of goods sold in the ordinary course of business). Thus a buyer will take subject to the perfected SI; the SI will have priority over a subsequent SI. This will apply to SIs perfected by control in the same way as to those perfected by other means. However, in order to preserve the ready transferability of investment securities the systems[109] apply rules that are in some ways comparable to those for negotiable instruments. Under the UCC, buyers are dealt with in Article 8. The Article deals with any purchaser and we have already considered its impact on subsequent secured parties.[110]

4.78 UCC Section 8-302 deals with directly held securities. It provides that a purchaser of a certificated or uncertificated security acquires all rights in the security that the transferor had or had power to transfer (and that a purchaser of a limited interest acquires rights only to the extent of its limited interest).[111] It is then provided that a 'protected purchaser' acquires its interest free of any 'adverse claim' (defined as meaning a 'claim that a claimant has a property interest in a financial asset and that it is a violation of the rights of the claimant for another person to hold,

the intermediary should have priority over an SI in favour of another that was perfected by control earlier. We suspect that in part the rationale may be that the intermediary's SI is likely to secure a loan to enable the entitlement holder to acquire the holding in the first place – in other words, to be a purchase-money interest. If this is so it follows from general principle that it should have priority. In addition, however, for a client to borrow from its intermediary against the security of its account is a quick and easy method of raising a secured loan (see above, para 4.55). That suggests that the intermediary should have priority even if the SI is not securing purchase-money. We would value advice on this point.

[106] DR 34 rule 4.

[107] Section 9-328(6).

[108] DR 34 rule 6.

[109] See also NZPPSA, s 97.

[110] See above, paras 4.72-4.73.

[111] UCC Section 8-302(a)-(b).

transfer or deal with the financial asset'[112]).[113] For certificated and uncertificated securities, a 'protected purchaser' is a purchaser who gives value,[114] does not have notice of any adverse claim and who obtains control.[115]

4.79 Purchasers of security entitlements are dealt with by Sections 8-501 and 8-502.[116] A purchaser is protected only if the securities are placed in an account in its own name.[117] By implication it might at first appear that if the buyer of indirectly held investment security does know of an SI over it - even if it is one merely perfected by filing - it will take subject to that SI. However it is also provided that in all cases of the purchase of investment securities, the purchaser has 'knowledge' only where it knows that the transaction is in breach of the security agreement.[118] This will be a rare case.

4.80 Thus a buyer of investment securities who takes control of a directly held investment, or who gets a security entitlement transferred into its own name, will normally be able to be confident that it will take free of any SI over it. This ensures the ready transferability of investment property. We have therefore followed the UCC approach.[119]

4.81 **We provisionally recommend that a buyer who takes control of a certificated or uncertificated security or, in the case of a security entitlement, has the entitlement transferred into its own name, for value and without knowledge that the sale or acquisition constitutes a breach of a security agreement creating or providing for a competing SI, should take free of that SI.**

Temporary perfection of SIs over certificated securities

4.82 Under the UCC, where a security is certificated, an SI is treated as temporarily perfected, without filing or taking possession,[120] for 20 days, provided that new value was given.[121] Presumably this is to enable the certificate to be delivered or

[112] UCC Section 8-102(a)(1).

[113] UCC Section 8-303(b).

[114] Article 8 does not deal with acquisition by donees (and some others): Section 8-302, Official Comment 2.

[115] UCC Section 8-303(a). On 'control', see above, paras 4.14-4.29.

[116] The Official Comment to Section 8-502 explains the reasons for the separate but parallel provisions for indirectly held securities in Sections 8-502 and 8-510 (which deals with the case where the purchaser takes from the entitlement holder but does not become the entitlement holder).

[117] This is the position as we understand it, and the draft regulations reflect this. However, we have since noticed that UCC Section 8-510 seems to give 'protected purchaser' status to a buyer who takes control without having the entitlement put into its own name. We will investigate the precise operation of this provision, and the draft regulations may need to be amended accordingly.

[118] See also WG s 30(9) (securities) and (10)-(11) (financial assets).

[119] See DR 32.

[120] Or, presumably, control, though this is not mentioned.

[121] Section 9-312(e).

the issuer to amend its books; it will preserve the SI in the event of the debtor's insolvency but not be effective against a purchaser without notice. Although we can see that this would save the secured party having to file to cover a short period, we wonder whether this provision is necessary, and would welcome advice. For the time being we have not replicated it in the draft regulations.

4.83 **We ask whether the draft regulations should include a provision to the effect that where a security is certificated, an SI is treated as temporarily perfected, without filing or taking possession, for 20 days, provided that new value was given.**

The 'broker's lien'

4.84 A broker has a general lien over share certificates until the client pays up.[122] The UCC creates a new but more powerful device for intermediaries, giving the intermediary an SI over the security entitlement complete with its own special rules about attachment of the SI.[123] Such an interest is perfected automatically.[124]

4.85 Do we need a similar provision as part of this project? The intermediary can take an SI over the entitlement under general principles and, as we saw earlier, that SI will also be perfected without more (though in this case it is treated as a form of 'control', so that it trumps other SIs). Why have an additional provision for the SI, particularly as it secures only the obligation to pay for the particular entitlement rather than being general? We understand the purpose to be to give the broker or intermediary an automatic right, so that a separate security agreement is not needed; but to ensure that if the investment security comes into the control of another secured party, the latter will have priority since the SI is merely perfected automatically.

4.86 So that consultees can see in detail how the UCC provision works, we have included it in the draft regulations.[125] We would welcome advice on whether an equivalent provision is necessary or desirable.[126]

4.87 **Do consultees think that it is necessary or desirable for the scheme we propose to include an automatic SI in favour of a securities intermediary who has credited the entitlement holder's account before receiving payment?**

[122] *Re London & Globe Finance Corpn* [1902] 2 Ch 416; R Goode, *Commercial Law* (2nd ed 1995) p 669.

[123] Section 9-206; compare WG s 12.1.

[124] Section 9-309(9). This means that it will be subordinated to the interest of another secured party who takes control, see above, para 4.19.

[125] See DR 16.

[126] The mechanism would remain subject to the Financial Services Authority rules, see in particular CASS 2.3.2R(3), CASS 2.4.2R(3) and COB 7.8 of the FSA Handbook.

Commodities

4.88 We have noted that commodity contracts are also a form of investment property that may be held by intermediaries; and that to this extent they are within the scheme. They are frequently referred to separately in the UCC and Canadian schemes and we have preserved this although it may be possible to treat them simply as a form of indirectly held investment property.[127]

4.89 Thus in DR 2 there are definitions of commodity contract (a commodity futures contract, a commodity futures option or other similar contract[128]), commodity customer, commodity intermediary[129] and commodity account. DR 6(12) provides that a purchaser has control of a commodity contract if the purchaser, the intermediary and the commodity customer have agreed that the intermediary will apply any value distributed on account of the commodity contract as directed by the purchaser without further reference to the commodity customer.

4.90 There are, in addition, rules on attachment,[130] perfection of an SI in a commodity account,[131] perfection of SIs created by commodity intermediaries[132] and priority[133] that match the provisions for investment securities. There are not, however, specific provisions on 'buyers' of commodity contracts. This is because, as we understand it, commodity contracts are not themselves bought or sold; rather, a further contract of sale is made.

4.91 We would welcome views on whether commodity contracts and commodity accounts should be treated separately, as in the North American schemes and the current version of the draft regulations, or should simply be brought within the definition of a financial asset. They would thus be covered by the rules governing SIs over what is currently termed a 'security entitlement'. (It would be possible to change the terminology to refer, for example, to an 'investment property entitlement'.)

4.92 **We provisionally recommend that the scheme for SIs over investment property should cover commodity contracts and commodity accounts. We**

[127] See above, para 4.11.

[128] We would welcome advice as to whether the drafting of this particular definition is appropriate. We have retained the UCC's phrase 'subject to the rules of a commodity futures exchange regulated under…'. It might be more appropriate to refer to a 'recognised investment exchange regulated under Financial Services and Markets Act 2000 (Regulated Activities) Order 2001' (SI 2001 No 544); and possibly simply to define commodity contracts by reference to that Order, see arts 3, 83 ('Options') and 84 ('Futures'). A European law definition may emerge if the proposed Directive on financial instruments markets is adopted: see Common Position (EC) No 9/2004, adopted by the Council on 8 December 2003, OJ C 060 E, 9 March 2004.

[129] Again we would welcome advice on this. It might be better to refer to those who 'are authorised and have permission to deal'.

[130] DR 15(13), compare DR 15(12) for investment securities.

[131] DR 21(2), compare DR 21(1).

[132] DR 21(5), compare DR 21(4).

[133] DR 34. Many of the paragraphs of this draft regulation apply to both investment securities and commodity contracts.

ask whether these should be treated separately, as in the draft regulations, or should simply be brought within the definition of a financial asset and thus within the rules governing SIs over what is currently termed a 'security entitlement'.

BANK ACCOUNTS

4.93 We explained earlier that cash kept in a bank account is a form of financial collateral within the meaning of the FCD and the FCAR.

4.94 As we explained in the CP,[134] a debtor may create a charge over a bank account in favour of a secured party other than the bank. There used to be doubt as to whether the bank itself could take a charge over an account held with itself, and instead a form of set-off agreement was often used; but it now appears that a bank can take a charge over an account of its own customer.[135] Such a charge is probably not currently registrable unless it is a floating charge.[136]

4.95 Earlier versions of UCC Article 9 did not allow for perfection of security over bank accounts. Revised Article 9 now allows for the creation of SIs over bank accounts (termed 'deposit accounts'), but this can take place only if the secured party (which may include the bank itself) has 'control' over the account.[137] Perfection by filing is not possible.

4.96 In the CP we suggested that we should take a similar approach, so that an SI over a bank account could be perfected only by control.[138] We now understand that the restriction under the UCC was the result of reluctance by the Federal authorities and is not seen by the drafting committee as a necessary restriction. Consultees agreed that SIs over bank accounts must be made possible but saw no reason to limit them in this way. We therefore provisionally recommend enabling a secured party to perfect an SI over a bank account by taking control, but we now see no need to prevent perfection by filing as an alternative. However, as with investment securities, we wish to ensure that a secured party who obtains control over the bank account will have priority over one who has perfected by filing only (whether or not the secured party taking control knows of the filed SI).

Why include bank accounts within the scheme?

4.97 There are a number of reasons for including SIs over bank accounts within our scheme for notice-filing and extending the notion of 'perfection by control' to bank accounts.

[134] CP paras 2.73-2.75.

[135] *Re Bank of Credit and Commerce International SA (No 8)* [1998] AC 214, 225-228.

[136] It may possibly be registrable as a charge over a book debt.

[137] UCC Section 9-312(b)(1).

[138] See CP para 5.51 n 95.

4.98 The starting point is that we think it important to facilitate the creation of SIs over bank accounts. For some companies cash in bank accounts constitutes an important form of asset. There are, for instance, many companies in the financial services sector that place large cash sums in bank accounts overnight. These accounts are a valuable form of collateral against which the company may wish to borrow.

4.99 One possible source of loans is the bank with which the account is maintained. Until recently it was unclear whether a bank was able to take a charge over an account with itself, since the account (when in credit) is no more than a debt owed by the bank to the customer, and in order to protect its loan it has had to rely either on rights of set-off or on some kind of flawed-asset arrangement.[139] There are doubts as to how effective either would be in the event of the company's insolvency. Now that it has been held that it is possible for them to take a charge over the account,[140] we understand that banks see this as important to their operations.

4.100 Third parties may also be prepared to lend against the security of cash held by a company in a bank account. It is true, as has been said to us, that often the bank itself will be a major creditor of the company and may have 'first call' on the account, so that there will be nothing in the account for anyone else. However, we understand that many companies do have funds in their bank accounts that exceed any sums they owe the bank. This cash might form simply one part of a company's assets that are subject to a general SI in favour of a third party, or the third party may be looking specifically to the bank account as collateral.

4.101 The question then arises of what steps should be required to create and to perfect an SI over a bank account. We deal first with SIs created by an agreement solely between the company and a secured party other than the bank, whether as part of a general SI over the debtor company's property or specifically relating to the bank account. Then we consider SIs where there is an agreement between the company, the bank and (where the secured party is not the bank itself but a third person) the secured party. We refer to the tri-partite agreements by the phrase used in the UCC, 'control agreements'.

SIs created without the agreement of the bank

4.102 We have said that, in the light of responses to our CP, we now think that it should be possible to take an SI over the bank account - for example, as part of a general SI over the company's property - without it being necessary to make an agreement to that effect with the bank as well as the debtor.

4.103 The question whether such an SI should have to be perfected by filing, or should be effective without filing, is more difficult. It was suggested to us that registration should not be necessary. It was argued that if SIs over bank accounts were to be left outside our scheme altogether, then priority over bank accounts would

[139] See CP para 6.49.

[140] See above, para 4.94.

continue to be governed by the rule in *Dearle v Hall*.[141] This in general gives priority to the first assignee to notify the debtor, so a secured party to whom the company had given an SI without the agreement of the bank would have a strong incentive to notify the bank as soon as possible. Once the bank is aware of the SI, it can (with the company's consent) warn other enquirers of the SI. Thus a second potential lender could safeguard its position by ensuring that the debtor requires the bank to disclose the existence of any SI over the account of which it has notice. We accept that this approach would go some way towards solving the problem.

4.104 However, we think it would be unsatisfactory in three respects. First, it would be confusing to exclude bank accounts but no other assets[142] from the priority rules of the scheme. Secondly, the rule in *Dearle v Hall* depends on whether or not the assignee knew, at the time that it took its assignment, of the existence of a prior assignment. That can involve difficult questions of fact and one of the aims of the scheme is, for purposes of priority between SIs, to move away from questions of knowledge to the more easily established order of filing. Thirdly, as notification of the bank would affect only the question of the SI's priority as against any other SI, this approach might be prejudicial to unsecured creditors. It could have the result that, in the event of the company's insolvency, a secured party would be entitled to the funds in the account as against the liquidator and unsecured creditors, even though there was no way that the unsecured creditors could have discovered the existence of the SI. We therefore reject this solution. Where the SI has been created without the bank's agreement, filing should be required in order to perfect the SI.

4.105 **We provisionally recommend that SIs created over a bank account should in principle be within the proposed scheme of notice-filing (though filing would not necessarily be required in all cases) and priority of SIs.**

SIs where there is a 'control' agreement

4.106 The next question is whether special provision should be made for SIs that, either when they were created or subsequently, are the subject of a control agreement between the company, the bank and (where the secured party is not the bank itself but a third person) the secured party. It has been suggested to us that no special provision for bank accounts is needed: filing should *always* be required. However, it is neither possible nor, we think, desirable to require filing in all cases.

4.107 To require filing is not possible because the FCD applies to bank accounts as much as it does to investment property held in the books of intermediaries. Thus where the secured party has taken 'possession or control' of the account, further formalities cannot be required.[143] What amounts to 'possession or control' is not

[141] (1828) 3 Russ 1.

[142] Save those for which there is a specialist register.

[143] This means that we cannot follow the PPSA schemes as far as bank accounts are concerned. The NZPPSA specifically recognises that a bank may take an SI over an account with itself (s 17(2)) but neither scheme has any specific rules for the perfection of SIs over bank accounts. Thus, as a bank account is not a tangible item that under the

defined. As with investment property, we think that our scheme should aim to provide a definition of 'control' in respect of SIs over bank accounts and, in addition, clear rules of priority to deal with competing SIs over bank accounts.

4.108 To require filing for all SIs over bank accounts is in any event not desirable. First, to require perfection by filing would mean that no secured party (whether the bank or a third party in agreement with the bank) could take an SI over an account without first searching; next, if it found on the register any financing statement covering a bank account, checking its coverage and possibly negotiating a subordination agreement; and lastly itself filing. That would be inconsistent with the aim of reducing impediments to financial transactions, expressed in the recital to the FCD.[144] Secured parties and the banks themselves[145] need to be able to perfect an SI over bank accounts by a simple agreement without having to search and in the confidence that they will have priority over the funds in the account. Secondly, where the intending secured party is a third person, if it is seriously relying on the account to provide security it will in practice wish to reach an arrangement with the bank that will give it the right to withdraw the funds in the event of the debtor company's default. The secured party will thus start by making enquiries of the bank (if necessary, getting the debtor to require the bank to disclose the existence of any existing SIs). If there is already an SI that is the subject of an agreement between the company, the bank and (where the existing secured party is not the bank) the secured party, the potential second secured party will discover the earlier SI.

4.109 It is true that if SIs over bank accounts may be perfected by 'control', unsecured creditors and (more realistically) credit rating agencies will find it less easy to discover them than if all SIs over bank accounts had to be perfected by filing. This is one of the situations in which the aim of providing publicity for SIs that will not be readily apparent has to be - indeed, by the adoption of the FCD, already has been - subordinated to the need to maintain the efficiency of the financial market. Moreover, charges over bank accounts are not currently registrable at all, so our proposals will not make things worse. In fact they make it somewhat easier for credit rating agencies to discover the existence of SIs over bank accounts, since (if our earlier proposal is accepted) those made without the bank's agreement will have to be perfected by filing. Moreover, if the company is seriously concerned to maintain or improve its credit rating, it may be prepared to authorise its bank to reveal to the credit rating agency the information it has about SIs over the company's bank accounts. The credit rating agency will be able to have confidence that there are no SIs other than those revealed by the bank or filed.

common law system can be the subject of possession (see M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 41.4 (pp 162-164)), neither the SPPSA, s 24 (perfection by possession) nor the equivalent NZPPSA, s 41(1)(b)(ii) would apply. NZPPSA, s 18 has a special extension of the notion of possession to cover dematerialised investment securities but it does not cover a bank account.

[144] See especially Recital 9.

[145] Further we suspect that SIs taken by the bank itself will become increasingly common if not universal. To require all of them to be filed would be pointless.

4.110 Thus we consider that there is a strong case for extending the notion of perfection by control, and its associated rule of priority, to encompass SIs over bank accounts, whether in favour of the bank itself or a third party creditor. **We provisionally recommend that SIs created over bank accounts should be brought within the provision for perfection by control and the associated priority rules.**

Basic principles

4.111 We set out earlier four basic principles that seem to us to underlie the UCC provisions on control over investment property. Three of them – (1) 'Control' means a right to realise or appropriate the collateral; (2) Control trumps other forms of perfection; and (3) As between SIs perfected by control, priority by order in which control obtained – seem to apply equally to control over bank accounts.

4.112 The fourth – (4) A bona fide purchaser for value who takes control of investment property in such a way that no one else can also have control of it takes free of other interests – applies in a way that is modified to the context. We will see that a secured party who becomes the account holder has stronger rights than one who merely enters a control agreement with the bank.[146] However a secured party who becomes the account holder does not thereby take free of an SI in favour of another secured party who had made a control agreement with the bank.[147]

The scheme for bank accounts in detail

Definitions

4.113 'Bank account' is defined in the draft regulations as a deposit held on a person's behalf by a bank (but it does not include either investment property or a monetary obligation evidenced by an instrument). A 'bank' means the Bank of England and others authorised to accept deposits.[148]

4.114 We were told that on occasions investment intermediaries will maintain entitlements to sums of cash on their books (for example, after an entitlement has been sold and before the proceeds are reinvested) and that these should be covered by the rules for investment property. Preliminary further enquiries suggested that though the securities account might show a cash balance, that would normally be held in a separate account, possibly with a private bank in the same group as the broker or other intermediary.[149] We have therefore assumed that all book entry entitlements to cash should be subject to the provisions on bank accounts. The practical difference is slight since the rules on security entitlements and bank accounts are closely parallel.

[146] See further below, para 4.124.

[147] See below, para 4.125.

[148] DR 2(1).

[149] The holding of client's money is subject to the Financial Services Authority rules; see CASS 4.

What amounts to control

4.115 It is possible that under current law a secured party will have 'control' over a bank account if it has merely given notice to the bank that the debtor has assigned the account to it.[150] We do not think that giving notice of assignment should amount to 'control' for the purposes of our scheme. It can only amount to control in a negative sense in that it may suffice to put others on warning.[151] We are told that in this country good practice is to secure the bank's agreement that it will transfer the funds to the secured party without further reference to the debtor – in other words, to secure control in the positive sense.[152] This accords with the basic principles of the UCC that we outlined earlier.[153]

4.116 Therefore in cases where the secured party is a third party, we think that either the secured party must 'become the account holder'[154] (sole or joint)[155] or there must be a tri-partite agreement between debtor, bank and secured party that the bank will accept directions from the secured party without further reference to the debtor.[156] The debtor's agreement is essential: we think that the effect of the bank reaching a control agreement in relation to a bank account might be so significant for the debtor that its agreement to this method of perfection should be required. The 'control' agreement must be in writing, as this appears to be required by the FCD and the implementing FCAR.

4.117 Where the secured party is the bank at which the account is held, we think that the SI should be treated as perfected without any further steps being required.[157]

4.118 It will not matter that the debtor retains the right to dispose of funds in the bank account.[158] Under existing law this might prevent there being a fixed charge; but it will be recalled that this is not the concept of 'control' that is relevant here.[159]

4.119 **We provisionally recommend that a secured party should be able to perfect an SI over a bank account by 'control', by:**

[150] Compare the discussion of notice of assignment in respect of indirectly held investment securities, above, para 4.53.

[151] See above, para 4.18.

[152] We are also told that in practice giving notice of assignment is not sufficiently certain for either party – the bank may be uncertain as to its obligations after notification, while the secured party may find that the bank rejects a notice.

[153] Above, paras 4.14-4.29.

[154] Section 9-104 refers to the secured party becoming the 'bank's customer with respect to the deposit account'.

[155] DR 7(3)(b).

[156] DR 7(3)(a) and (4); compare UCC Section 9-104 and the provisions on investment securities, above, paras 4.51-4.53. This formulation differs slightly from what is required for a 'control agreement' accepted by an intermediary: the latter does not require the participation of the debtor, but it does require the debtor's consent (see DR 6(8)), so in reality the two seem much the same.

[157] DR 7(2) and DR 23(g).

[158] DR 7(5). Again, compare investment securities, above, paras 4.62-4.63.

[159] See above, para 4.15 n 16.

(1) becoming the account holder; or

(2) entering an agreement with the debtor and the bank that the bank will accept directions from the secured party without further reference to the debtor; or

(3) where the secured party is the bank at which the account is held, without any further steps being required.

There may be perfection by control even though the debtor retains the right to dispose of funds in the account.

Bank's agreement required for control

4.120 As 'control' of a bank account requires either an agreement that the bank may follow directions from the secured party as to the disposition of funds in the account without further reference to the debtor, or that the secured party 'becomes a customer' of the bank, it follows that the bank's consent is essential. The bank cannot be required to enter a control agreement even if the customer so instructs.[160] For the avoidance of doubt we have included a provision to this effect.[161]

Disclosure of the control agreement

4.121 The existence of a control agreement is information that is confidential to the customer and that the bank would normally refuse to disclose. However a subsequent potential lender may reasonably require a confirmation from the bank as to what, if any, control agreements already exist in relation to the account. For consultation purposes we have included a provision that the bank should disclose this information if required to do so by the debtor.[162] **We ask whether a bank that has entered a control agreement with a secured party should have to disclose it to a third party if required to do so by the customer/debtor.**

Priority

4.122 In accordance with the general rule for SIs perfected by control,[163] if there are competing SIs over a bank account, one perfected by control will take priority over one that is perfected only by filing.[164]

4.123 Under Revised Article 9, an SI perfected by control will also have priority over a claim to funds in the account as proceeds of collateral subject to some other SI. It will be recalled that if the SI over the other collateral was perfected, there will be

[160] Section 9-342. The bank could of course give its consent in advance.

[161] DR 7(6).

[162] DR 7(7); compare UCC Section 9-332; compare above, para 4.58 (indirectly held investment property).

[163] See above, para 4.19.

[164] DR 35(1) rule 1; compare UCC Section 9-327(1). It will obviously have priority also over one that is not perfected at all.

an SI over the cash proceeds of that collateral so long as they remain as cash.[165] However the SI over the proceeds is not perfected by control. This is true even if the SI over the original collateral was perfected by control, for example, if the original collateral was investment property held in a securities account. This is for two reasons. First, the interest in the proceeds is regarded as 'automatically perfected'[166] and an automatically perfected SI will be trumped by one perfected by control. Secondly, the bank will be a transferee of the money and, save in exceptional circumstances, will take free of the SI in the cash proceeds.[167] If the claim to the funds as proceeds were to have priority over the SI over the account as original collateral, it would be too difficult for banks to assess the extent to which they can safely lend as against the security of the funds in the account. Thus we recommend replicating this aspect of the UCC scheme, so that an SI over a bank account perfected by control has priority over one perfected in any other way, including as proceeds.[168]

4.124 Priority between SIs perfected by control[169] will depend upon who the competing parties are. The most common competition will be between the bank and a third party secured party. We have seen that if the bank has taken an SI over the customer's account, it is treated without more as having 'control'. That gives it priority over an SI perfected by filing. Article 9 goes further in ensuring that the bank will normally have 'first call' over the account: even if it has already entered a control agreement in favour of a third party, or does so later, the bank will have priority unless the third party 'becomes a customer of the bank'.[170] In other words, to ensure that it has and will retain priority over the bank itself, a third party secured party needs to ensure that the account is transferred into its name, or (for example, if it wishes the debtor to be able to continue using the account) the joint names of itself and the debtor. Again we have replicated this rule, which we think accords with commercial expectations.[171] We would welcome comments, however, particularly as to the appropriateness of giving the bank such a strong priority position.

4.125 It is also conceivable that there may be a contest between two secured parties each of whom has a control agreement with the bank.[172] In this case Article 9 provides that priority will be in the order that control was acquired.[173] It should be noted that as against secured parties other than the bank, a secured party will not

[165] See above, para 3.187.

[166] This is not obvious from the text of Section 9-315 but is clearly stated in the Official Comments.

[167] Section 9-332(a).

[168] See DR 34 rule (1), compare Section 9-327(1).

[169] Which seems an unlikely problem (compare UCC Section 9-327 Official Comment 3) but is a possibility that should be provided for.

[170] This is the effect of Section 9-327(3) and (4). The position can of course be varied if a subordination agreement is made.

[171] DR 35(1) rule 3.

[172] Section 9-104; compare investment securities, para 4.25 above.

[173] Section 9-327(2).

get higher priority by 'becoming a customer of the bank'.[174] If this were not the rule, a secured party who had merely entered a 'control agreement' but had not become a customer would always be at risk of losing priority to a subsequent secured party.[175] Although the scenario described in this paragraph seems unlikely to occur we think that we should include a rule similar to that of the UCC. The different priority treatment accorded to a secured party who becomes the account holder compared to a secured party who has a security entitlement into its own name[176] seems to us to be justified by the greater need to ensure the ready transferability of investment securities compared to bank accounts.

4.126 **We provisionally recommend that as between competing SIs over a bank account:**

(1) an SI perfected by control should take priority over one perfected by other means;

(2) as between SIs perfected by control, priority should depend on the date of control, except that where one of the secured parties is the bank itself, the bank should have priority unless the other secured party has become the account holder.

Transferability of funds

4.127 It is of course important that the transferability of money or funds drawn from the account should not be impeded, and we have already noted in Part 3 the protection given to transferees of money and other negotiable collateral.[177]

4.128 We note that in relation to holders of money and recipients of fund transfers from a bank account, the protection given by Revised Article 9 differs from that provided by our draft regulation.[178] The recipient is protected whether or not it gave value and whether or not it had knowledge, unless it 'colluded' with the debtor. We would welcome advice on whether the transferee should be protected unless (as under the SPPSA) it did not give value or knew that the transfer was in breach of the security agreement;[179] or whether we should use the test of the UCC. Our inclination is to follow the SPPSA model as following the current rules at common law that a recipient of money in good faith and for value receives

[174] In the even less likely event of the bank and two other 'control' secured parties being in contest, the combination of this rule and the rules giving priority to the bank except over a 'customer' could produce a classic problem of circularity. If SP1 had a mere control agreement and later SP2 had become a customer of the bank, the bank would have priority over SP1, SP1 would have priority over SP2; and SP2 would have priority over the bank. However, this seems so unlikely that it is not something that concerns us.

[175] By becoming a customer a secured party will be able to prevent the bank entering any further control agreements without secured party's consent but they would not have priority in any event.

[176] See above, para 4.72.

[177] DR 38. See above, paras 3.229-3.236.

[178] Sections 9-332(a)-(b).

[179] Compare SPPSA, s 31(1)-(2).

good title[180] and that a proprietary claim to money (for example where proceeds of the collateral have been paid by fund transfer) will fail as against a bona fide purchaser for value.[181] DR 38 is drafted accordingly for the time being.

4.129 **Should a transferee be protected:**

(1) unless it did not give value or it knew that the transfer was in breach of the security agreement, or, alternatively,

(2) whether or not it gave value or had knowledge, unless it colluded with the debtor?

Bank's right of set-off

4.130 The bank should, unless agreed otherwise, continue to have its normal rights to raise against the secured party defences and set-offs that it has against the debtor.[182] This should apply even where the bank also has an SI over the account.[183] However, where the secured party becomes the customer of the bank, the bank will no longer be able to raise against it set-offs that the bank may have against the debtor.[184] This is simply because a set-off against one customer (the debtor) cannot be raised against another (the secured party who has become the account holder). **We provisionally recommend that the existence of a control agreement with a third party secured party should not prevent the bank exercising defences and set-offs that it has against the debtor, but it should not be able to raise or exercise a right of set-off that it has against the debtor against a secured party who has taken control by becoming the customer of the bank.**

Bank's obligations to debtor

4.131 Under the UCC, unless agreed otherwise, the bank will continue to have its normal obligations to the debtor, for example, to honour the debtor's instructions, despite the perfection of the SI by control.[185] We would welcome comment on whether such a provision is really necessary. For the time being we have not included it.

4.132 **We ask whether consultees consider it necessary or desirable to include a provision in the draft regulations providing that, unless agreed otherwise, the bank will continue to have its normal obligations to the debtor despite an SI in the bank account perfected by control.**

[180] R Goode, *Commercial Law* (2nd ed 1995) p 491.

[181] R Goode, *Commercial Law* (2nd ed 1995) pp 499-500.

[182] Compare Section 9-340(a).

[183] DR 35(2); compare Section 9-340(b).

[184] DR 35(2)(a); compare Section 9-340(c).

[185] Section 9-341.

PROCEEDS OF LETTERS OF CREDIT

Background

4.133 The proceeds of letters of credit are not financial collateral in the sense in which that phrase is usually used. We deal with them in this Part simply because under Revised Article 9 the notion of perfection by control is applied also to SIs over 'letter-of-credit rights'. When a debtor assigns a chose in action either by way of security or outright, and the chose in action is not represented by a document,[186] the UCC, like our proposed scheme, normally requires that the assignment be perfected by filing. Priority will then depend primarily upon the date of filing, rather than (as in current English law) on the date of notification of the assignment to the account debtor. This is thought to be more compatible with receivables financing practice: it is not practicable for intending assignees to check with each debtor to see if it has been notified of a previous assignment.

4.134 Under the UCC there are two major exceptions to this principle, both involving types of chose in action where any intending secured party or buyer is likely to check with the debtor. The first, for bank accounts, we have dealt with. The second is for what the UCC calls 'letter-of-credit rights'.[187] These are defined in the UCC to mean:

> [A] right to payment or performance under a letter of credit, whether or not the beneficiary has demanded or is at the time entitled to demand payment or performance. The term does not include the right of a beneficiary to demand payment or performance under a letter of credit.[188]

4.135 Under the UCC, SIs over these may also be perfected by 'control'. We will see that this means that the issuing or confirming bank has agreed to pay the proceeds of the letter of credit to the secured party.

4.136 The UCC also treats this type of chose in action differently from most others: Article 9 does not apply to outright sales of letter-of-credit rights. This is because the Article applies to sales of 'accounts,…payment intangibles, or promissory notes' and letter-of-credit rights are not within the definition of either account or payment intangible.[189] Thus only transactions in letter-of-credit rights that create

[186] Documentary intangibles such as negotiable instruments may be the subject of possessory SIs.

[187] A letter of credit is not a documentary intangible. Under English law the 'letter' is the right of the beneficiary to payment upon presentation of the stipulated documents, eg, the shipping documents, invoice and insurance policy; the letter notifying the beneficiary need not be presented and transferring that letter to another would not transfer any right to claim or give them the right to the proceeds. It may be that North American practice is different, as the SPPSA treats a letter of credit or advice of credit like a negotiable instrument, provided that the letter or advice states on it that it must be surrendered on claiming payment: SPPSA, s 2(1)(v)(iii) ('instrument'): see then ss 24(1)(c) (perfection by possession) and 31(4). We have not replicated these provisions as far as letters of credit are concerned.

[188] UCC Section 9-102(a)(51).

[189] Nor are bank accounts, but these are not usually thought of as being sold.

'security interests' - that is, that secure payment or performance of an obligation[190] - are within Article 9.

4.137 A letter of credit is often a way of ensuring performance of another obligation owed by the party who opens the letter of credit – for example, the buyer's obligation to pay for the goods shipped. If the buyer's obligation is assigned, so normally will be the right to the proceeds of the letter of credit.

4.138 It is necessary to distinguish between transfers of the letter of credit and assignments of the proceeds. If the letter of credit itself is transferred, then the transferee rather than the original beneficiary will be entitled to present the documents necessary to obtain payment, and to demand the payment. If the proceeds are assigned, the original beneficiary is still the party to present the documents and who is entitled to demand that payment be made,[191] but (assuming that the bank has been notified of the assignment) payment must be made to the assignee.[192] This distinction is clearly recognised in the Uniform Customs and Practice (UCP 500) that apply to letters of credit. Article 48 of UCP 500 states that a credit is not transferable at all unless so designated by the issuing bank, and even then the confirming bank (or other transferring bank not itself the issuer) is under no obligation to effect the transfer unless it consents to do so.[193] Article 49 provides that the fact that the letter of credit is not transferable does not affect the beneficiary's right to assign the proceeds. It is only assignment of the proceeds with which we are concerned, and the UCC's definition of letter-of-credit rights includes only assignment of the proceeds.[194]

4.139 The letter-of-credit rights are what the UCC terms a 'supporting obligation'. In Part 3 we provisionally recommended that, when a right to payment is supported by a letter of credit, and an SI attaches to the right, an SI over the proceeds of the letter of credit should arise and attach automatically. Perfection of the SI in the

[190] See Section 1-201(37) ('security interest').

[191] The assignee may present the documents as the agent of the beneficiary: R Goode, *Commercial Law* (2nd ed 1995) p 1023. If the letter of credit itself is to be transferred, there must be a novation under which the transferor is replaced by the transferee, at least so far as concerns that part of the credit that is transferred: *ibid,* p 1021. In practice the original letter of credit is returned and a new one, or new ones, issued: *ibid,* p 1016.

[192] In practice payment will be made by a transfer to the assignee's account.

[193] In practice letters of credit are often transferable, but we are told that the transfer would not normally have a security purpose: it would usually provide a simple mechanism for the seller/beneficiary to pay its own supplier. In such a case the amount due to the supplier may be less than is due to the seller; then the credit will be transferred only in part.

[194] Section 9-102(a)(51); and see also Section 9-107, Official Comment 4. There might however be cases in which the proceeds have been assigned and then the credit is transferred. Section 5-114(e) provides that in such a case the transferee's rights prevail. We do not think we need an equivalent provision as part of our scheme. Official Comment 4 to Section 9-329 points out that a transfer might be taken by way of security. This suggests that this would not be within Article 9 but that the courts are invited to apply its provisions by analogy, so (for instance) to require the return of any surplus to the debtor. We too can leave this to the courts.

monetary obligation would also perfect the SI in the proceeds of the letter of credit.[195]

The Revised Article 9 approach to letter-of-credit rights

4.140 Under Revised Article 9, an SI over letter-of-credit rights can be perfected as a 'supporting obligation' or by 'control'. In addition, an SI over letter-of-credit rights may be perfected on a temporary basis where it represents the proceeds of another form of original collateral.[196] Perfection by filing is not an option.[197] We have already considered supporting obligations. Here we deal with the other methods of perfection of an SI over letter-of-credit rights.

Control

4.141 If the beneficiary of a letter of credit assigns its right to the proceeds of the letter of credit, that is, the sum payable by the issuing bank or the confirming bank, by way of security, and the secured party obtains the bank's consent to the assignment, the SI over the letter-of-credit rights is perfected by control.[198] (Under UCC Section 5-114(c) a bank need recognise an assignment of proceeds only if it has consented to the assignment.) As in the other cases of control, a party who obtains control over a letter-of-credit right will have priority over an SI over the same letter-of-credit right perfected by other means (for example, automatically as a supporting obligation).[199]

4.142 These provisions seem to serve two purposes. First, it is possible that the assignee of the proceeds of the letter of credit has not perfected its SI over the principal obligation by filing, but has merely obtained the bank's agreement to the assignment of the proceeds. Under these provisions the SI over the proceeds will be perfected by the assignee's 'control' of the proceeds. Secondly, a principal obligation supported by a letter of credit might be assigned more than once. Although the second assignment may (because of the order of filing or other form of perfection) be junior, it is possible that the junior secured party will contact the bank and get its agreement that the proceeds of the letter of credit should be paid to it, whereas the senior might not have chosen to do this. In such a case the

[195] See above, paras 3.51-3.57.

[196] Section 9-312(b)(2).

[197] Sections 9-308(d) and 9-312(b)(2); and see Official Comment 4(d) to Section 9-101. At first sight, the opening words of Section 9-312(b) seem to suggest that other forms of perfection (eg, filing) may suffice when the letter-of-credit rights represents the proceeds of collateral that was subject to an SI but which has been sold. However, Section 9-315, which deals with perfection over proceeds, makes it clear that this gives only a form of temporary protection: at the end of the period the SI will become unperfected unless the secured party takes control, since that is the only permissible way of perfecting in such a case.

[198] Section 9-107; Section 9-314. Unlike the case with investment securities, the SI will remain perfected by control only so long as the secured party itself has control over the letter-of-credit-rights: Section 9-314(b).

[199] Section 9-329.

'junior' secured party will gain priority. This is said in the Official Comments to the UCC to represent international practice.[200]

4.143 In accordance with the general rule, an SI over letter-of-credit rights that is perfected by control takes priority over one that is not.[201] SIs perfected by control rank in order to the time of obtaining control.[202]

Perfection as proceeds

4.144 In this case there is a partial exception to the rule that an SI over letter-of-credit rights must be perfected by 'control'.[203] Provided that the SI over the original collateral was perfected, the SI over the proceeds is regarded as continuously perfected for 20 days.[204] It will then become unperfected unless it is perfected by other means.[205] These 'means' have to be one of the ways of perfecting that are effective for the particular type of collateral, and with letter-of-credit rights that means by taking control.[206] Even within the 20 days the secured party's protection is feeble since it will be trumped by another secured party taking control or becoming a 'transferee' (that is, someone who becomes the beneficiary and acquires the right to draw).[207]

Should we adopt the Article 9 notion of control over letter-of-credit rights?

4.145 On this point the underlying English law seems to differ from that of the US. In English law the bank need not consent to an assignment: a legal assignment requires notice to the debtor but not its consent.[208] An equitable assignment may be effective even though the debtor has not been notified, but the assignee of the right to proceeds of a letter of credit would want to notify the bank in order to ensure that it does not lose priority under the rule in *Dearle v Hall*.[209]

4.146 Other than that the bank's consent is not required, how in practice does the UCC rule differ from current English law? Under the rule in *Dearle v Hall* the order of priority will normally be governed by the order in which competing secured parties

[200] UCC Section 9-329, Official Comment 2.

[201] Section 9-329(1). Note that this is subject to rule about transferees of the letter of credit (see above, para 4.139 n 194) even if the transfer is taken for a security purpose. See Official Comments 3 and 4.

[202] Section 9-329(2).

[203] See the opening words of Section 9-312(b).

[204] Section 9-315(c).

[205] Section 9-315(d).

[206] The letter-of-credit rights in this type of case will not be a 'supporting obligation'.

[207] See Official Comment 4 to Section 9-107.

[208] It would be possible for the bank to stipulate that the credit shall not be assignable, in which case it could insist on paying the original beneficiary. This would not prevent the assignment being effective as between the assignor and assignee; the assignor would have to claim payment and would then hold the proceeds for the assignee. See R Goode, *Commercial Law* (2nd ed 1995) p 1023.

[209] (1828) 3 Russ 1.

gave notice to the debtor. That seems very like the UCC rule. However there is one difference. Under the rule in *Dearle v Hall* a subsequent secured party cannot gain priority by being the first to notify the debtor if when it took its assignment it knew of the prior assignment.[210] Under the UCC control rule - and indeed generally under the rules of priority as between competing SIs - whether or not the subsequent secured party knew of an earlier unperfected SI is irrelevant.

4.147 That seems to make the UCC rule rather more certain in its operation, and might justify bringing letter-of-credit rights within the 'control' scheme.

4.148 What other possibilities are there?

(1) One would be to allow perfection of an SI over letter-of-credit rights as supporting obligations but not to introduce 'control' as a method of perfection for this type of collateral. This would mean that the priority of an SI over letter-of-credit rights perfected by filing would depend simply on the priority of the SI over the principal obligation.

(2) Another one would be to allow perfection of SIs over letter-of-credit rights as supporting obligations or by control, and that 'control' trumps other methods, but to say that merely giving notice of the assignment to the bank amounts to control.

(3) A third would be simply to leave letter-of-credit rights outside our scheme altogether, so that the priority of competing SIs over letter-of-credit rights would continued to be governed by *Dearle v Hall*.

We do not think that option (1) above would be a sensible solution. It does not seem to us to produce results that a financier will reasonably expect. Nor do we favour option (3). That would mean, for example, that letter-of-credit rights might be subject to old-style 'floating' charges. Moreover, the scheme generally, and in particular Part 5 dealing with the statement of rights and remedies, would not apply to letter-of-credit rights. This would prevent the law affecting SIs over letter-of-credit rights being uniform with the rest. Therefore we think we should include them in the scheme.

4.149 We are tempted by option (2), since it seems to leave more of our present law intact. However, we suspect that the UCC, by giving priority to a party who has obtained the bank's agreement, comes closer to what is thought of as good practice in the UK. Therefore, the draft regulations include similar provisions to the UCC relating to control of letter-of-credit rights, together with associated priority rules, for the purposes of consultation. However, they refer to 'the proceeds of a letter of credit' rather than using the term 'letter-of-credit right'. We have followed the UCC approach to requiring the bank's consent to the assignment for the purposes of control. We would welcome views.

[210] See R Goode, *Commercial Law* (2nd ed 1995) p 705. Note that this rule applies even if the second assignment is a 'legal' assignment under the Law of Property Act 1925, s 136, as even a legal assignee takes 'subject to equities'.

4.150 **Do consultees agree that:**

(1) an SI over the proceeds of a letter of credit should be regarded as perfected by control if the SP has obtained the bank's agreement to the assignment,[211] **and**

(2) an SI over the proceeds of a letter of credit that is perfected by control should take priority over one that is not, and that SIs perfected by control should rank according to priority in time of obtaining control?

[211] We have followed the UCC wording here. Given that in English law an assignment does not require the bank's consent (compare UCC Section 5-114, above, para 4.138), perhaps it would be more appropriate to say 'if the bank has agreed to pay the proceeds to the secured party'.

PART 5
A STATEMENT OF THE RIGHTS AND REMEDIES UNDER A SECURITY AGREEMENT

INTRODUCTION

5.1 As we explained in Part 2, the UCC and the PPSAs all contain provisions setting out the law on the creation of SIs, the rights and duties of the parties to the security agreement, and the enforcement of SIs following default. These rules apply to most SIs, whether they are 'traditional' securities, such as charges or mortgages, or quasi-securities such as title-retention devices. However, the provisions relating to default and enforcement apply only to 'in-substance' SIs (that is, they do not apply to sales of accounts nor to leases for more than one year or commercial consignments that do not secure payment or performance of an obligation, even though these are defined as SIs for the purposes of perfection and priority).[1]

5.2 In the CP we described these provisions as a 'restatement' of the law of security. We suggested that including a 'restatement' would make it easier to see which rules should apply to the SI in question,[2] and we provisionally proposed that our scheme should contain similar provisions.[3] We also asked whether any 'restatement' should form part of the 'companies-only' stage, or whether it should wait until a scheme for all debtors is implemented. In Part XI of the CP we outlined the provisions that might be wanted, and we gave further details in Appendix B, along with consultation questions on each topic. Only a small number of respondents dealt with the questions in Appendix B, but the answers are quite revealing. It seems that provisions on certain topics are seen as much more important than on others.

5.3 Since the publication of the CP, we have been able to examine the issues in more detail, to consult informally on them[4] and to draw up provisional recommendations. In Part 2 we explained our conclusions that:

(1) although the rules that we now provisionally recommend in this Part to a large extent reflect current law, there are a number of significant changes, particularly in that the same rights and remedies will, in general

[1] SPPSA, ss 3(2) and 55(2); NZPPSA, ss 17(1)(b) and 105. The UCC seems to address the application of the rules of its Part 6 ('Default') on a rule-by-rule basis, see, eg, Section 9-608(a). In the case of the New Zealand scheme, *all* transfers of accounts are excluded from the application of the default rules, whether or not they have a security purpose. This may have been a drafting error: M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 105.4 (pp 384-385). We do not suggest following a similar approach to New Zealand.

[2] CP para 11.37.

[3] CP para 11.47.

[4] A supplementary paper was produced for a discussion seminar held at Berwin Leighton Paisner on 5 November, 2003.

terms, apply to all interests that have a security purpose. It is therefore more appropriate to speak of a legislative 'statement of rights and remedies' rather than a 'restatement';

(2) if quasi-securities are to be included, it is necessary for our companies scheme to contain a number of provisions relating to the rights and duties of the parties in respect of any surplus realised when the collateral is disposed of after default;

(3) it is very desirable that the scheme should include a number of other provisions. These deal principally with the remedies available in the event of the debtor's default, and the rights of the debtor. These rules would replace the current rules of common law and equity that apply specifically to the relevant security or transaction, and such statutory provisions as affect them. They would aim to simplify the law by setting out a system that, so far as is feasible, applies to all types of interests created by companies that have a security purpose; and

(4) the statement of rights and remedies should be introduced at the companies-only stage, rather than only if and when the scheme is extended to SIs created by unincorporated debtors.[5]

5.4 Under the terms of the Financial Collateral Directive, collateral takers must be given a right to appropriate the financial collateral.[6] This is in some ways akin to a power of sale, in others to foreclosure. There are special provisions dealing with the duty to account for any surplus, etc. This therefore requires separate consideration. Financial collateral that is subject to a financial collateral arrangement within the meaning of the FCAR will therefore be treated somewhat differently under the scheme to be considered in this Part. It is considered later.[7]

5.5 This Part does not deal with questions of SIs over crops, fixtures, accessions and processed or commingled goods. Although in the CP and our informal discussion paper these were covered under the heading of the 'restatement', the issues are more accurately described as ones of priority. They were discussed in Part 3.[8]

SUMMARY OF PROVISIONAL RECOMMENDATIONS

5.6 In this Part we provisionally recommend that rules relating to the distribution of any surplus and the payment of any deficiency should be included in our scheme; they are essential for the proper functioning of the full scheme we have outlined in the preceding Parts of this consultative report. We also provisionally recommend that it would be desirable for the scheme to include rules relating to what might broadly be said to be prohibitions on assignment, the duties of the

[5] See above, para 2.188.

[6] See FCAR, Part 4.

[7] See below, paras 5.120-5.133.

[8] See above, paras 3.264-3.282. Attachment has also been dealt with earlier: see above, paras 3.71-3.85.

parties and their rights and remedies on default. Although the statement will supersede the current law governing the law of security and the quasi-security transactions brought within the scheme, it is not intended that it should affect general principles of law – for example, on the formation or validity of contracts. There is therefore a savings provision for principles of common law, law merchant and equity save as far as such principles are inconsistent with our legislation. The draft regulations contain provisions relating to these matters for consultees to consider and assess.

5.7 We explain briefly why we are not recommending the inclusion of a number of provisions found in the PPSAs and UCC. Some of these seem to be aimed at consumer protection and may need to be reconsidered if and when the scheme is extended to SIs created by consumers.

5.8 In the CP and the later informal discussion paper we suggested that the legislation might usefully include a general provision to the effect that the rights and remedies under the scheme must be exercised in good faith and in a commercially reasonable manner. As we explained in Part 2, in the light of consultation and further examination of the way in which such provisions operate in other schemes, we have concluded that a general provision is not needed and may be undesirable. Instead we provisionally recommend merely that certain remedies (principally, the secured party's sale or disposal of the collateral) must be exercised in a commercially reasonable manner.

5.9 We would welcome views on whether specified rules in the restatement should be mandatory or whether the parties should be able to vary the rules to the detriment of the debtor. Provisions making the specified rules mandatory have been included for consultees to evaluate but, in our view, they could be altered without affecting the structure as a whole.

SCOPE OF THE STATEMENT OF RIGHTS AND REMEDIES

Application to 'in-substance' SIs

5.10 It is important to note that, subject to one exception, the provisions comprising the statement of rights and remedies in Part 5 of the draft regulations will only apply to 'in-substance' SIs. Thus the provisions of Part 5 that we discuss here will not apply to those interests that are 'deemed' SIs for the purposes of the application of the rules of perfection and priority (that is, outright sales of accounts or promissory notes, or leases for more than one year or commercial consignments that do not secure payment or performance of an obligation). This is made clear by DR 56(1). The exception referred to above is that a secured party who has taken an outright transfer of an account on a recourse basis must exercise its collection rights in a commercially reasonable manner.[9]

5.11 **We provisionally recommend that the statement of rights and remedies should not, in general, apply to 'deemed' SIs.**

[9] See below, para 5.50.

5.12 In addition, in this Part of the consultative report we discuss two provisions that are not in Part 5 and which apply to both 'in-substance' and 'deemed' SIs. They concern the preservation and use of collateral[10] and the prohibition of non-assignment clauses.[11] Both are discussed below.[12]

Other limitations on the scope of the statement of rights and remedies

Financial collateral

5.13 We have noted above that specific treatment is accorded to financial collateral.

Ships

5.14 As we noted when we were dealing with the specialist registers, the provisions of the statement of rights and remedies is without prejudice to Admiralty practice relating to the enforcement of mortgages and charges over ships (those that fall within the scope of the scheme).[13]

SIs over both personal property and land

5.15 Although the creation or transfer of interests in land are generally excluded from the scope of the scheme as a whole,[14] we have included a provision in the draft regulations that addresses the question of overlap of our scheme with interests of land, for the purposes of the statement of rights and remedies.[15] This provision is intended to facilitate the situation where it would be convenient to dispose of personal property along with land (for example, where the mortgagee of a hotel wishes to sell both the hotel and its equipment at a single sale). Accordingly, the draft regulation provides that if the same obligation is secured by an interest in land and an SI to which the draft regulations apply, the secured party may either proceed under Part 5 of the draft regulations as to the collateral (that is, the personal property subject to the SI within the scheme) without limiting the secured party's rights, remedies and duties with respect to the land, or the secured party may proceed as to both the land and the personal property. If the secured party opts for the latter course, its rights, remedies and duties with respect to the land apply to the personal property as if the personal property were land, and Part 5 of the draft regulations will not apply. An equivalent provision is found in the North American schemes.[16]

5.16 We think that such a provision might be helpful clarification, but we would welcome the views of consultees as to whether it should be included. **We ask whether the scheme should provide that, if the same obligation is secured**

[10] DR 17.

[11] DR 45.

[12] See below, paras 5.31-5.46.

[13] See above, paras 3.34-3.336.

[14] DR 12(1)(g), and see above, para 3.63(1).

[15] DR 57.

[16] SPPSA, s 55(4)-(6); OPPSA, s 59(6); UCC Section 9-604(a).

by an interest in land and an SI to which the draft regulations apply, the secured party may either proceed under Part 5 as to the personal property, or proceed as to both the land and the personal property, in which case its rights, remedies and duties will be as if all the property were land.

Secured party acting through a receiver

5.17 The draft regulations provide that the rights, powers and duties of a secured party under Part 5 (that is, the statement of rights and remedies), as well as DR 17 (dealing with preservation and use of collateral) apply equally when the secured party acts through a receiver.[17] This is discussed further below.[18]

ESSENTIAL PROVISIONS: SURPLUS AND DEFICIT

Distribution of any surplus

5.18 The CP proposed that any 'restatement' forming part of a system that included quasi-securities should clearly set out the rights and duties in respect of surplus.[19] This was opposed only by those consultees who did not wish to see quasi-securities brought within the scheme at all.

5.19 The need for such a provision follows from the decision to treat quasi-securities, and in particular title-retention devices, in the same way as the traditional securities to which they are functionally equivalent. We explained in the CP that under current law, where a secured asset is subject to a 'traditional' form of security and is sold by the creditor, it must account to the debtor for any surplus above the amount of the secured sum including the properly incurred costs, charges and expenses of the sale.[20] However, with a quasi-security there is no obligation to account for any surplus from the sale of repossessed goods. The creditor under a quasi-security agreement is therefore in some ways better off than the holder of a fixed charge would be. We noted in the CP that this has sometimes led the courts to make some efforts to prevent the creditor being able to take property worth more than the amount owed, or if the property repossessed was worth more, to retain the excess.[21]

5.20 We noted in Part 2 that the UCC and PPSAs re-characterise SIs that have a security purpose in the sense that any surplus[22] becomes payable to the debtor;

[17] DR 58(2).

[18] See below, paras 5.99-5.101.

[19] CP para 12.129.

[20] CP para B.47.

[21] See CP para 6.21, discussing *Clough Mill Ltd v Martin* [1985] 1 WLR 111. See also *On Demand Information plc (in Administrative Receivership) v Michael Gerson (Finance) plc* [2003] 1 AC 368.

[22] After deduction of all that is due to the secured party, including sums to which it would have been entitled had the agreement run its course, and reasonable expenses.

and that this seems to reflect the expectations and interests of the parties to such agreements in England and Wales.[23]

5.21 **We provisionally recommend that the draft regulations contain a provision setting out expressly how, unless otherwise provided by law or the agreement of all interested parties, the secured party must apply the proceeds of any disposition of the collateral.**[24]

Payment to subordinate secured parties

5.22 A further question is to whom, and in what order, the SP should account for any surplus in priority to the debtor. The SPPSA requires the secured party who is left with a surplus to account for it to any subordinate creditor who has filed against the collateral before the distribution of the surplus.[25] In contrast, the UCC merely requires it to pay the surplus to subordinate secured parties who have sent it an authenticated demand before distribution of the proceeds is completed.[26] In other words, the secured party does not have to search to see what other secured parties have filed before it distributes the proceeds.

5.23 In many cases the secured party will already have searched because it may be under a duty to notify subordinate secured parties before it disposes of the collateral.[27] This will not be the case, however, where the secured party is merely collecting on the collateral,[28] nor when there is no duty to give notice to other secured parties before disposing of the collateral (for example, when the collateral is sold in a recognised market[29]); and it is possible that the subordinate

[23] See above, para 2.110.

[24] We have already noted that the provisions of Part 5 of the draft regulations will not apply to 'deemed' SIs. Thus although, under our provisional recommendations, any lease of goods for more than one year and any consignment of goods would need to be perfected, the 'surplus' rules would not apply if the particular lease or consignment were shown not to have a security function, eg, if it were shown that the lease was a long-term operating lease or the consignment was merely because the goods were on sale-or-return, the consignee having already paid a deposit equal to the purchase price. Similarly, when accounts are sold outright, eg, under a factoring agreement, the SI will be perfected (by filing), so as to warn other parties that the accounts are no longer the debtor's to dispose of. However, the factor who has bought the debt is entitled to keep all the proceeds; the difference between the discounted price paid and the amount the factor collects represents its profit. Therefore there is no obligation to account for the surplus. It is otherwise if the accounts are not sold outright but are transferred by way of security (as happens at present with a charge over book debts). Then the transfer does secure payment or performance of an obligation and the rules on surplus do apply. UCC Section 9-608(b) likewise excludes the rules on surplus and deficiency if the underlying transaction is a sale of accounts.

[25] SPPSA, s 60(2), which also requires payment to a subordinate secured party who was in possession of the collateral when it was seized, and to anyone else who has given a written notice to the secured party of an interest in the collateral. See further para 5.25 n 33.

[26] UCC Section 9-607 and Section 9-615.

[27] See below, paras 5.73-5.86.

[28] See below, paras 5.49-5.51.

[29] See below, para 5.71.

secured party has filed since any notice was given. Thus there may be a case for the wider SPPSA provision; but in most cases the junior creditor can be expected to know that the senior secured party is collecting on the collateral or intends to dispose of it and to notify the secured party of its interest. Surpluses are in any event uncommon. Therefore it seems unnecessary to place this additional burden on the senior secured party. For the time being we have followed the UCC approach, but we would welcome advice on this.

5.24 Consequently, the draft regulations provide that any surplus[30] must be paid first to a person who has a subordinate SI in the collateral and who has given a written notice of the interest to the secured party prior to the distribution, and secondly to the debtor or any other person who is known by the secured party to be an owner[31] of the collateral.[32]

5.25 The order of distribution stated is without prejudice to the priority of any claimant.[33] If there is doubt about entitlement or priority, the secured party may pay the money into court.[34]

5.26 **We provisionally recommend that any surplus be accounted for and paid over in the following order:**

(1) to a person who has a subordinate SI in the collateral and who has given written notice of the interest to the secured party prior to the distribution, and

(2) to the debtor or any other person known by the secured party to be an owner of the collateral.[35]

5.27 **We ask consultees whether the secured party should have to pay any surplus proceeds only to those subordinate secured parties who have**

[30] Any surplus distributed in accordance with DR 65 must be dealt with after deduction of various reasonable expenses and the satisfaction of the obligations secured by the SI: DR 62(9).

[31] 'Owner' in this context is not intended to include the secured party who is a lessor or other retainer of title, but rather to cover the situation where the debtor may be co-owner of the collateral. We think this is sufficiently clear from the context, but if consultees think there is ambiguity in the draft regulation, this point can be clarified.

[32] DR 65(2).

[33] This follows the SPPSA, s 60(2), closing words. This seems to envisage that the first secured party may pay in the order stated and, if that is not the order of priority, the other interested party who had priority but was not paid can claim in restitution against the one without priority who was paid. The NZPPSA, s 117 requires the first secured party to pay other secured parties who have filed in order of priority, which appears to put the risk of making an error onto the secured party. We do not consider that to be appropriate.

[34] We explained in Part 2 that we are now no longer provisionally recommending a 'general' duty of good faith and commercial reasonableness, but how instead the draft regulations include specific instances of the need to act in a commercially reasonable manner. See above, para 2.1820. This provision is an example.

[35] Below, at para 5.163, we provisionally recommend that this provision on surplus should be mandatory in the sense that it cannot be varied against the interests of the debtor.

given it a written notice of their interests or also to any subordinate creditor who has filed against the collateral before the date of distribution.[36]

Payment into court

5.28 Under Revised Article 9 the secured party has the option of paying any surplus into court rather than paying it to subordinate secured parties or the debtor. The SPPSA also permits payment into court but limits this right to cases in which there is a question as to who is entitled to the surplus.[37] We think it will be in cases of doubt as to who should receive any surplus that it would be most useful to have the right to pay the money received from the disposition into court, but we see no reason to limit the right to these cases. We have accordingly included an unrestricted provision in the draft regulations.[38] **We provisionally recommend that, as an alternative to paying over any surplus in the order specified in the draft regulations, the secured party should have an unqualified right to pay it into court.**

Deficiency

5.29 The draft regulations contain a similar provision to that found in the SPPSA: unless otherwise agreed or provided for by the draft regulations or by statute, the debtor is liable to pay any deficiency to the secured party.[39] **We provisionally recommend that our scheme should provide that, unless otherwise agreed or provided for by statute, the debtor is liable to pay the amount of any deficiency to the secured party.**

DESIRABLE PROVISIONS

5.30 The provisions we explained in the previous section are those that we think are essential for the full scheme explained in Part 3 to function effectively. The other schemes contain a number of other provisions that we think are desirable even for our companies-only scheme, and which we have accordingly included in the draft regulations for consultees to consider. Most of these were outlined in the CP. The provisions may be treated under three broad headings: prohibitions on assignment, a statement of the duties of the parties and a statement of their rights and remedies on default. The first two heads would apply to all SIs, whether the SI secures payment or the performance of an obligation or is a

[36] We see no need to require the secured party to notify a secured party who had possession of the collateral before it was seized, as is required by SPPSA, s 60(2)(a)(ii); such a secured party will inevitably know of the senior secured party's intentions and can make a demand if it wishes any surplus to be paid to it.

[37] SPPSA, s 60(4).

[38] DR 65(2).

[39] See DR 66. Equivalent provisions can be found in the SPPSA, s 60(5) and the UCC Sections 9-608(a)(4) and (b) and 9-615(d)(2). The NZPPSA, s 116(c) implicitly suggests the debtor remains liable for the outstanding balance. This of course assumes that the secured party has acted properly in the way it disposed of the goods. Again, this provision does not apply to the 'deemed' SIs, although an account may of course be sold on a recourse basis, so that in effect the debtor does become liable for a deficiency.

'deemed' SI; the statement of rights and remedies on default would (with one exception) apply only to 'in-substance' SIs.

Effect of prohibition on assignment

5.31 An issue that we mentioned in the CP without raising it for discussion, but that has been the subject of considerable debate subsequently, is whether the scheme should render ineffective prohibitions on assignment. The current law is that if a contract - for example, a contract of sale on credit, giving rise to a book debt - provides that the debt may not be assigned without the debtor's consent, the account debtor is entitled to ignore any notice of assignment and may insist on paying the assignor.[40] This does not prevent the assignee acquiring a proprietary right to the debt as against the assignor,[41] but the 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 UCC and the SPPSA contain express provisions to the effect 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] We have been urged very strongly by some to adopt the same rule.

5.32 Opinion is divided. The principal concern is that a debtor may want a prohibition to avoid having to deal with an assignee who is not known to it and whose demands may be much more insistent than those of the assignor.[46] A second concern stems from the staged nature of this project. It would be awkward to have one rule for companies and another for unincorporated businesses. A third is simply that the proposed rule would be an interference with freedom of contract.

5.33 On the first point, discussion with a number of those who raised the point has revealed that their main concern is that this might affect loans. In the context of high value loans, prohibitions on assignment are seen as important for the borrower, not only to protect the borrower from an assignee who might be more

[40] 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.

[41] See R Goode, *Legal Problems of Credit and Security* (3rd ed 2003) paras 3.41-3.43 (pp 107-110).

[42] *Ibid*, 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.

[46] Other reasons are to avoid the risk of overlooking a notice of assignment and paying the wrong person, and to preserve rights of set-off, see above, para 5.31 n 40.

demanding than the original creditor, but also to prevent the debt being sold to one of the borrower's competitors. These consultees said that they would not be concerned were the prohibition confined to accounts receivable. It was not our intention that the prohibition would affect loan agreements. The provision we have included for consultation in the draft regulations is limited to non-assignment clauses in contracts between assignors and 'account debtors'. This by definition excludes money due under a loan.[47] We would add that we have no evidence that in the jurisdictions in which this rule has been adopted there are serious problems of oppression by assignees.

5.34 It was also suggested to us that any prohibition of anti-assignment clauses should be limited to receivables financing, that is, where receivables are sold in large numbers. We agree that this is where the principal problem with anti-assignment clauses arises, but we do not think that limiting the rule to receivables sold in 'bulk' would be workable, since any receivable may be sold either in bulk or on its own.[48]

5.35 The second argument, that prohibitions on assignment cannot appropriately be invalidated as part of a companies-only scheme, involves two issues.

5.36 The first is that any prohibition will be contained not in the security agreement but in the contract that gives rise to the debt or other right purportedly assigned. Changing the rule would effectively mean that anyone dealing with a company could no longer employ a prohibition on assignment in its contracts with the company. It strikes some consultees as inappropriate that regulations on companies should remove the rights of those who are not companies. With respect, we think this objection is misconceived. It has always been the case that the legislation governing company charges - for example, the provisions invalidating a charge that is not registered within the 21-day period - affects the rights of creditors who may not themselves be companies. The proposed rule overriding any contractual prohibition on assignment would be no different in this respect.

5.37 The second issue does cause us concern. This is that under a companies-only scheme the proposed rule could not affect receivables that are payable to a business that is not a company. Thus the proposed rule would increase the differences between the rules applying to companies and the rules applying to other businesses. However, as we stated in Part 2,[49] we take the view that it is better to make the companies-only scheme as complete as possible, even at the risk of some further fragmentation of the law.[50]

[47] See the discussion of 'account debtor' and 'account', above, paras 3.12 and 3.21.

[48] There is no such restriction in the 2001 UN Convention on the Assignment of Receivables in International Trade.

[49] See above, para 2.167.

[50] 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 para 8.36.

5.38 The third argument, that a prohibition of anti-assignment clauses is an interference with freedom of contract, is obviously correct. The question is, however, whether the interference is justified. The arguments are finely balanced. We have provisionally concluded that, given the clear inconvenience of the current rule in the context of receivables financing and the international trend towards overriding such prohibitions, the interference is justifiable.

5.39 **We provisionally recommend that in a contract between a company and a third party creating an account 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.**[51]

Duties of parties under the security agreement but before default

5.40 We think that it would be useful to include provisions that set out the rights and duties of the secured party in respect of the care and use of collateral, and in relation to 'proceeds' such as dividends received from it. We discuss these in the following paragraphs. As we indicated earlier, the provisions would (save as otherwise stated) apply to both 'in-substance' and 'deemed' SIs.

Care in custody and preservation of collateral

5.41 The SPPSA and UCC each provide that if the collateral is in the possession of the secured party, it must take reasonable care of it and preserve it, including (in the case of an instrument) taking steps to protect it from third parties.[52] The sections do not impose an obligation to insure the collateral. However, unless agreed otherwise, the cost of any steps reasonably taken, including insurance, are chargeable to the debtor and secured on the collateral; and if the goods are accidentally lost or damaged, any shortfall in the insurance rests on the debtor. We have included similar provisions in the draft regulations. **We provisionally recommend that the secured party who has possession of the collateral should be under a duty to take reasonable care of it and should be able to insure it at the debtor's expense.**[53]

5.42 The UCC provides that a duty to preserve rights against the prior parties will apply also to an outright buyer of accounts (for example, a factor) if the sale was on a recourse basis.[54] This seems a sensible rule that fits with commercial expectations: the seller would not, we think, expect to be liable in respect of a non-payment that was caused by a commercially unreasonable failure on the part of the factor to preserve its rights against the account debtor (for example, allowing the debt to become statute-barred).[55] **We provisionally recommend that an outright buyer of accounts or of a promissory note should be under**

[51] DR 45.

[52] SPPSA, s 17; UCC Section 9-207. Fungible property may be commingled.

[53] See DR 17(2).

[54] UCC Section 9-207(d).

[55] Compare the parallel issue that arises in respect of collection of receivables sold on a recourse basis: below, para 5.52. We are not aware on any authority on whether a recourse buyer is subject to any implied duty.

a duty to take necessary steps to preserve rights against other parties unless the sale was on a non-recourse basis.[56]

Income, etc. from collateral

5.43 Where collateral is in the secured party's possession or control, the draft regulation provides that the secured party may hold as additional collateral any increase or profits (except money) received from the collateral. In the case of money received, the secured party must either remit it to the debtor or apply it to reduce the amount of the secured obligation.[57] **We provisionally recommend that the secured party who has possession or control of collateral should apply any money received from the collateral to reduction of the obligation secured or remit it to the debtor; and in the case of other proceeds should be entitled to hold them as additional collateral.**[58]

Right of use

5.44 We have included in our draft regulations that in the case of financial collateral[59] the secured party should have a right of use, including a right to create a further security (sub-pledge) in the collateral.[60] (This aspect, although included in this Part in the 'desirable' provisions might be considered to be 'essential', given the requirements of the FCAR.)

5.45 As to a right to use other collateral, the SPPSA and UCC provide that the secured party may use the goods only for the purpose of preserving the collateral or to the extent authorised by the agreement or the court.[61] Where the secured party takes possession of physical collateral, so that there is a pledge, most of these results would probably follow at common law,[62] but to include a provision covering these matters would make the law much more accessible.

5.46 **We provisionally recommend that, unless otherwise agreed, the secured party who has possession of collateral should be permitted to use it for the purpose of preserving the collateral or to the extent authorised by the security agreement or the court; to create an SI in it, and, where the secured party has possession or control of collateral that is investment property, and the parties so agree, to sell it.**[63]

[56] See DR 17(6).

[57] Compare SPPSA, s 17(3) and UCC Section 9-207(c).

[58] See DR 17(5)(a).

[59] See above, paras 4.68-4.69.

[60] Compare UCC Section 9-207(c).

[61] See SPPSA, s 17(4); UCC Section 9-208 (a)-(b) (similar save that a consumer may not consent to the secured party using the goods). The OPPSA, s 17 contains similar rules.

[62] See *Chitty on Contracts* (29th ed 2004) paras 33-130 - 33-131 (duty of care); N Palmer and A Hudson, 'Pledge' in *Interests in Goods* (eds N Palmer and E McKendrick 2nd ed 1998) p 640 (pledgee cannot use goods unless necessary to look after them, eg, milking a cow).

[63] See DR 17(4)-(5).

Rights and remedies on default

5.47 We provisionally recommend the inclusion of a number of provisions that set out the rights and remedies of the parties, and in particular the remedies available to the secured party,[64] in the event of the debtor's default. The advantages of including a scheme of remedies that would apply uniformly to all SIs were outlined in Part 2.[65] We repeat that, with one exception,[66] these would apply only to SIs that have a security purpose, and not, for instance, to outright sales of receivables or to operating leases.[67]

No effect on judicial remedies

5.48 What follows, and Part 5 of the draft regulations, provides a set of essentially self-help remedies to which a secured party may resort in the event of default by the debtor. The secured party has only the remedies provided by the scheme and the rights and remedies provided in the security agreement. However this is without prejudice to judicial remedies otherwise available to enforce the rights of the parties.[68] Thus the fact that the scheme does not refer, for example, to the court granting an injunction would not prevent the court from so doing if that were an appropriate way to enforce one party's rights.

Collection rights

WHERE THE SI SECURES PAYMENT OR PERFORMANCE OF AN OBLIGATION

5.49 The SPPSA[69] provides that in the case of an 'in-substance' SI over an intangible (which includes accounts) or an instrument, in the event of default by the

[64] Under most of the PPSAs, the remedies provided (for example, taking of possession and sale or retention of the collateral) may be exercised by any secured party, even if another secured party has priority over the same collateral. The junior secured party will hold the collateral subject to the prior SI; and if the junior secured party were to sell it, it would have to do so subject to the prior SI, which would be binding on the purchaser. It is only the interest of the debtor and any SIs subordinate to the secured party's interest that would be extinguished by the sale: see eg, SPPSA, s 59(14). This is the case also under current English law. It is of course possible for the junior creditor to persuade the senior creditor to join in the sale, presumably at the cost of paying the senior creditor off; and under the Law of Property Act 1925, s 50 the court may order that the sale be free of any incumbrance if enough to cover the payments due is paid into court. In contrast, under the NZPPSA the remedies are normally stated to be exercisable only by 'a secured party with priority over all other secured parties': See, eg, ss 109, 111 and 120. It appears that this was done deliberately, but possibly under the misapprehension that otherwise the senior secured party would be left unsecured: M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 109.2, especially n 32 (pp 392-396). We do not think this approach should be adopted.

[65] See above, paras 2.160-2.167.

[66] The exception relates to receivables sold outright but on a recourse basis; see below, para 5.52.

[67] See above, para 5.10.

[68] DR 56(4)(a).

[69] In the CP para B.13, we erroneously said the NZPPSA has a similar provision. In fact, the right to notify the debtor, etc. has to be implied: see M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 108.1 n 25 (p 391).

debtor,[70] the secured party may require the party liable on the receivable, etc. to pay it to the secured party, whether or not collections were being made before such notification. Equally, if the secured party is entitled to the proceeds of collateral it may 'take control' of them.[71] The secured party enforcing its SI must also give notice to the debtor within 15 days of doing so.[72] It may then apply the money received, or equally any 'account, instrument or security in the form of a debt obligation [for example, a negotiable instrument] taken as collateral' to the satisfaction of the secured obligation. Where the collateral is a licence, the secured party may 'seize' it by giving notice to both the debtor and the grantor (or successor) of the licence. The secured party may deduct reasonable expenses of collection from amounts so collected or money held as collateral.[73]

5.50 The SPPSA provision reflected those of UCC former Article 9.[74] Revised Article 9 has a broader scope, as it applies not only to 'account debtors' (that is, those liable on receivables) but also to 'other persons obligated on collateral to make payment'.[75] This is in part a matter of drafting not of substance: it applies to those liable to make payment on some other forms of intangible property that under the UCC do not fall within the definition of 'account', but that would fall within the rather wider definition used in our scheme. However the UCC provision is also wider in substance. The Official Comments give as an example a claim for breach of warranty on equipment that has been given as collateral, or a claim for infringement of a patent that forms collateral.[76] The section also covers the rights of a party that has taken an SI over a bank account to apply the funds to the obligation secured (where the secured party is the bank) or to have them paid to it (where the secured party is a third party).[77]

5.51 Consultees' views were divided on whether a provision equivalent to that in the SPPSA should be included in a restatement, some taking the view that it should be left to the parties to agree expressly. We think that, although these rules reflect, broadly, the current law, and cover matters that frequently will be agreed expressly, it would nonetheless be useful to include a set of 'default' rules along the lines of the SPPSA provision. The provisions should deal expressly with bank accounts. We do not, however, think that it is necessary to include in a companies-only scheme a requirement on the collecting secured party to notify the debtor that it has enforced its interest. The additional issues covered by the

[70] Ie, the party whose obligation is secured, whether or not it is the person who has provided the receivables as collateral: see above, para 2.12(1).

[71] 'Control' here should not be confused with the concept of perfection by control (a concept not used in the PPSAs). Our draft regulations do not use 'control' in this context.

[72] SPPSA, s 57.

[73] SPPSA, s 57(3)-(5).

[74] Former Article 9, Section 9-502.

[75] Revised Article 9, Section 9-607.

[76] Section 9-607 allows a junior secured party to enforce the relevant obligations. See above, para 5.47 n 64.

[77] UCC Section 9-607(a) (4)-(5).

UCC can also be left to the parties to deal with expressly.[78] We have drawn up the draft regulation dealing with this area accordingly. **We provisionally recommend that the statement of rights and remedies provide that where the collateral is an account and the debtor defaults, the secured party may:**

(1) notify the account debtor to make payment to the secured party, whether or not the secured party was making collections on the collateral before the notification by the secured party;

(2) take any proceeds of collateral to which it is entitled; and

(3) apply the money received, or any account, instrument or security in the form of a debt obligation taken as collateral to the satisfaction of the secured obligation.[79]

There should be similar provisions for bank accounts.[80]

OUTRIGHT SALES OF RECEIVABLES

5.52 There is another difference between the SPPSA and the UCC. The SPPSA provisions on collection by the secured party do not apply to outright sales of receivables. The UCC also imposes a duty on the outright buyer of this type of collateral, unless the sale was on a non-recourse basis (in which case the debtor has no interest in the amount that the secured party recovers from the account debtor).[81] The secured party must collect the receivables in a commercially reasonable manner.[82] We think that the secured party should be required to act in a commercially reasonable manner in such cases and we consider that an English court would probably hold this to be an implied term of the recourse agreement.[83] It would be as well to state this explicitly here.[84] **We provisionally recommend that a secured party who buys receivables on a recourse basis should be required, if it collects on the receivables, to proceed in a commercially reasonable manner.**[85]

[78] Nor do we feel it is necessary to provide expressly, as does UCC Section 9-607(e), that the provisions only affect the rights of the secured party as against the debtor.

[79] See DR 60(1), (2) and (4).

[80] See DR 60(3).

[81] It applies to case of default and to any other cases in which it has been agreed by the parties that the secured party may collect on the collateral.

[82] Section 9-607(c). Compare the parallel provision on care of the collateral, discussed above, paras 5.41-5.42.

[83] We are not aware of any relevant authority.

[84] This is one of the few specific instances in which we propose that there should be an obligation to proceed in a commercially reasonable manner. We are no longer proposing that there should be a general provision requiring commercial reasonableness, see above, para 2.182.

[85] See DR 60(5). This is the one provision contained in Part 5 of the draft regulations which applies to a 'deemed' SI. See above, para 5.10.

'NON-CASH' PROCEEDS

5.53 It may be that the account debtor is unable to pay cash but discharges its obligation by some other form of performance that is accepted by the secured party in lieu, for example by giving a promissory note. The secured party may wish to wait until the note is due rather than have to raise cash immediately by selling the note at an unfavourable discount. The UCC permits this (termed as 'applying or paying over the non-cash proceeds') unless to wait would be commercially unreasonable. If the secured party does apply the non-cash proceeds, it must do so in a commercially reasonable manner.[86] This seems a useful rule. **We provisionally recommend that the secured party should be able to defer applying or paying over non-cash proceeds, provided that is it not commercially unreasonable; and that where a secured party does apply or pay over non-cash proceeds, it must do so in a commercially reasonable manner.** [87]

Taking possession on default

5.54 As we said in the CP, rules on the secured party's right to take possession of the collateral and to enforce the SI seem to state an obvious principle, but it would be very odd to have a statement of rights and remedies without including provisions on this issue. The question is rather, what provisions should be included? We deal with the questions by reference to the model of the SPPSA or, in some cases, the NZPPSA. In some cases we contrast these provisions (which frequently derive from earlier versions of Article 9 of the UCC) with the provisions of Revised Article 9. (For the moment we will assume there is only one secured party.)

TAKING POSSESSION: GENERAL

5.55 The SPPSA provides that the secured party has, unless otherwise agreed, the right to take possession of the collateral or otherwise enforce the security agreement by any method permitted by law.[88] It also provides that if the collateral is a document of title, the secured party may proceed either as to the document of title or as to the goods covered by it, and that a method of enforcement available with respect to the document of title is also available, with any necessary modification, with respect to the goods covered by it.[89]

5.56 As we explained in the CP, these provisions broadly follow existing law, though in some cases the right to take possession may need to be stated in the agreement. We think that they should be replicated in the statement of rights and remedies, and accordingly they are included in the draft regulations.[90]

[86] UCC Section 9-608(a)(3).

[87] See DR 60(6).

[88] SPPSA, s 58(2). Compare NZPPSA, ss 109(1), 112; UCC Section 9-609(a)(1).

[89] *Ibid*.

[90] DR 61.

5.57 The phrase 'by any method permitted by law' seems to refer to the common law principle that the secured party must not commit a breach of the peace. It seems unnecessary to state this, and we have omitted it. A more pertinent issue is whether the secured party may enter land in order to take possession unless this is authorised by the agreement or by a court.[91] **We provisionally recommend that the secured party should have an implied right to enter the debtor's premises in order to repossess collateral on the debtor's default, but should have to obtain a court order to enter the premises of a third party.**[92]

COLLATERAL THAT CANNOT READILY BE MOVED OR STORED

5.58 If the collateral cannot readily be moved, the secured party may need to be able to 'take possession' in some other way. Both the SPPSA and the NZPPSA in effect provide that where the collateral is of a kind that cannot readily be moved from the debtor's premises, or is of a kind for which adequate storage facilities are not readily available, the secured party may repossess the collateral without removing it from the debtor's premises.[93] Both then provide that the secured party may sell the collateral from the premises, but that the secured party must not cause the person in possession of the premises any greater inconvenience than is necessary.

5.59 The UCC does not limit the right to render equipment unusable and dispose of it from the debtor's premises to cases in which the collateral cannot readily be moved; it applies in any case.[94] Subject to the caveat that the secured party must not cause the person in possession of the premises any greater inconvenience or cost than is necessary, we think this is a better approach, and the draft regulation reflects this.

5.60 **We provisionally recommend that on default the secured party should have the right to disable equipment collateral that is on the debtor's premises and to sell it from there, provided that the secured party does not cause the person in possession of the premises any greater inconvenience and cost than is necessary.**[95]

[91] A court order is required for regulated agreements under the Consumer Credit Act 1974, section 92.

[92] See DR 61(2) and (6).

[93] SPPSA, s 58(2)(b), which provides that possession may be taken 'in any manner by which a sheriff acting pursuant to a writ of execution may seize without removal' (the type of collateral is also limited to goods); NZPPSA, s 111, which uses the concept of 'apparent possession', although the meaning of this is not explained.

[94] UCC Section 9-609(a)(2).

[95] See DR 61(3)-(4). It will be noted that this avoids the formula used in the SPPSA referring to the disabling of the equipment as a form of repossession. Although under our scheme repossessing goods is treated as a form of perfection (see above, paras 3.106-3.107), we do not consider that merely to disable equipment should be seen as a method of taking apparent possession that might perfect an otherwise unperfected SI, since the fact that the equipment has been disabled may not make it evident to third parties that an SI exists over it.

ASSEMBLY OF THE COLLATERAL

5.61 We have included a provision from the UCC to the effect that a secured party may require the debtor to assemble the collateral and make it available to the secured party at a reasonably convenient place.[96] This seems to be a useful provision where the collateral comprises a large number of goods (for example, fleets of vehicles) or payment intangibles kept in different places. We would welcome the views of consultees as to whether this provision should be retained. **We ask whether the secured party should be able to require the debtor to assemble the collateral and make it available to the secured party at a place to be designated by the secured party which is reasonably convenient to both parties?**

Power of sale

5.62 The secured party's power of sale is a central topic that cannot sensibly be omitted from a statement of rights and remedies. As we stated in the CP, under the current law, all secured creditors are permitted to sell the collateral if it has been agreed in the security agreement, though there are various statutory restrictions.[97]

5.63 The SPPSA provides that the secured party may dispose of collateral 'after seizing or repossessing' it.[98] We see no reason for restricting the powers in this way; there may be occasions on which the secured party can make an advantageous sale even before it has taken possession. **We provisionally recommend that the secured party should have the power to dispose of collateral on default by the debtor**.[99]

METHOD OF SALE OR DISPOSITION

5.64 The SPPSA sets out specific rules on exercise of the power of sale. These include:

(1) The sale may be by public sale (including auction or closed tender[100]) or private sale.[101]

(2) The secured party may buy the collateral, but only at a public sale, and only for a price that bears a reasonable relationship to its market value.[102]

[96] DR 61(5), and see UCC Section 9-609(c).

[97] CP paras B.34-35.

[98] SPPSA, s 59.

[99] DR 62(1). Compare UCC Section 9-610(a).

[100] We assume that 'closed tender' means a competitive tendering procedure under which sealed bids are submitted. We think the phrase 'competitive tender' used in the draft regulations would be more readily understood in this country.

[101] SPPSA, s 59(3)(a), (b). NZPPSA, s 113 refers also to 'other method': M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 113.1 (p 403).

(3) The collateral may be sold in its existing condition or after 'repair, processing or preparation for distribution'.[103]

(4) The collateral may be sold as a whole or in commercial units.[104]

(5) The secured party may delay disposition of all or some of the collateral.[105]

(6) If the agreement so provides, payment for the collateral may be deferred[106] or the collateral may be disposed of by lease.[107]

DISPOSITION TO BE MADE IN A COMMERCIALLY REASONABLE MANNER

5.65 These rules as a whole are subject to the general provision contained in the SPPSA that all rights under the Act or the agreement are to be exercised in good faith and in a commercially reasonable manner.[108] In the last respect, the structure of the UCC is rather different. As we have explained, there is no general requirement of commercial reasonableness;[109] it applies a requirement of commercial reasonableness in specific cases. We have already indicated that we provisionally recommend the 'specific case' approach.[110] The UCC's section on disposition of collateral is the principal one to which the requirement applies. The steps taken by the secured party – including both any preparation of the collateral for sale and the method, manner, time, place and other terms of the disposition – must be commercially reasonable. The net effect in relation to the secured party's right to dispose of collateral is thus very much the same under the SPPSA and the UCC.

5.66 It seems appropriate to require the disposition to be made in a commercially reasonable manner. As we explained in the CP:

> Under current law a secured creditor (or receiver appointed by it) does not owe a general duty to use reasonable care when exercising its powers and in dealing with the assets of the

[102] SPPSA, s 59(13). Notwithstanding any other provision, where the collateral is a licence, the collateral may be disposed of only in accordance with the terms and conditions under which the licence was granted or which otherwise pertain to it: *ibid*, s 59(18).

[103] SPPSA, s 59(2). The secured party may apply the proceeds to the reasonable costs of doing this and other expenses in seizing, repossessing, holding and disposing of the goods, and any other expenses reasonably incurred, before applying them to the obligations secured: *ibid*.

[104] SPPSA, s 59(3)(c).

[105] SPPSA, s 59(5).

[106] SPPSA, s 59(4).

[107] SPPSA, s 59(3)(d). There is no equivalent in the NZPPSA.

[108] SPPSA, s 65(2). See above, para 2.174.

[109] See above, para 2.173.

[110] Above, para 2.182.

mortgagor.[111] However equity imposes certain duties including a duty on the secured creditor to take reasonable care to obtain a proper price[112] and a duty to exercise its power in good faith for the purpose of obtaining repayment.[113] This duty is owed to the mortgagor and to a subsequent encumbrancer.[114]

The formulation used by the UCC and the PPSAs is slightly different to that used in current English law in that, rather than imposing a duty to take reasonable care, they impose one to act in a commercially reasonable manner; but it is hard to see any difference in substance between the two formulations.

5.67 **We provisionally recommend that the scheme should incorporate a provision to the effect that:**

(1) The sale may be by public sale (including auction or competitive tender) or private sale.

(2) The secured party may buy the collateral, but only at a public sale, and only for a price that bears a reasonable relationship to its market value.

(3) Collateral may be sold in its existing condition or after 'repair, processing or preparation for distribution'.

(4) Collateral may be sold as a whole or in commercial units.

(5) The secured party may delay disposition of all or some of the collateral.

(6) If the agreement so provides, payment for the collateral may be deferred or the collateral may be disposed of by lease.

5.68 The regulations should require that in exercising its rights under this provision the secured party act in a commercially reasonable manner.[115]

NON-CASH PROCEEDS

5.69 On occasions a secured party may dispose of collateral not for cash but for some other form of proceeds, for example a bill of exchange or promissory note. We

[111] See *Cuckmere Brick Co Ltd v Mutual Finance Ltd* [1971] Ch 949 and *Downsview Nominees Ltd v First City Corporation Ltd* [1993] AC 295. See also R Goode, *Commercial Law* (2nd ed 1995) p 691, and *Medforth v Blake* [2000] Ch 86. In the case of mortgages of goods falling within the Bills of Sale Acts and the Consumer Credit Act 1974 there are additional requirements for the giving of notice. (Footnote in original.)

[112] *Cuckmere Brick Co Ltd v Mutual Finance Ltd* [1971] Ch 949. (Footnote in original.)

[113] *Downsview Nominees Ltd v First City Corporation Ltd* [1993] AC 295. (Footnote in original.)

[114] CP para B.41.

[115] See DR 62. We do not think it necessary to follow UCC Section 9-610(d) and (e) in providing for implied warranties in the contract of disposition as to the right to sell, etc. These issues are adequately covered by other legislation.

have already considered this issue in relation to the proceeds of collection, and suggested that a secured party should not have to apply the proceeds of sale where they are non-cash proceeds unless the failure to do so would be commercially unreasonable; and that if the secured party does apply or pay over such non-cash proceeds, it must do so in a commercially reasonable manner.[116] We think the same rule should apply to the non-cash proceeds of a disposition.[117]

5.70 **We provisionally recommend that a secured party need not apply or pay over non-cash proceeds[118] of disposition unless the failure to do so would be commercially unreasonable, but where a secured party does apply or pay over such non-cash proceeds it must do so in a commercially reasonable manner.[119]**

PURCHASE BY THE SECURED PARTY AT A PRIVATE SALE

5.71 The UCC permits the secured party to buy the collateral at a public sale (as does the SPPSA),[120] but also by a private sale 'if the collateral is of a kind that is customarily sold on a recognised market or the subject of widely distributed standard price quotations', subject to special rules about calculating the surplus or deficiency after such sales. Essentially, if the disposition is to a secured party, a person related to the secured party or a secondary obligor, and the proceeds are significantly less than a normal disposition would raise, the surplus or deficiency is to be based on what would have been obtained by a proper disposition.[121] This seems a useful set of provisions since often the secured party will be willing to offer the 'going rate' for the collateral and there is no point in incurring the expense of a public sale or a private sale to a third party; but equally safeguards are needed.

5.72 **We provisionally recommend that the secured party should be permitted to buy the collateral:**

(1) at a public sale, or

(2) at a private sale if the collateral is of a kind that is customarily sold on a recognised market or the subject of widely distributed standard price quotations, subject to special rules about calculating the surplus or deficiency after such sales.[122]

[116] See above, para 5.53.

[117] Compare UCC Section 9-615(c).

[118] Non-cash proceeds are defined as proceeds other than money, cheques, deposits in or money credited to a bank account or insurance payments: DR 2(1).

[119] DR 65(5).

[120] UCC Section 9-610(c); SPPSA, s 59(13). This is provided that the price bears a reasonable relationship to the market value of the collateral. A sale at a marked difference would seldom be commercially reasonable.

[121] Section 9-615(f).

[122] See DRs 62(7) and 64.

NOTICE REQUIREMENTS

5.73 The SPPSA sets out detailed requirements on notices to be given before the sale.[123] The secured party has to give at least 20 days' notice of disposition to the debtor or other known owners, to subordinate secured parties who have either filed financing statements in the name of the debtor (or as serial numbered goods) or who have perfected by possession when the goods were seized/repossessed, and to any other interested person who has given notice to the secured party prior to the day on which the notice of disposition is given to the debtor.[124]

5.74 The notice has to contain a number of detailed requirements:

(1) a description of the collateral;

(2) the amount required to satisfy the obligations secured by the SI;

(3) the sums actually in arrears, and a brief description of any default other than non-payment (and the provision of the security agreement breached);

(4) the amount or reasonable estimate of 'applicable expenses';

(5) a statement that, on payment of the amount due, a person who is entitled to receive the notice may redeem the collateral;

(6) a statement that, on payment of the sums in arrears or on the curing of any other default, as the case may be, together with payment of the amounts due, the debtor may reinstate the security agreement;

(7) a statement that, unless the collateral is redeemed or the security agreement is reinstated, the collateral will be disposed of and the debtor may be liable for any deficiency; and

(8) details of location, date etc. of any sale or closed tenders.[125]

There are also provisions as to notices to be given by receivers.[126]

5.75 However, in quite a wide range of circumstances notice is not required. In particular, collateral may be sold without notice if it is sold on an organised

[123] SPPSA, s 59.

[124] UCC Section 9-611(c) contains a similar list.

[125] Where notice has to be given to persons other than the debtor, not all the information listed need be supplied: SPPSA s 59(8).

[126] The required contents of a notice given by a receiver are slightly less than for a secured party. The notice is to contain a description of the collateral; a statement that, unless the collateral is redeemed, it will be disposed of; and details of any sale by public auction, closed tender or private disposition: SPPSA, s 59(11).

market.[127] Notice is also not required where the collateral is perishable; if the secured party reasonably believes that the collateral will decline substantially in value if not disposed of immediately; if the cost of care and storage is disproportionately large in relation to the collateral's value; if it is foreign currency; if, after default, each person entitled to receive a notice of disposition consents in writing to the disposition of the collateral without compliance with the notice requirements; or if for any other reason, a court on a 'without notice' application is satisfied that a notice is not required.[128]

5.76 Even with the exceptions, this scheme[129] is in marked contrast to that of the current law. First, it is far more detailed than any general provisions of English law. The Law of Property Act 1925, section 103 provides that the statutory power of sale may not be exercised until notice requiring payment of the mortgage money has been served on the mortgagor, and default has been made in payment of the mortgage money, or of part thereof, for three months after such service; but notice is not required if some interest under the mortgage is in arrears and unpaid for two months after becoming due; or there has been a default of some other kind under the mortgage deed. Section 196 merely stipulates what names and addresses may be used if the notice is to be sufficient. The degree of detail in the SPPSA scheme is matched only by the provisions of the Consumer Credit Act 1974.[130]

5.77 Secondly, the Law of Property Act scheme applies only if there is no express provision in the mortgage. An expressly agreed scheme may provide for sale when no money is due under the mortgage and without notice to the mortgagor.[131] The only compulsory notice requirements are those under the Consumer Credit Act 1974. In contrast, the SPPSA scheme cannot be varied so as to reduce the debtor's rights whatever the status of the debtor.[132]

5.78 We can see the value in requiring notice to the debtor in cases where it is feasible, and understand that in practice most well-drafted charges will contain such provisions. Presumably the same is true of most other forms of SI where there is currently a power of sale. However, even with the exceptions provided by

[127] Thus there is no need for notice if the collateral 'is of a type that is to be disposed of by sale on an organised market that handles large volumes of transactions between many different sellers and many different buyers': s 59(16)(d).

[128] SPPSA, s 59(16).

[129] NZPPSA has a broadly similar scheme in s 114 and the Personal Property Securities Regulations 2001 (reg 23 and Form 1, Sched 2); but these provisions have been severely criticised: M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 114.1 (pp 405-406).

[130] Sections 87 and 88, and the regulations made thereunder.

[131] *The Maule* [1997] 1 WLR 528 (PC).

[132] Section 56(3).

the SPPSA,[133] we do not think that such detailed regulation of a mandatory kind is appropriate for a scheme covering only SIs created by companies.[134]

5.79 The question is whether there should be a compulsory notice requirement of a less detailed kind. We think that when the collateral will be disposed of on an organised market, there should be no notice requirement, both because it would prevent prompt realisation of the security and because it seems unnecessary. Notice requirements seem to serve two functions: (1) to enable the debtor who is able to pay to redeem the property and (2) to enable the debtor or anyone else interested to check that the sale is made for the best possible price. When the sale is on an established market for essentially fungible items, there is no need for such a check, while the debtor who would have responded to the notice by redeeming the property can purchase equivalent property and it can readily be established whether the sale was at market price.

5.80 Where the goods are not of a kind for which there is an organised market in which identical goods can be bought or sold, we can see a case for requiring notice unless it is impractical for other reasons, for example because the goods are perishable or liable to decline in value in a short space of time. On balance, we think this issue is sufficiently important to be worth including in the scheme, and we have therefore included in the draft regulations a notice requirement unless the collateral is sold on an organised market or is perishable, or likely to decline rapidly in value if not disposed of immediately. However, we would welcome the views of consultees. In any event, we believe that the notice requirements should be less rigid than those of the SPPSA in terms of time and content.

The period of notice

5.81 We think that the notice requirement might safely be made more flexible than the minimum of 20 days required under the SPPSA. We suggest following the approach of the UCC, which is to require that the notice is sent a reasonable time before the sale and to provide that 10 business days' notice is sufficient.[135] This is what the UCC terms the 'safe-harbor' approach.[136]

Form and content

5.82 We think that the notice should have to be in writing (which can include an electronic communication). As to its contents, rather than have a list of fixed requirements, we suggest following again the UCC 'safe-harbor' approach. We think a notice should be treated as sufficient if it indicates:

(1) the debtor (or party who owns the collateral);

[133] See above, para 5.75.

[134] Conversely, the exceptions seem too broad to protect consumers: a consumer will not be entitled to notice, and thus to be given a chance to reinstate the agreement, if the goods are sold in a market.

[135] UCC Section 9-612.

[136] UCC Section 9-612, Official Comment 3.

(2) the secured party, and gives an address at which it may be contacted in sufficient time;

(3) the collateral to be sold or disposed of;

(4) the intended method of disposition;

(5) the time and date of any sale or after which any other disposition will be made.

It would be possible to provide a 'standard form' of notice that would be taken to be sufficient.[137]

5.83 **We ask consultees whether, where there is no organised market (or where the collateral is neither perishable nor likely to decline rapidly in value if not disposed of immediately), the secured party should have to give notice a reasonable time before the sale or disposition. If so, do they agree that 10 business days' notice should be sufficient?**[138]

5.84 **If there is to be a notice requirement, we provisionally recommend that the notice should have to be 'sufficient', and that it will be sufficient if it indicates:**

(1) the debtor (or party who owns the collateral);

(2) the secured party, and gives an address at which it may be contacted in sufficient time;

(3) the collateral to be sold or disposed of;

(4) the intended method of disposition;

(5) the time and date of any sale or after which any other disposition will be made.[139]

It would be possible to provide a 'standard form' of notice that would be taken to be sufficient.[140] **We would welcome views on whether it would be useful to provide a standard form of notice in the draft regulations.**

Parties to be notified

5.85 We think that the notice should be sent to the parties listed in the SPPSA.[141] We would suggest adding to the list senior secured parties (the SPPSA requires

[137] Compare UCC Section 9-613(5).

[138] See DR 63(1) and (3)-(4).

[139] See DR 63(1)-(2).

[140] Compare UCC Section 9-613(5).

[141] SPPSA, s 59(6), and see above, para 5.73. This is in effect the same persons that may be entitled to any surplus: see above, paras 5.22-5.27.

notice only to subordinate secured parties[142]), and any guarantor[143] of the debt, provided the secured party knows of the guarantee and the guarantor's name and address.[144] Each of these has a significant interest in the fate of the collateral or the amount raised by its disposition.

5.86 **We provisionally recommend that, when a notice is required before collateral is disposed of, it should be sent to:**

(1) the debtor or any other person who is known by the secured party to be an owner of the collateral;

(2) a person with an SI in the collateral if, before the day on which the notice of disposition is given to the debtor, that person has filed a financing statement;

(3) any person who has given an indemnity or guarantee for the debt, if the secured party knows that one exists and knows the name and address of the person, and

(4) any other person with an interest in the collateral who has given a written notice to the secured party of that person's interest in the collateral prior to the day on which the notice of disposition is given to the debtor.[145]

Effect of disposition

5.87 The SPPSA provides that a purchaser who acquires the interest for value and in good faith and who takes possession of it, acquires the collateral free from the debtor's interest, an interest subordinate to that of the debtor, and an interest subordinate to that of the secured party, whether or not the other requirements of the SPPSA relating to disposition have been complied with by the secured party.[146] This seems a sensible provision to include. **We provisionally recommend including a provision on the effect of disposition.**[147]

[142] Compare UCC Section 9-611(c). It may be a junior creditor who has taken possession of the collateral and intends to dispose of it. Senior secured parties might fall within s 59(6)(c) but only if they have given written notice.

[143] We would include also a party who has given an indemnity. UCC Section 9-611 refers to 'any secondary obligor', which includes both.

[144] Compare UCC Section 9-611(c)(2), which must be read with Section 9-605.

[145] See DR 63(1).

[146] SPPSA, s 59(14). UCC Section 9-617 is to similar effect. The NZPPSA has been criticised for omitting a similar provision: M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 115.2 (pp 408-409). A person who is liable to a secured party pursuant to a guarantee, endorsement, covenant, repurchase agreement or the like and who receives a transfer of collateral from the secured party or who is subrogated to the rights of the secured party has thereafter the rights and duties of the secured party; the transfer of collateral is not a disposition of the collateral: SPPSA, s 59(15) (replicated in our DR 62(10)).

[147] See DR 62(8).

Retention of collateral by secured party ('foreclosure')

5.88 Foreclosure involves the termination by order of the court of the right to redeem, the effect of which is to vest the mortgaged property in the mortgagee. The mortgagee is then completely free from the equity of redemption.[148] The remainder of the debt is extinguished by foreclosure and the mortgagee is assumed to have taken the property in satisfaction of the debt owing.

5.89 Foreclosure is available under current law only to a mortgagee; it requires a court order. We understand that it is rarely used.[149] However, an approximate equivalent may occur when a finance company repossesses goods that are let on hire-purchase or under a finance lease, in that the finance company is entitled to take the goods without having to account for any surplus value over and above the amount owed.[150]

5.90 Under the SPPSA,[151] there is no foreclosure as such, but rather a scheme under which the secured party can make a proposal to retain the collateral. After default,[152] the secured party may propose to take the collateral in satisfaction of the secured obligation,[153] but must give notice of such a proposal to the debtor or to the same other parties who would be entitled to receive notice were the secured party proposing to sell the property.[154] If any person who is entitled to such a notice and whose interest would be adversely affected by the secured party's proposal objects within 15 days after the notice was given, the secured party is required to dispose of the goods (for example, by sale).[155] Failure to

[148] R Goode, *Commercial Law* (2nd ed 1995) p 692.

[149] R Bradgate, *Commercial Law* (3rd ed 2000) para 22.2.1.3.

[150] In the CP we noted the attempts by the courts to avoid equivalent results when a supplier repossesses under a retention of title clause: para 6.21.

[151] Section 61. NZPPSA, ss 120-124 are broadly similar. UCC Section 9-620 introduces an alternative system that in some cases dispenses with the need for the secured party to make a proposal. This seems an unnecessary complication.

[152] It should be made clear that this refers to default by the debtor, not eg, the case where the secured party is in breach because the goods are defective and the secured party agrees to take them back and release the debtor. See M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 120.3 (pp 418-420). It also seems sensible to ensure that the parties are free to agree that the collateral is returned in exchange for cancellation of the debt if the debtor is not in default but is in difficulties: *ibid*. However, such an agreement should not be effective if there are junior creditors or other parties with an interest in the collateral (the debtor may have no interest in the fate of the collateral if the total of security over it exceeds the value, but junior creditors may be concerned if the senior creditor's interest may be less than the value of the collateral).

[153] It seems that this refers to the whole sum secured on the collateral, even if the sum is evidently greater than the collateral. This has led to a proposal in New Zealand that the debtor's obligation be reduced only by the reasonable value of the collateral. The proposal is criticised by M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 123.4 (pp 425-426).

[154] See above, para 5.85; SPPSA, s 61(1).

[155] SPPSA, s 61(2); compare NZPPSA, s 121. This is subject to proof of the objector's SI being forthcoming if demanded by the secured party; and an objection may be overridden by a court order if the objection is made not in order to protect the objector's interest but for another purpose, or if the value of the property is less than the secured party's interest: see *ibid*, ss 61(5)-(6). (Compare NZPPSA, s 122.)

object within 15 days results in the secured party being deemed to have irrevocably elected to take the collateral in satisfaction of the secured obligation. The secured party is then entitled to hold or dispose of the collateral free from all rights and interests of the debtor and from the rights and interests of any person entitled to receive notice who has been given that notice.[156]

5.91 This scheme strikes us as a sensible one that we should also adopt. It seems sensible to provide explicitly in what circumstances a secured party may simply take and keep the collateral rather than having to sell it in a commercially reasonable manner. However, we think that we should adopt a number of refinements that have been introduced by Revised Article 9 of the UCC. The principal ones are that either party should be able to initiate the process; and that it should be possible for the secured party to accept the collateral in partial satisfaction of the obligation secured, rather than only in full satisfaction. Given that the debtor or any person interested may, if they are not happy with the proposal, simply block the process and insist on the secured party disposing of the collateral, there seems no danger in this extension and we can see that it may often be advantageous to all concerned that the secured party should take the collateral in partial satisfaction rather than incur the expense and possible uncertainty of a sale. Of course all the parties could agree to that, but the Revised sections of the UCC provide a convenient mechanism by which it is not necessary to get each party's positive consent; instead, interested parties must be notified and have a chance to object.

5.92 The debtor or other party should be given a notice that conforms to the requirements proposed earlier for notices before disposition of collateral, but with the addition that the notice should not be treated as automatically sufficient unless it indicates:

(1) where the proposal is to take the collateral in full satisfaction, the amount (including the secured party's costs, etc.) secured by the collateral; or

(2) where the proposal is to taken in partial satisfaction, the amount of the obligation secured that will be discharged.

[156] SPPSA, s 61(3). A party who should have been notified but was not will retain rights against the secured party; it can presumably redeem the property, and in Canada it has been held that such a person can force the secured party to sell the collateral (M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 123.3 (p 425)), but a good faith purchaser from the secured party will take free of those rights whether or not the requirements of the section have been followed: s 61(7). The position of a party with rights in the collateral but who was not entitled to notice (eg, one with an SI but who had failed either to file or to notify the secured party) are not wholly clear but probably they are cut off when the secured party takes the collateral in satisfaction. It should be made clear that these rules are for the benefit of the debtor and others with an interest in the collateral, not for the secured party's benefit. Thus a secured party who simply takes the collateral without complying with the proper procedures should not subsequently be able to claim that its election was ineffective, so that when the property falls in value it can insist on a sale and recovering the shortfall from the debtor: see J Ziegel and D Denomme, *The Ontario Personal Property Security Act Commentary and Analysis* (2nd ed 2000) para 65.3 (pp 538-539).

Without that information the debtor or other party is not usually in a position to judge whether or not to object to the secured party's proposal.[157]

5.93 **We provisionally recommend that the statement of remedies should include provisions for the secured party, on the initiative of either party, to take the collateral in full or partial satisfaction of the obligation secured, provided that the debtor has agreed in writing, and other interested parties have been notified and have not objected within 20 business days.**

Redemption

5.94 The debtor's right to redeem the property before it has been sold or taken by the secured party in satisfaction ('foreclosure') forms an important counterbalance to the secured party's rights[158] and should be included in any statement of rights and remedies.[159] The SPPSA[160] provides that, prior to the secured party or receiver disposing of the collateral or the secured party irrevocably electing to retain the collateral, a person who is entitled to notice of disposition[161] may redeem the collateral by tendering fulfilment of the obligations secured by the collateral and paying a sum equivalent to the reasonable expenses of enforcing the security agreement.[162] The NZPPSA contains similar but slightly more elaborate provisions.[163] We consider that we should adopt provisions similar to those of the SPPSA, and the draft regulations reflect this.[164]

5.95 **We provisionally recommend that a person entitled to notice of disposition under DR 63 may, unless otherwise agreed in writing after default, redeem the collateral by tendering fulfilment of the obligations secured by the collateral and paying a sum equal to the reasonable expenses incurred by the secured party in preparing etc. the collateral for disposition and enforcing the security agreement.**

[157] M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 120.2 (p 418).

[158] M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 132.1 (p 441).

[159] As was recommended by both the Crowther and Diamond reports: CP para B.60.

[160] UCC Section 9-623 is in very similar terms.

[161] Under the SPPSA, s 59(6) or (10); see above, para 5.73.

[162] SPPSA, s 62(1)(a). This encompasses the expenses of 'seizing, repossessing, holding, repairing, processing and preparing the collateral for disposition' actually incurred and any other reasonable expenses actually incurred.

[163] NZPPSA, s 132(1). The New Zealand legislation goes further by stating that the debtor's right to redeem the collateral has priority over any other person's right to redeem the collateral: s 132(2). It has been remarked that this it is unlikely that both the debtor and another party with an interest in the collateral will want to redeem: M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 132.2 (p 441).

[164] The equitable doctrine of consolidation should not apply to require a debtor who wishes to redeem one piece of collateral to redeem all the SIs it has granted to the same secured party (see Fisher & Lightwood's *Law of Mortgages* (11th ed 2002) ch 27). The doctrine has not applied to mortgages since 1882: see the Law of Property Act 1925, s 93. However, as under that provision, contractual provisions to the like effect might be permitted.

Remedies are cumulative

5.96 The remedies set out above are intended to be cumulative. This is provided explicitly in the SPPSA and the UCC,[165] and for the avoidance of doubt we have included a declaration to this effect.[166] Again for the avoidance of doubt, the draft regulations provide that the secured party may enforce its personal rights under the obligation secured by the SI, and may seek to execute any judgment against the debtor's property, including the collateral over which it has the SI, without extinguishing the SI.[167]

5.97 **We provisionally recommend that it be provided that the rights and remedies of each party against the other are cumulative, and may be exercised simultaneously so long as they are not mutually incompatible and simultaneous exercise is not commercially unreasonable.**[168]

5.98 **We also provisionally recommend that it be provided that the secured party may enforce its personal rights under the obligation secured by the SI, and may seek to execute any judgment against the debtor's property, including the collateral, without extinguishing the SI.**

Appointment of receiver and secured party acting through receiver

5.99 We noted above that the draft regulations contain a provision that the rights, powers and duties of a secured party under Part 5 (that is, the statement of rights and remedies), as well as draft regulation 17 (dealing with preservation and use of collateral) apply equally when the secured party acts through a receiver.[169] In addition, they also contain a provision that a security agreement may provide for the appointment of a receiver and, except as provided for in the draft regulations or any other enactment (such as the Insolvency Act 1986), for the rights and duties of a receiver.[170]

5.100 However, as we explain below, we do not think it necessary for the draft regulations to set out the powers of administrative receivers.[171]

5.101 **We provisionally recommend that it be stated specifically that a security agreement may provide for the appointment of a receiver and for the rights and duties of a receiver (save as provided for by the draft regulations or another enactment). We also provisionally recommend that the rights, powers and duties of a secured party under Part 5 and DR 17 of the draft regulations should apply equally when the secured party acts through a receiver.**

[165] SPPSA, s 55(3); UCC Section 9-601.

[166] DR 59(1)-(2).

[167] DR 56(2).

[168] DR 59(1)-(2).

[169] DR 58(2).

[170] DR 58(1).

[171] See below, paras 5.114-5.118.

PROVISIONS NOT RECOMMENDED

5.102 There are a number of provisions contained in the PPSAs (both in the Parts dealing with rights and remedies and in other Parts dealing with obligations) which we do not think it necessary to include within any statement of rights and remedies, and accordingly equivalent provisions do not appear in the draft regulations.[172]

Interpretation of acceleration clause

5.103 The SPPSA provides that a clause in an agreement that the secured party may accelerate payment or performance by the debtor when the secured party thinks that the collateral is in jeopardy or the secured party believes itself to be insecure should be interpreted to apply only when the secured party's view is reasonable.[173] We suspect acceleration clauses that apply before there has been an actual default are not as common in England and Wales as they appear to be in North America, and we think that an English court would interpret the clause in a similar fashion in any event.[174] We therefore think it is unnecessary to include such a provision in our legislation.

5.104 **We provisionally recommend that the scheme should not contain a provision relating to the interpretation of an acceleration clause.**

Taking possession on anticipated default

5.105 Under the NZPPSA, a secured party with priority over all other secured parties may take possession of and sell collateral when the collateral is 'at risk'.[175] Collateral is defined as being 'at risk' if the secured party has reasonable grounds to believe that the collateral has been or will be:

> destroyed, damaged, endangered, disassembled, removed, concealed, sold, or otherwise disposed of contrary to the provisions of the security agreement.[176]

5.106 In the CP we suggested that it would be useful to include such a provision in the restatement.[177] Of the three consultees who responded, two agreed. The third appeared to think that the provision was dealing with accidental damage to collateral, but we think that the definition of 'at risk', quoted above, shows that this is a misunderstanding.

5.107 It might be thought that this could be left to the secured party to provide for in the security agreement. In most of the schemes we have considered that might not

[172] We have dealt earlier with the question whether a security agreement that is not perfected by possession must be evidenced in a signed writing: paras 3.75-3.82.

[173] SPPSA, s 16.

[174] Compare the cases on whether one party's 'satisfaction' has to be bona fide: G Treitel, *The Law of Contract* (10th ed 1999) p 61.

[175] NZPPSA, s 109(1)(b). There is no equivalent in the SPPSA.

[176] NZPPSA, s 109(2).

[177] Para B.18.

be possible because it would reduce the rights of the debtor, which they prohibit. Now that we are not provisionally recommending a general mandatory requirement[178] we see no need for a provision on anticipatory default.

Measure of damages when lease is ineffective because unperfected

5.108 In the CP we asked whether the 'restatement' should deal with the measure of damages that might be recovered by a lessor from the lessee if the leased goods are seized by a judgment creditor.[179] Under the other systems if an SI has not been perfected, third parties such as judgment creditors or liquidators are entitled to seize the property that is subject to the SI. Where the underlying security agreement is a loan, the debtor will still be liable for the outstanding balance and can recover the sums due from the debtor or prove in the insolvency. If however the underlying agreement was a lease or a consignment, the amount payable by the debtor is not so obvious. The SPPSA provides that in each case the measure of damages is the value of the leased or consigned goods at the date of seizure plus any further loss suffered as a result of the termination of the lease or consignment.[180] Only three consultees commented on this proposal, but they thought the provision to be unnecessary.[181] We agree.

5.109 **We provisionally recommend that the scheme should not contain a provision dealing with the measure of damages relating to leases or consignment goods seized when the lessor's or consignor's interest is ineffective because it is unperfected.**

An account of the distribution

5.110 Some of the PPSAs require that the secured party must, within a set time, give all those persons to whom it has to account and pay over the surplus a written account relating to the method and outcome of the disposition, including the costs and distribution of the amount received, and of any surplus.[182] In the context of consumer debtors this may be an important provision, to enable the interested parties to check that the secured party has acted correctly; but we do not consider that a similar provision is necessary in cases in which the debtor is a company. We note that the equivalent provision in the UCC is limited to cases of consumer debtors.[183] **We provisionally recommend that the secured party should not be under an obligation to give other secured parties a written account of the nature of the disposition, the amount raised and how it was distributed.**

[178] See below, paras 5.142-5.171.

[179] CP para 12.135.

[180] SPPSA, s 21.

[181] There does not seem to be an equivalent in the NZPPSA or UCC.

[182] Eg, SPPSA, s 60(3).

[183] See UCC section 9-616.

Reinstatement of security agreement

5.111 We noted above that we provisionally recommended including a provision permitting certain people to redeem the collateral before the secured party disposed of the collateral or irrevocably agreed to accept it in full or partial satisfaction.[184] The SPPSA and NZPPSA go further than this. As we noted in the CP,[185] both also give the debtor the right to reinstate the security agreement prior to the secured party disposing of the collateral.[186] Reinstatement may occur where the debtor pays the sums in arrears 'exclusive of the operation of an acceleration clause in the security agreement', remedies any default by reason of which the secured party is intending to sell or dispose of the collateral, and pays reasonable expenses incurred by the secured party in enforcing the security agreement.[187] There are limits on the frequency with which the debtor may reinstate the agreement.[188]

5.112 A legislative right to reinstate may be appropriate to consumer transactions,[189] but we think that in other agreements it should be left to be agreed between the parties. In the Ontario PPSA, for example, the right applies only to consumer transactions,[190] and we have not included an equivalent provision in the draft regulations.

5.113 **We provisionally recommend that the scheme should not contain a provision dealing with reinstatement of the security agreement.**

Receivers

5.114 We provisionally recommended above that the statement of rights and duties contain a limited provision in relation to receivers.[191] As we said in the CP,[192] the powers of an administrative receiver - that is, a receiver or manager of the whole, or substantially the whole, of a company's property, appointed by a floating charge holder[193] - are comprehensively set out in Schedule 1 to the Insolvency Act 1986,[194] but are also generally set out in the debenture. The powers of administrative receivers can be separated into two categories. First, there are the

[184] See above, para 5.95.

[185] Para B.61.

[186] SPPSA, s 62(1)(b); NZPPSA, s 133.

[187] *Ibid*.

[188] SPPSA, s 62(2); NZPPSA, s 134.

[189] CP para B.62 noted that there are no direct equivalents in English law but the closest analogy seems to be the power of the court to make a 'time order' under the Consumer Credit Act 1974, ss 129-130.

[190] Section 66(2): see J Ziegel and D Denomme, *The Ontario Personal Property Security Act Commentary and Analysis* (2nd ed 2000) para 66.2 (pp 543-544).

[191] See above, para 5.92.

[192] Para B.25.

[193] Insolvency Act 1986, s 29(2).

[194] The general powers and duties of a receiver are contained in the Insolvency Act 1986, ss 42-43. There are 23 separate powers set out in the Schedule.

rights that are derived from the security created by the debenture.[195] Secondly, there are the powers which the receiver has which are executed as agent of the company.[196] These powers are used in order to facilitate the continuance of the business, such as the power to employ and dismiss members of staff.[197] The powers as a company agent come to an end when the company goes into liquidation. The receiver is also personally liable for any contract entered into by him in the carrying out of his functions but is entitled to an indemnity out of the assets of the company in respect of the liability incurred.[198]

5.115 The Enterprise Act 2002 prohibits the appointment of an administrative receiver by floating charge holders save in particular situations. The aim is to prevent the floating charge holder being able to block an administration order by appointing an administrative receiver. The exceptions relate to capital market arrangements; public-private partnership projects; utility projects; where the company is a 'financed project' company, and certain financial market transactions.[199] However, the prohibition on appointment of an administrative receiver does not apply to existing floating charge holders. Thus administrative receivership will continue to be of some importance.

5.116 A receiver may also be appointed to receive income from the secured property or to manage just part of a company's property. The powers of such a receiver are set out in the Law of Property Act 1925, section 109.

5.117 In the CP we asked whether the powers of receivers should be set out more fully in any restatement, as they are in the SPPSA.[200] Of the few who responded to this question, the majority thought it was unnecessary. In the light of the reduced importance of administrative receivership, because we think that it must be rather rare for a receiver to be appointed under the Law of Property Act 1925, section 109, save over real property, we agree. The powers are already sufficiently stated in statutory form.[201]

5.118 **We provisionally recommend that the statement of rights and remedies should not contain provisions relating to the powers of receivers.**

APPLICATIONS TO COURT

5.119 We have included in the draft regulations a provision that a debtor, creditor, secured party or other person with an interest in the collateral may apply to the

[195] This includes powers to hold and dispose of the assets, as well as collecting them.

[196] R Goode, *Commercial Law* (2nd ed 1995) p 865.

[197] Insolvency Act 1986, Sched 1, para 11.

[198] Insolvency Act 1986, ss 44(1)(a)-(c).

[199] Enterprise Act 2002, s 250.

[200] SPPSA, s 64.

[201] There will need to be consequential amendments to the Insolvency Act 1986, s 29(2), which currently defines administrative receiver by reference to floating charges. This should be changed to refer to a power to appoint a receiver given by an SI that covers the whole, or substantially the whole, of the company's property.

court, in relation to Part 5 of the draft regulations (the statement of rights and remedies on default) or DR 17 (preservation and use of collateral) for orders:

(1) necessary to ensure compliance, relieving a person from compliance or staying enforcement of rights,

(2) directing persons regarding the exercise of rights or discharge of obligations, and

(3) necessary to ensure protection of the interest of any person in the collateral.

Although seeking relief from the courts would probably be an available option even if the draft regulations were silent, we think it would be sensible for such provision to be included. **We provisionally recommend that there be a provision relating to court orders to ensure compliance, enforcement, stay etc.**

FINANCIAL COLLATERAL

5.120 We noted above that slightly different treatment was needed in case of financial collateral, and that we would accordingly deal with this issue separately. The other provisions of the statement of rights and remedies we have discussed above will have application, where appropriate, to financial collateral, but additional provisions will be necessary.

Security financial collateral arrangements

5.121 Recital (17) of the Financial Collateral Directive states that the FCD 'provides for rapid and non-formalistic enforcement procedures.' Article 4 provides for the realisation of financial collateral held under a security financial collateral arrangement by sale, appropriation or the setting off of its value against the obligations secured, though without prejudice to requirements of national law that the realisation or valuation and the calculation of the relevant financial obligations be conducted in a commercially reasonable manner.[202]

5.122 Article 4 of the FCD has been implemented by regulations 17 and 18 of the FCAR in the following terms:

> 17. Where a legal or equitable mortgage is the security interest created or arising under a security financial collateral arrangement on terms that include a power for the collateral-taker to appropriate the collateral, the collateral-taker may exercise that power in accordance with the terms of the security financial collateral arrangement, without any order for foreclosure from the courts.
>
> 18. (1) Where a collateral-taker exercises a power contained in a security financial collateral arrangement to appropriate the financial collateral the collateral-taker must value the financial collateral in

[202] Art 4(6).

accordance with the terms of the arrangement and in any event in a commercially reasonable manner.

(2) Where a collateral-taker exercises such a power and the value of the financial collateral appropriated differs from the amount of the relevant financial obligations, then as the case may be, either –

(a) the collateral-taker must account to the collateral-provider for the amount by which the value of the financial collateral exceeds the relevant financial obligations; or

(b) the collateral-provider will remain liable to the collateral-taker for any amount whereby the value of the financial collateral is less than the relevant financial obligations.

5.123 It will be seen that although regulation 17 of the FCAR refers to foreclosure, the power exercisable by the collateral taker is actually akin to the power of sale described earlier. This is because regulation 18 requires that the financial collateral be valued and any surplus paid to the collateral-giver.

5.124 We think that it would be perfectly possible to incorporate these requirements within our scheme. We have seen that where there is a ready market for the collateral, it may be disposed of by the secured party without notice. There is no explicit provision for the secured party to retain the collateral at a commercially reasonable valuation and pay the difference to the secured party, but such a remedy would not be incompatible with the scheme. However, subject to what is said below, it seems simpler to provide that the scheme of remedies in the legislative statement of rights and remedies is without prejudice to any right of appropriation under a security financial collateral arrangement within the meaning of the FCAR,[203] and this is the course we have adopted in the draft regulations.[204]

5.125 **We provisionally recommend that the statement of rights and remedies set out in the draft regulations should be without prejudice to any agreement in a financial collateral arrangement within the meaning of the FCAR.**

Title transfer financial collateral arrangements

5.126 It should be noted that the FCD does not require any particular remedies to be given in the event of a default under a title transfer financial collateral arrangement such as a repo. This was presumably because it was assumed that these devices already provide adequate 'rapid and non-formalistic enforcement procedures'. The traditional interpretation is that the debtor merely has contractual rights to repurchase the collateral that have been transferred to the collateral-taker and that, if the collateral-giver defaults, these rights will be lost or modified, as the parties choose to agree.

5.127 This creates a potential difficulty. It is arguable that a repo has a security purpose within the meaning of our scheme – that is, it may be designed to secure

[203] See above, Part 4.

[204] DR 56(3)(a).

payment or performance of an obligation. As we explained in the CP, under a repo a party that wishes to raise capital on an asset sells the asset to a buyer, with an undertaking to re-purchase the asset or equivalent assets, at a future date or on demand.[205] The re-purchase price is often the original purchase price plus a financing charge. This looks like a form of title financing. Moreover, as we understand it, it is usually provided that in the event of a failure by the original seller to re-purchase, the original buyer will sell or take the assets at their then market value, and this amount will be 'netted' against the original seller's obligation. This seems further confirmation that the transaction may have a security purpose, since it appears that the 'seller' will have to make up any shortfall between the sums paid to it plus the credit charges (together constituting the re-purchase price) and the value of the assets 'sold' – and, conversely, will be entitled to any 'surplus'.

5.128 The Prefatory Note to Article 8 states that a repo 'might be characterised as an outright sale or as the creation of a security interest. Article 8 does not attempt to specify any categorical rules on that issue'.[206] In the US courts, repos have been held not to constitute SIs,[207] but we do not find the reasoning in the leading case to put the matter beyond doubt. We have also received conflicting opinions from experts in this country. Thus the question of whether a repo has a security purpose is an open one.

5.129 If a repo does have a security function, it will fall within our scheme (unless repos are to be specifically exempted).[208] That would include the statement of rights and remedies outlined above. Thus instead of simply retaining the financial collateral, the collateral taker would have to dispose of it and pay the surplus to the collateral giver, or make an offer to purchase it that the collateral-giver could accept or refuse. That might be compatible with the letter of the FCD. We are not sure, however, that it would be consistent with its spirit; the FCD seems to assume that the collateral-taker who takes 'title' will have no less remedies than one who takes 'security.' There seem to be three possible solutions to this.

5.130 One would be simply to exempt title transfer financial collateral arrangements within the meaning of FCAR[209] from either the statement of rights and remedies

[205] CP para 6.38. A fuller description of repos will be found in the Prefatory Note to Article 8, para III.C.10. In the CP we proposed that repos should be exempt from registration: para 7.50. Even if a repo is within our scheme as creating an SI, filing would not normally be required because the SP/original buyer will have control. However, as noted in the Prefatory note just cited, there are 'hold-in-custody' repos under which the buyer leaves securities in the hands of the seller, relying on the representation that the buyer will hold them for the seller. If the repo were to amount to an SI, under such an arrangement it would not be perfected under our scheme (or that of the UCC).

[206] Para III.C.10.

[207] *In re Bevill, Bresler & Schulman Asset Mgt Corp*, 67 BR 557 (DNJ 1986).

[208] On perfection of repos, see para 5.127 n 205 above.

[209] We would not recommend exempting all repos from our scheme, because we do not think it appropriate that a repo that is being used as a way of borrowing against securities but that takes the 'hold-in-custody' form (see above, para 5.127 n 205) should be exempt. We think it should be treated as unperfected so that a creditor who subsequently takes an SI over the same securities will have priority irrespective of any question of knowledge; and

set out in the draft regulations or from the scheme as a whole. We think either would be unfortunate. As to exemption from the scheme of remedies, it has to be remembered that the repo agreement may provide other remedies besides appropriation, remedies that might be less favourable to the debtor than the mandatory requirements of our scheme. This would also leave the remedies available regulated only by the existing common law rules of contract. To exempt title transfer financial collateral arrangements from the scheme completely would mean that the definitions of control and the rules on priority would also not apply. It is true that this will seldom bite on title transfer financial collateral arrangements, but it is hard to predict the results. It might result in arguments over whether the arrangement in question was a title transfer financial collateral arrangement that is outside the scheme or a security financial collateral arrangement that falls within it.

5.131 The other solution would be to build into our scheme a right of appropriation for financial collateral arrangements of all types, as we have already provisionally recommended for security financial collateral arrangements. Thus the statement of remedies should be without prejudice to any contractual right to retain, appropriate or dispose of financial collateral under a title transfer financial collateral arrangement within the meaning of the FCAR.

5.132 We think the last approach seems the most appropriate. Accordingly, the application of Part 5 of the draft regulations is stated to be without prejudice to any contractual right to retain, appropriate or dispose of financial collateral under a title transfer financial collateral arrangement, within the meaning of the FCAR.[210] However we would welcome the views of consultees.

5.133 **We ask whether in respect of a title transfer financial collateral arrangement:**

(1) the statement of remedies should be without prejudice to any contractual right to retain, appropriate or dispose of financial collateral under a title transfer financial collateral arrangement, within the meaning of the FCAR; or

(2) whether title transfer financial collateral arrangements should be exempted from the statement of remedies in Part 5 of the draft regulations; or

(3) whether title transfer financial collateral arrangements should be exempted from the scheme as a whole.

so that a subsequent buyer who does not know of the 'hold-in-custody' arrangement will take free. It may also be appropriate that the SI should be ineffective in the event of the 'borrower's' insolvency, since it is not attended by any publicity.

[210] DR 56(3)(b).

GOOD FAITH AND COMMERCIAL REASONABLENESS

5.134 On consultation – particularly in the informal seminars – two provisions that are found in the comparable schemes proved highly controversial even though, in our view, neither their inclusion nor exclusion would have an enormous effect on the scheme of remedies as a whole. One of these was a provision imposing a general obligation to act in good faith or in a manner that is commercially reasonable. We have already discussed this in Part 2, and so we do not go into detail here again, save to say that we no longer propose that the scheme should incorporate any general requirement that the parties act in good faith or a commercially reasonable manner in exercising or discharging their rights or duties. Instead, we provisionally recommend that the question of commercial reasonableness be dealt with in the context of individual provisions.[211] We sought consultees' views on these provisions above, but in summary we provisionally recommend that commercial reasonableness be required in relation to:

(1) simultaneous exercise of either the secured party's or the debtor's rights under DR 59 (in that the simultaneous exercise of the different rights should not be commercially unreasonable),[212]

(2) collection or enforcement of an account with recourse,[213]

(3) withholding, or application or paying over, of non-cash proceeds of collection and enforcement under DR 60,[214]

(4) the methods of disposal of collateral on default,[215] and

(5) withholding, or application or paying over, of non-cash proceeds of disposition under DR 65.[216]

5.135 **We provisionally recommend that there be no general requirement of good faith included in the draft regulations, but that a specific requirement of commercial reasonableness be included in relation to DRs 59(1)-(2), 60(5)-(6), 62(6) and 65(5).**

Determining whether conduct was commercially reasonable

5.136 The draft regulations contain two provisions. The first, and perhaps most important, is in relation to the provisions which we provisionally recommend should not be capable of being amended or waived.[217] (These contain several instances of a requirement of commercial reasonableness.) In relation to these,

[211] See above, para 2.182.

[212] DR 59(1).

[213] DR 60(5).

[214] DR 60(6).

[215] DR 62(6).

[216] DR 65(5).

[217] See below, para 5.170.

there is a statement that the parties may, by agreement, determine the standards which fulfil the rights of a debtor or obligations of a secured party under those provisions, provided that the standards are not 'manifestly unreasonable'. This in effect means that the parties are free to agree their own meaning of 'commercial reasonableness'.

5.137 **We provisionally recommend that the parties to a security agreement should be able to determine the standards which fulfil the rights of a debtor or obligations of a secured party under any provision mentioned in DR 59(3), provided that the standards are not manifestly unreasonable.**

5.138 The second provision that the draft regulations contain is one giving guidance as to when certain conduct will be deemed to be commercially reasonable. The UCC provides that a disposition is made in a commercially reasonable manner if it is made:

(1) in the usual manner on any recognised market,

(2) at the price current in any recognised market, or

(3) otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.[218]

5.139 In addition, a 'collection, enforcement, disposition or acceptance' is made in a commercially reasonable manner if it has been approved:

(1) in judicial proceedings,

(2) by the equivalent of a creditors' committee (under the Insolvency Act 1986),

(3) by a representative of creditors, or

(4) by an assignee for the benefit of creditors.[219]

5.140 The UCC makes clear that the fact that a higher amount could have been obtained at a different time or by a different method than that used by the secured party does not prevent the secured party from establishing that it acted in a commercially reasonable way. We think that some legislative guidance on what would amount to a commercially reasonable disposition would be helpful. This provision is itself not mandatory, so it would be open to the parties to exclude its operation if they are seeking to set their own standards of commercial reasonableness.

5.141 **We provisionally recommend that the scheme should include guidance on steps that are sufficient to ensure that particular methods of collection,**

[218] UCC Section 9-627(b).

[219] UCC Section 9-627(c).

enforcement, disposition or acceptance are 'commercially reasonable' within the meaning of the draft regulations.[220]

MANDATORY OR DEFAULT RULES?

5.142 The other provision that proved highly controversial during the formal and informal consultation process was a provision that the rules in the 'restatement' should be mandatory, in the sense that the parties should not be able to vary the rules to the detriment of the debtor. The extent to which the parties should be able to agree on rights and remedies that differ from those set out in any 'statement', or should be able to modify the legislative rules, is a difficult issue and one that the UCC and the PPSAs do not answer uniformly. The extent to which the rules on SIs should be mandatory is particularly important in relation to the rights and remedies on default but it affects the entire legislative scheme.

5.143 Much of the scheme that we have provisionally recommended elsewhere in this consultative report is designed essentially to protect third parties – subsequent secured parties, buyers and other disponees and, less directly, unsecured creditors. The parties should not be able to alter these rules in any way that might prejudice third parties. Thus the rules requiring perfection, whether by filing, possession or control, and the rules on priority should be mandatory, just as the equivalent rules are under current law.[221]

5.144 This does not prevent the secured party making an agreement with a third party that will alter their rights as between themselves, for example a subordination agreement. Equally, a party does not have to exercise its rights, but it will not be able to avoid the consequences unless it obtains the agreement of other parties who are affected. Thus a secured party is under no obligation to file a financing statement to cover a non-possessory SI but, if it does not, it will normally suffer the consequences in terms of loss of priority and ineffectiveness of the SI if the debtor becomes insolvent. If, however, a prior secured party has agreed that a subsequent secured party shall have priority, that agreement might be effective as between the two of them even if the subsequent secured party does not perfect its SI in the normal way.[222]

Protection of the debtor

5.145 As between the debtor and the secured party, there is greater scope for freedom of contract, but even here current law imposes some controls on securities given by companies.[223] Most obviously, the right to redeem a mortgage may not be

[220] DR 69.

[221] Although there will be no criminal sanctions for failing to comply with the rules.

[222] See *Euroclean Canada Inc v Forest Glade Investments (Trustee)* (1985), 16 DLR (4th) 289, 49 OR (2nd) 769 (CA Ont) (a debenture permitted the creation of subsequent PMSIs having priority to the debenture; this was held to be effective to give priority although a subsequent PMSI was not perfected).

[223] For individuals, the Bills of Sale Acts 1878-1882 and the Consumer Credit Act 1974 impose quite extensive controls.

excluded ('once a mortgage always a mortgage'[224]) nor may there be a clog on the equity of redemption.[225] Nor may the agreement give the creditor collateral (that is, parallel) advantages that are unfair and unconscionable.[226]

5.146 The purpose of these rules is to protect the debtor, which is normally in a weaker position than the lender. It seems to be a generally accepted policy in the jurisdictions which have adopted notice-filing schemes that the parties should be free to agree terms that give the debtor greater rights, or exclude some remedy that would normally be available to the secured party. However, the other schemes then diverge.

The Ontario and Saskatchewan PPSAs

5.147 These schemes are quite restrictive. Lip service seems to be paid to the principle of freedom of contract in provisions such as:

> Where the debtor is in default under a security agreement, the secured party has the rights and remedies provided in the security agreement and the rights and remedies provided in this Part… .[227]

But in fact the Ontario and Saskatchewan PPSAs not only make rules that may affect third parties mandatory but also, with very limited exceptions,[228] commonly prevent the parties from excluding or restricting the rules that are intended to protect the debtor.[229]

The New Zealand PPSA

5.148 The NZPPSA takes a different approach, which is to permit the debtor to waive its rights but to prevent that affecting third parties. In its original version section 107(2) provided that the parties were free to 'make their own terms in respect of provisions in this [Remedies] Part to the extent that those provisions do not relate to the rights of third parties'. To counter criticism that this left too much uncertainty, section 107 was amended[230] and now lists the provisions that may be

[224] See Fisher & Lightwood's *Law of Mortgages* (11th ed 2001) para 28.8.

[225] *Ibid*, para 28.11.

[226] *Ibid*.

[227] Ontario PPSA, s 59(1).

[228] Eg, under the SPPSA, the debtor may waive the secured party's obligations to take steps to preserve the debtor's rights against third persons under an instrument or an investment security taken as collateral or to keep the collateral identifiable (s 17(1)-(2)). See also s 59(3)(d) (secured party may dispose of property by lease), and s 59(4) (secured party may dispose of collateral on deferred payment terms). A number of provisions allow for a post-default agreement, eg, s 60(2) (order of payment of surplus may be altered 'by the agreement of all interested parties', and s 62(1) (rights of redemption).

[229] Thus the SPPSA, s 56(3) provides that, with listed exceptions, the rights, remedies and obligations provided by the Act to the extent that the provisions give rights to the debtor or impose obligations on the secured party, cannot 'be waived or varied by agreement or otherwise'. See also the OPPSA, s 59(2), and J Ziegel and D Denomme, *The Ontario Personal Property Security Act Commentary and Analysis* (2nd ed 2000) para 59.2 (pp 481-482).

[230] Personal Property Securities Amendment Act 2001, s 9.

altered by agreement. For some provisions it is provided simply that the parties may contract out.[231] These are mainly provisions in favour of the secured party, but at least three are in the debtor's favour:

(1) the right to be notified before the collateral is sold;[232]

(2) the right to be paid the surplus,[233] and

(3) the right to reinstate the security agreement.[234]

5.149 It is further provided[235] that the parties may contract out of the debtor's rights to:

(1) recover surplus under section 119,[236]

(2) receive notice of a secured party's proposal to retain collateral under section 120(2),

(3) object to a secured party's proposal to retain collateral under section 121; and

(4) redeem collateral under section 132.[237]

5.150 These provisions have been strongly criticised by a team of Canadian and New Zealand authors.[238] They point out that it is not adequate to leave business parties to agree their own terms, as 'this ignores…the reality that even in business financing the lender's standard terms are rarely open to any meaningful negotiation'. They add that permitting contracting-out may require a detailed consideration of the terms of the agreement that the creation of a unified system of remedies was designed to avoid. This would especially be the case if the courts were to hold that parties had implicitly contracted-out, for example implicitly contracting-out of the debtor's right to receive the surplus by choosing a lease rather than a charge. Another international team has questioned whether any party would wish to exclude the rights listed.[239]

[231] Section 107(1), as amended.

[232] NZPPSA, s 114(1)(a).

[233] NZPPSA, s 117(1)(c).

[234] NZPPSA, s 133.

[235] We omit references to a number of provisions that are not applicable to our scheme, for example, concerning the removal of accessions.

[236] There is a somewhat awkward division between the right to be paid the surplus under s 117 and the right to recover it under s 119.

[237] Section 107(2). There are additional protections for consumers under the Credit (Repossession) Act 1997.

[238] M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 107.1 (pp 388-389).

[239] L Widdup and L Mayne, *Personal Property Securities Act: A Conceptual Approach* (2002) para 33.11 (p 308).

5.151 The economy of New Zealand is different from that of the UK, and it may be that greater freedom of contract than that advocated by the authors cited for New Zealand would be justified in legislation to affect SIs created by companies registered in England and Wales. However, the parties' freedom in business-to-business transactions is also severely restricted in Ontario. Moreover, the provisions of the NZPPSA produce results that are quite hard to understand or, we think, to justify.[240]

The UCC Revised Article 9

5.152 The approach of Revised Article 9 is different again. Rather than rely on a general provision to prevent waiver or variation, like the SPPSA,[241] UCC Section 9-602 lists specific rights and obligations that cannot be altered against the interests of the debtor. If applied to our scheme, these would be the following:

(1) DR 60(5) (duty to act in commercially reasonable manner as to collection of outright sales of receivables etc. on a recourse basis),

(2) DR 60(6) (duty to apply non-cash proceeds in commercially reasonable manner),

(3) DR 62 (disposal of collateral),

(4) DR 63 (disposal of collateral: requirement to give notice),

(5) DR 64 (calculation of surplus or deficiency in disposition to secured party etc.),

(6) DR 65(1) and (2) (distribution of surplus),

(7) DR 67 (acceptance of collateral in full or partial satisfaction of obligation),

(8) DR 68 (redemption),

(9) DR 59(5) (provision void if purports to exclude duty or limit liability).

5.153 As we have noted, Section 9-603 permits the parties in their agreement to determine the standards by which it is to be determined whether the parties have fulfilled their rights and duties – in other words, to set for themselves what is required by phrases such as 'commercially reasonable' – provided that the standards agreed are not manifestly unreasonable.

5.154 Rights may be waived by the debtor by an agreement made after default but only if the agreement is authenticated.[242]

[240] See above, para 5.149 n 236.

[241] SPPSA, s 56(3), see above, para 5.147 n 229.

[242] See UCC Section 9-620 and Section 9-624.

5.155 Of the three approaches, we consider the most attractive one to be that of the UCC, because it produces a relatively short and clear list of the provisions on rights and remedies that may not be varied against the interests of the debtor. With this in mind, we turn to the question of which rights it should not be possible to vary.

The provisions that should be mandatory

5.156 Because of the importance of this question, it seems necessary to consider the various rights individually. We think that it is clear that where there is a requirement to act in a commercial reasonable manner, that should be a mandatory provision, even though the parties are free to determine what will be commercially reasonable. We have already provisionally recommended that there be a requirement to act in a commercially reasonable manner with respect to:

(1) collection by a secured party who buys accounts outright on a recourse basis;[243]

(2) a secured party who receives non-cash proceeds of collection and enforcement under DR 60 and who chooses to apply or pay over for application the proceeds;[244]

(3) every aspect of a disposition of collateral after the debtor's default.[245]

We provisionally recommend that the requirements to act in a commercially reasonable manner should be mandatory.

The right to be notified before the collateral is sold

5.157 We suggested earlier that notice should be required where the goods are not of a kind for which there is a ready market, unless it is impractical for other reasons, for example, because the goods are perishable. We can see that when notice is required, a fixed period of notice that could not be varied by the parties would be unduly restrictive, but we do not think it would ever be in the parties' interests to dispense with notice entirely. Instead we suggest that the requirement should be made flexible by providing merely that it should be sufficient and providing that it will be deemed sufficient if the notice meets certain criteria in content and timing. This provides the secured party with certainty that, if it complies with these criteria, the notice cannot be challenged as insufficient.

5.158 It would be possible to give even greater certainty by providing, as does the UCC, that where the legislation calls for one party's rights or conduct to be measured by a standard – reasonableness or sufficiency – the parties may determine those standards by agreement provided that the standards determined are not

[243] See above, para 5.52 and DR 60(5).

[244] See above, para 5.53 and DR 60(6).

[245] See above, para 5.68 and DR 62(4)-(6).

manifestly unreasonable.[246] Thus the debtor could not be deprived of any right to notice of the sale, but the parties could agree that a particular form of notice given a set time ahead would suffice and this would normally prevent any challenge to the sufficiency of the notice. This seems a useful innovation.

5.159 **We provisionally recommend that the parties should be free to set standards as to the notice to be given before disposal of collateral, provided that the standards set are not wholly unreasonable; but, subject to that, even as between debtor and secured party the notice requirements should be mandatory.**

The right to receive the surplus

5.160 Under traditional security devices – the mortgage, charge or pledge – the debtor has an inalienable right to any surplus. The position is otherwise under title-retention devices.[247] However, we are told that in practice lenders are not concerned with recovering more than the capital and interest that is due to them, plus any expenses they have incurred, and frequently agree that if there is a surplus it shall be paid to the debtor.[248]

5.161 We have also pointed out that under the terms of the security agreement the debtor may be obliged to pay a certain amount to the secured party even if it does not default.[249] Thus a finance lease may provide that when the lessee (the debtor) no longer requires the equipment it may sell it as agent of the lessor (the secured party) and keep the proceeds less 5%, which is to be returned to the lessor. This right of the secured party would not be affected by the scheme; it would be one of the obligations secured. In other words, no question of a surplus would arise unless when the secured party repossessed and disposed of the equipment it realised more than the rental payments due, plus the lessor's expenses, plus 5% of the residual value. Thus the secured party would be fully protected.

5.162 In the light of this we cannot see what real interest would be served by permitting the debtor to give up its right to the surplus. The argument is reinforced by the problem of third parties with an interest in the surplus, such as another party with an SI over the same collateral. They may not know that the prior secured party's security agreement entitles it to retain a surplus. The NZPPSA, true to its principle of prohibiting contracting out to the detriment of third parties, provides that it is only the debtor who can give up the right to the surplus. Thus SP1 may be entitled to the surplus as against the debtor but have to pay it to SP2.[250] It

[246] UCC Section 9-603(1). There is a delightful provision in Section 9-602 to the effect that the parties may not determine the standard applicable to the duty to avoid breaches of the peace while repossessing collateral.

[247] See CP para 6.4 and above, para 5.19.

[248] See above, para 2.110.

[249] See above, para 2.112.

[250] See M Gedye, R Cuming and R Wood, *Personal Property Securities in New Zealand* (2002) para 107.2 (p 389). As the authors point out, the debtor could evade the surrender of its rights by arranging an SI in favour of a 'friendly' third party.

seems simpler and more effective to make the surplus rule mandatory, as do the Canadian schemes[251] and the UCC.[252]

5.163 **We provisionally recommend that the provisions on surplus should be mandatory.**

Notice before acceptance of collateral in full or partial satisfaction of obligation

5.164 To allow the parties to agree that the secured party may 'foreclose' without informing the debtor, or allowing the debtor to object, seems so risky for the debtor that we cannot see any merit in allowing the parties to agree this. **We provisionally recommend that the provisions on acceptance of collateral in full or partial satisfaction of the obligation secured should be mandatory**.

The right to redeem collateral

5.165 The right to redeem is fundamental to the notion of a mortgage or other traditional security. There is no such general right under title-retention devices but the thrust of our proposed reforms is to bring these closer into line with traditional securities rather than the other way about. We thus hesitate to permit the parties to exclude the right to redeem, even though the NZPPSA allows the debtor to give up this right.[253] **We provisionally recommend that the provisions on redemption should be mandatory.**

Exclusion and restriction of liability

5.166 A linked question is whether a party may exclude or restrict its liability for breach of any duty imposed by this Part, or any other Part, of the draft regulations. The SPPSA states that any clause purporting to have this effect shall be void.[254]

5.167 By definition, the rules that are mandatory under Part 5 cannot be excluded or limited. However, there is also the question of liability for breach of duties or obligations imposed by other Parts of the draft regulations.

5.168 Our provisional view is that any clause that purports to exclude or limit the secured party's liability for failure to comply with duties and obligations imposed by the draft regulations should be of no effect. However, we are unsure as to whether this is appropriate, and would welcome views.

5.169 **We seek consultees' views as to whether the draft regulations should deny effect to any provision in a security agreement or other agreement that purports to exclude or limit the secured party's liability for failure to comply with duties and obligations imposed by the draft regulations.**

[251] SPPSA, s 59(3) and OPPSA, s 59(2).

[252] Section 9-602(5). The rule does not of course apply to outright sales of receivables, see above para 5.21 n 24.

[253] They are mandatory under the PPSAs and UCC Section 9-602(11).

[254] SPPSA, s 65(10).

Waiver

5.170 The UCC contains a limited provision to the effect that a debtor may 'waive' its mandatory rights after there has been a default (for example, as part of a settlement).[255] The SPPSA does not have an equivalent. We would welcome advice on whether such a provision is desirable. There was some uncertainty as to whether a settlement agreement is exempt from the Unfair Contract Terms Act 1977, but there the issue was whether such an agreement was caught by section 10, which deals with 'secondary' contracts, rather than the main provisions. In any event it was held that the Act does not affect settlement agreements.[256] We have not thought it necessary to exempt settlement agreements from the restrictions on exempting or excluding liability but we would welcome advice.

5.171 **We ask whether it is necessary or desirable for the draft regulations to contain provisions setting out when a debtor may waive its mandatory rights or agree to an exclusion or restriction of liability as part of a settlement agreement.**

[255] UCC Section 9-624.

[256] *Tudor Grange Holdings Ltd v Citibank NA* [1992] Ch 53.

PART 6
LIST OF PROVISIONAL RECOMMENDATIONS AND CONSULTATION QUESTIONS

6.1 We set out below a summary of our provisional recommendations and questions on which we invite the views of consultees. We would be grateful for comments not only on the matters specifically listed below, but also on any other points raised by this consultative report. It would be very helpful if, when responding, consultees could indicate either the paragraph of the summary that follows to which their remarks relate, or the paragraph of this consultative report in which the issue was originally raised.

PART 2 – CRITICAL ISSUES

Replacing the scheme of registration and priority for company charges

6.2 We provisionally conclude that there are significant weaknesses in the way the current company charge registration system operates. (Paragraph 2.6.)

6.3 We provisionally recommend that a wholly electronic notice-filing scheme for company charges, and an associated scheme of priorities, should be introduced. (Paragraph 2.68.)

6.4 We would welcome consultees' estimates of the costs and benefits of introducing the scheme as set out in the draft regulations, but limited to 'traditional' securities. (Paragraph 2.69.)

Unincorporated businesses

6.5 We provisionally recommend that the notice-filing scheme for companies should be extended to SIs created by other business debtors as soon as possible. (Paragraph 2.79.)

6.6 We would welcome consultees' estimates of any additional costs and benefits of extending the companies scheme as set out in the draft regulations to all business debtors. (Paragraph 2.80.)

Quasi-security devices

6.7 We provisionally recommend that even at the companies-only stage:

(1) sales of receivables should be brought within the notice-filing scheme for the purposes of perfection and priority (but not the statement of remedies); and

(2) title-retention devices that have a security purpose should be brought within the scheme (including the statement of remedies).

If consultees do not agree with these recommendations we ask whether they think that the relevant SIs should be brought into the scheme:

(a) only at an 'all business debtors' stage, or

(b) not at all. (Paragraph 2.135.)

6.8 We ask consultees whether they agree that operating leases of over one year and commercial consignments that do not have a security purpose should be brought within the scheme for the purposes of perfection and priority:

(c) at the 'companies-only' stage (our provisional recommendation), or

(d) only at an 'all business debtors' stage, or

(e) not at all. (Paragraph 2.136.)

6.9 We would welcome consultees' estimates of any additional costs and benefits of including (a) sales of receivables, and (b) title retention devices in the scheme as set out in the draft regulations. If it is possible, it would be helpful if consultees were to give separate estimates for both a companies-only scheme and one for all business debtors. (Paragraphs 2.137.)

Financial collateral

6.10 We provisionally recommend that SIs over investment property should be brought within the scheme, and that it should be possible to perfect such SIs by 'control'. (paragraph 2.148.)

6.11 We provisionally recommend that SIs over bank accounts should be brought within the scheme; and that it should be possible to perfect such SIs by control. (Paragraph 2.157.)

6.12 We would welcome consultees' estimates of the costs and benefits of our provisional recommendations for financial collateral. (Paragraph 2.159.)

A statement of the parties' rights and obligations

6.13 We provisionally recommend that any scheme of rights and remedies should not contain a general reference to 'good faith', nor a general requirement that either party exercise its rights or perform its obligations in a commercially reasonable manner. Instead there should be specific requirements when these are necessary. (Paragraph 2.182.)

6.14 We provisionally recommend the inclusion of a statement of rights and remedies in the 'companies-only' scheme. (Paragraph 2.190.)

6.15 We would welcome consultees' estimates of the costs and benefits of our provisional recommendations for including a statement of rights and remedies. (Paragraph 2.191.)

PART 3 – THE SCHEME IN FULL

Scope of the scheme

6.16 We would welcome views on whether the scheme we provisionally propose should be limited to registered companies and LLPs, or should apply also to other corporate bodies; and, if so, as to which corporate bodies should be included. (Paragraph 3.8.)

6.17 We would welcome advice on whether we should continue to use a definition of 'debtor' that may refer to either the party creating the SI or the party whose obligation is secured, where they are not the same person, or both.[1] If not, should we refer to the first as 'the debtor' and the second as 'the obligor', as does the UCC; or do consultees have other suggestions? (Paragraph 3.14.)

Security interests

'In-substance' SIs

6.18 On the assumption that the scheme should apply to quasi-securities, we provisionally recommend that the definition of 'security interest' should encompass all those transactions that have a security purpose, irrespective of the form of the transaction or who has title to the collateral. (Paragraph 3.33.)

'Deemed' SIs

6.19 We provisionally recommend that leases for over one year that do not have a security purpose should be brought within the definition of 'security interest' for the purposes of perfection and priority. (Paragraph 3.38.)

6.20 We ask whether consultees agree with the way 'lease for a term of more than one year' has been defined in the draft regulations.[2] (Paragraph 3.40.)

6.21 We provisionally recommend that commercial consignments that do not secure payment or performance of an obligation should nonetheless be 'deemed' to be SIs. (Paragraph 3.43.)

6.22 We provisionally recommend that sales of accounts should be treated as SIs for the purposes of perfection and priority. (Paragraph 3.48.)

6.23 We ask consultees whether, for the purposes of priority, sales of promissory notes should also be treated as SIs that are automatically perfected. We also ask consultees whether sales of bills of exchange should be treated as SIs in the same way as sales of promissory notes. (Paragraph 3.49.)

Supporting obligations

6.24 We provisionally recommend that:

(1) where an SI attaches to a monetary obligation, an SI attaches automatically to any supporting obligation for the collateral;

(2) perfection of an SI in the collateral also perfects an SI in the supporting obligation. (Paragraph 3.57.)

[1] As set out in DR 5.

[2] DR 8.

Partial and total exclusions from the overall scheme

6.25 We ask consultees whether there are there other interests that should be wholly or partially excluded from the application of the draft regulations. (Paragraph 3.66.)

6.26 We provisionally recommend that the interests listed in DR 12 should be excluded from the scheme. We provisionally recommend that SIs over insurance policies and tort claims should be within the scheme. (paragraph 3.67.)

Attachment of SIs

6.27 We provisionally recommend that for a non-possessory SI to attach there should be no requirement that a security agreement should be, or be evidenced, in writing (whether signed or not), and that the Law of Property Act 1925, section 53(1)(c) should, so far as it would otherwise apply, cease to apply to SIs under our scheme. (Paragraph 3.81.)

6.28 We ask whether the scheme should contain a provision dealing with the reattachment of an SI to goods which have been returned or repossessed. (Paragraph 3.85.)

Methods of perfection in detail

Perfection by Filing

6.29 We provisionally recommend that the filing of a financing statement should be capable of perfecting an SI that has attached (whether before or after filing) over any type of collateral. (Paragraph 3.94.)

Automatic perfection

6.30 Should the scheme provide that an assignment 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 will be automatically perfected on attachment? (Paragraph 3.98.)

Perfection by possession and goods in the possession of bailees

POSSESSION BY SECURED PARTY

6.31 We provisionally recommend that actual possession of collateral by the secured party (or its agent) should perfect an SI in goods, an instrument, a negotiable document of title or money. (Paragraph 3.100.)

6.32 We provisionally recommend that where the goods are in the possession of the debtor or its agent, attornment to the secured party will not amount to possession by the secured party. (Paragraph 3.102.)

POSSESSION BY BAILEE

6.33 We provisionally recommend that, where the goods are in the possession of a bailee other than the debtor, the SI may be perfected in three ways:

(1) by the bailee attorning to the secured party;

(2) by the bailee issuing a document of title in the name of the secured party;

(3) or by the secured party perfecting an SI in a negotiable document of title to the goods, where the bailee has issued one. (Paragraph 3.104.)

SEIZED OR REPOSSESSED GOODS

6.34 We provisionally recommend that a secured party who has not perfected its SI by filing but who has seized or repossessed the goods should not be excluded from having possession of them for the purposes of perfection. (Paragraph 3.107.)

TRUST RECEIPTS AND TEMPORARY PERFECTION

6.35 We provisionally recommend that where an SI over instruments or certificated securities has been perfected by possession, or one over goods in the possession of a bailee has been perfected by the bailee issuing a negotiable document of title or otherwise, if the collateral or document of title is returned for specified purposes, the SI should remain perfected for a limited time thereafter. We ask whether 15 business days is an appropriate period. (Paragraph 3.112.)

Filing: Financing statement

6.36 We would welcome views on whether the financing statement should record that the debtor is a trustee and, if so, whether the beneficiary of a bare trust should also be identified. (Paragraph 3.121.)

6.37 We provisionally 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 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.

We ask consultees to identify any additional information that they consider should be provided or any information that should not be required. (Paragraph 3.134.)

WHO FILES?

6.38 We provisionally recommend that any person should be able to file a financing statement. (Paragraph 3.137.)

FILING FOR FUTURE SIS

6.39 We provisionally recommend that it should be possible to file before or after a security agreement has been made. (Paragraph 3.139.)

CONSENT OF THE DEBTOR TO FILING

6.40 We provisionally recommend that a financing statement that is filed before a security agreement is made should be ineffective if it is made without the debtor's consent (whether before or after the filing). (Paragraph 3.140.)

6.41 We ask consultees whether they think a power should be taken to impose a criminal sanction on those who file without the debtor's consent when there is no security agreement in existence. (Paragraph 3.141.)

'LAST-MINUTE' FILING

6.42 We provisionally recommend that, when our scheme is introduced, section 245 of the Insolvency Act 1986 be amended to apply to any SI 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). (Paragraph 3.146)

VERIFICATION STATEMENT

6.43 We provisionally recommend that, when a financing statement has been filed, the Registrar must send the secured party a verification statement. The secured party must then send a copy of the statement to the debtor within 10 business days, unless the debtor has waived the right to receive a copy. (Paragraph 3.150.)

EFFECT OF FAILURE TO FILE OR PERFECT BY OTHER MEANS

6.44 We provisionally recommend that it should not be compulsory to perfect an SI by filing or any other means; but that an unperfected SI should be:

(1) at risk of losing priority to one that has been perfected;

(2) ineffective against a liquidator or administrator on insolvency and other secured parties;

(3) ineffective against an execution creditor who completes execution before the SI is perfected;

(4) ineffective against some purchasers (whether a buyer or subsequent secured party) in certain circumstances. (Paragraph 3.153.)

FINANCING CHANGE STATEMENTS

6.45 We provisionally recommend that the creditor should be able to make amendments to the financing statement by means of a financing change statement. The debtor should be able to demand that an incorrect or out of date financing statement is, as appropriate, corrected or removed. (Paragraph 3.162.)

ERRORS IN THE FINANCING STATEMENT

6.46 We provisionally recommend that the effectiveness of a filing should not be affected by a defect, irregularity, omission or error in the financing statement unless it would have the result that a reasonable search, conducted in accordance with the requirements of the draft regulations and the Rules relating to searches, would not reveal the financing statement. An error in the collateral description will result in the SI remaining unperfected in relation to collateral that was omitted but will not affect it as regards other collateral that is described in the financing statement. (Paragraph 3.168.)

EFFECT OF UNAUTHORISED OR ACCIDENTAL DISCHARGE

6.47 We provisionally recommend that where there has been mistaken or unauthorised lapse or discharge of a financing statement, the secured party should be able to re-activate the financing statement within 30 days of the lapse or discharge. Where this is done, the lapse or discharge should not affect the priority ranking of the SI as against those SIs which, prior to the lapse or discharge, were subordinate in priority to it. However, this should not be the case as against SIs that are perfected by filing after the lapse or discharge but before the financing statement was re-activated, nor to the extent that the competing SI secures advances made or contracted for in that period. The Rules should deal with the procedure for re-activation of the financing statement. (Paragraph 3.170.)

SEARCHING

6.48 We provisionally recommend that it should be possible to search the register on-line by the company name; the company registered number (where it has one – overseas companies may not be registered at Companies House); the financing statement number (the number allocated by the registry on filing); and (for collateral prescribed in the Rules) the unique identifying number. (Paragraph 3.174.)

SYSTEM FAILURE

6.49 We ask 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. (Paragraph 3.175.)

SIS OVER VEHICLES

6.50 We provisionally recommend that where goods are of a type that is designated by the Rules as having a unique serial number, the financing statement may include that serial number. If it does not, a buyer of the goods who does not know of the SI will normally take free of it, and, where the goods are equipment, the SI will not be treated as perfected for the purposes of priority as against other SIs over the same goods. (Paragraph 3.180.)

Proceeds

RIGHT TO PROCEEDS OF DISPOSITION

6.51 We provisionally recommend that where collateral is disposed of by the debtor, unless the secured party has authorised the dealing free of the SI or the case is one in which the buyer will take free of the SI, the SI should continue in the collateral and attach to the proceeds. (Paragraph 3.183.)

6.52 We ask consultees whether the scheme should include a provision to limit the secured party's recovery from original collateral and proceeds to the market value of the collateral. (Paragraph 3.184.)

6.53 We provisionally recommend that whether proceeds are identifiable and traceable should not depend on the presence of a fiduciary relationship. (Paragraph 3.185.)

PERFECTION OF RIGHT OVER PROCEEDS

6.54 We provisionally recommend that an SI in proceeds should be continuously perfected if the SI in the original collateral is perfected by filing, and

(1) the financing statement contains a description of the proceeds that would be sufficient to perfect an SI in original collateral of the same kind; or

(2) the financing statement covers the original collateral, if the proceeds are of a kind within the description of the original collateral; or

(3) the proceeds consist of money, cheques, deposits in or money credited to a bank account or insurance payments.

In other cases, the secured party should have a short period in which to perfect against the proceeds. (Paragraph 3.187.)

Obtaining additional information about the SI

6.55 We conclude from the point of view of obtaining information about security that there is little point in maintaining the company's own register of charges. We ask whether the scheme should contain a provision enabling the debtor to require the secured party to supply information relating to the amount owing and the collateral subject to the SI. In particular, we seek views on whether:

(1) only the debtor should be entitled to make an 'information request',

(2) the secured party should be obliged, at the debtor's request, to supply the information to a named third party,

(3) the court should be able to order the sanctions set out in DR 18, including extinguishing the SI. (Paragraph 3.197.)

Priority between competing SIs

'Residual' priority rules

6.56 We provisionally recommend the following residual rules:

(1) Perfected SIs take priority over unperfected ones.

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

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

(4) The priority that an SI has under the rules above applies to all advances, including future ones, whether or not made under an obligation. (Paragraph 3.201.)

Specific priority rules

PURCHASE-MONEY SIS

6.57 We provisionally recommend that an SI in collateral, to the extent that it secures all or part of the collateral's purchase price, and an SI taken by a person who gives value for the purpose of enabling the debtor to acquire rights in the collateral, to the extent that the value is applied to acquire those rights, should have priority over any other SI given by the debtor in the same collateral. Interests of lessors and consignors of goods should have the same priority. (Paragraph 3.208.)

6.58 We ask consultees whether our scheme should limit PMSIs to SIs over goods or whether it should include an SI over any type of collateral other than investment property. (Paragraph 3.209.)

6.59 We provisionally recommend that for an SI over inventory to have PMSI status, it must be perfected, and a notice must have been given to any other secured party who has filed a financing statement covering the same type of collateral, before the debtor (or another person on its behalf, if earlier) obtains possession of the collateral. The notice must state that the person giving the notice expects to acquire an SI in inventory, and describe the inventory by item or kind. (Paragraph 3.214.)

6.60 We provisionally recommend that a PMSI over goods that are not inventory should have priority over any other conflicting SI provided that it is perfected not later than 10 days after the debtor obtains possession of the collateral. In the case of a PMSI over intangibles, the 10 day period should date from attachment. (Paragraph 3.219.)

6.61 We provisionally recommend that PMSI status in one piece of inventory should extend to other inventory supplied by the same supplier, even if the particular item claimed has been paid for. (Paragraph 3.220.)

6.62 We provisionally recommend that where two PMSIs in goods or proceeds conflict, a PMSI taken by a seller, lessor or consignor has priority over any other PMSI, providing that it is perfected, in the case of non-inventory, within 10 days of the debtor obtaining possession of the collateral or, in the case of inventory, at the time the debtor obtains possession of the collateral. (Paragraph 3.221.)

6.63 We provisionally recommend that a secured party claiming an accounts as original collateral should have priority over a secured party claiming the account as the proceeds of a PMSI, provided that the receivables financier perfected its SI by filing before the PMSI secured party supplied the goods in question or filed in respect of its SI. (Paragraph 3.223.)

6.64 For the purposes of the priority rules, should the scheme provide that a PMSI in livestock be treated in the same way as a PMSI in inventory? (Paragraph 3.226.)

6.65 We ask whether the scheme should provide that an SI taken by a secured party who effectively enables a crop to be produced should have priority over competing SIs in the resulting crop or its proceeds. If so, should there be time limits or notice requirements in relation to this? (Paragraph 3.228.)

PROTECTION OF TRANSFEREES OF 'NEGOTIABLE' COLLATERAL

6.66 We provisionally recommend that a purchaser of an instrument for value, without knowledge of the SI, and who takes possession of the instrument should have priority over any SI in the instrument, whether or not the SI was perfected, unless the purchaser not only knew of the SI but knew that the transaction would violate the terms of the security agreement. (Paragraph 3.231.)

6.67 We provisionally recommend that:

(1) holders of money (that is, notes and coins in any currency) which is subject to an SI, whether perfected or not, should have priority over that SI if the holder acquired the money without knowledge that it was subject to an SI, or is a holder for value, whether or not the holder acquires the money without knowledge of the SI;

(2) a creditor who has received payment of a debt owing to it by the debtor other than by payment in cash, should have priority over an SI in the funds, intangible or instrument used to effect the payment, whether or not it knew of the SI at the time of payment. (Paragraph 3.235.)

6.68 We provisionally recommend that a holder to whom a negotiable document of title is negotiated, and who gave value, should have priority over an SI in the document of title, whether or not the SI was perfected, unless the holder not only knew of the SI but knew that the transaction would violate its terms. (Paragraph 3.236.)

PRIORITY IN TRANSFERRED COLLATERAL

6.69 We provisionally recommend that if collateral is transferred by the debtor to a party who takes subject to the SI, then provided the secured party's interest was perfected at the time of transfer and has remained so, it should have priority over any SI created by the transferee. This is so whether the SI created by the transferee was created or filed before or after the SI created by the transferor. (Paragraph 3.246.)

LIENS

6.70 We provisionally recommend that where a person in the ordinary course of business supplies materials or services with respect to goods which are subject to an SI, a lien that that person has with respect to those services and materials has priority over the SI (unless the lien is a statutory lien which expressly provides otherwise). (Paragraph 3.249.)

Priority as against execution creditors

6.71 We provisionally recommend that execution creditors should have priority over unperfected SIs[3] and over a perfected SI in respect of further advances made

[3] DR 20(3).

after the secured party knows of the execution creditor's interest, unless the secured party was under an obligation to make the advance. (Paragraph 3.252.)

Priority as against buyers or lessees

UNPERFECTED SIS

6.72 We provisionally recommend that a buyer or lessee of collateral should take free of an unperfected SI unless it had knowledge of the existence of the SI. (Paragraph 3.256.)

SALES IN THE ORDINARY COURSE OF BUSINESS

6.73 We provisionally recommend that a buyer of goods from a seller who normally sells goods of that kind, or a lessee from a lessor who normally leases goods of that kind, should take free of any perfected SI created by the seller or lessor unless the buyer or lessee knows that the sale or lease is in violation of the security agreement. (Paragraph 3.260.)

LOW PRICE GOODS BOUGHT FOR PRIVATE PURPOSES

6.74 We ask consultees whether a person who

(1) buys goods for a purchase price of, say, £1000 or less (or leases them where they have that market value),

(2) does so primarily for personal, family or household purposes,

(3) and does not know that the goods are subject to an SI,

should take free of any perfected or unperfected SI in the goods. If so, is the figure of £1000 appropriate? (Paragraph 3.262.)

Other priority situations

FIXTURES

6.75 We ask whether consultees agree that specific rules dealing with fixtures are not needed. (Paragraph 3.268.)

CROPS

6.76 We provisionally recommend that a perfected SI 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. (Paragraph 3.272.)

6.77 We ask consultees whether growing trees should be treated like other crops or should be left outside the scheme. (Paragraph 3.273.)

ACCESSIONS, COMMINGLED GOODS AND PROCESSED GOODS

6.78 We provisionally recommend that specific rules on accessions are not needed. (Paragraph 3.277.)

6.79 We provisionally recommend that there is no need for our scheme to include special rules to deal with commingled goods. (Paragraph 3.278.)

6.80 We provisionally recommend that there is no need for our scheme to include specific provisions on processed goods. (Paragraph 3.282.)

Liability in damages

6.81 Do consultees agree with the approach we have set out in DR 71 of permitting damages for reasonably foreseeable loss? If not, what sanctions should exist for failing to carry out any obligation imposed by the draft regulations? Should the availability of damages be limited to those to whom the duty or obligation is owed? If damages are an appropriate sanction, should there be provision for fixed-sum awards for breach of particular provisions? (Paragraph 3.286.)

6.82 Should there be a provision effectively limiting any duty of a secured party towards debtors and other secured parties unless the secured party knows that the person is a debtor or secured party as appropriate, and their identities? (Paragraph 3.288.)

SIs and the 'specialist' registries

Land

6.83 We provisionally recommend that the creation and transfer of interests in land should be excluded from the scope of the draft regulations. Arrangements should be made to make available on or via the Companies House register information about charges over a company's land that are registered at the Land Registry. (Paragraph 3.309.)

6.84 We provisionally recommend that interests over rights to payment arising from an interest in land should not be excluded from the scheme. (Paragraph 3.312.)

Aircraft

6.85 We provisionally recommend that SIs over aircraft registered in the UK or anywhere else in the world should be excluded from our scheme. (Paragraph 3.322.)

Ships

6.86 We provisionally recommend that any SI over a ship that is registered in the UK and to which the 'private law provisions' apply, or over a ship registered anywhere else in the world, should be outside our scheme. (Paragraph 3.333.)

6.87 For those SIs in ships that fall within the scope of the draft regulations, we provisionally recommend that the statement of rights and remedies contained in Part 5 of the draft regulations should be made without prejudice to current Admiralty practice relating to the enforcement of charges and mortgages in ships. (Paragraph 3.336.)

Intellectual property

6.88 We provisionally recommend that SIs over registered designs, patents and trade marks should be excluded from our scheme. (Paragraph 3.342.)

SIs over assets abroad or created by 'foreign' companies

Companies registered in England and Wales

6.89 We provisionally recommend that the scheme should apply to SIs created by companies registered in England and Wales over assets outside the UK. (Paragraph 3.363.)

Companies incorporated outside the UK

6.90 We provisionally recommend that SIs created by foreign companies over their assets in England and Wales, or to which the law of England and Wales would apply for the purposes of determining questions of perfection and priority , should be subject to the scheme. (Paragraph 3.372.)

Scotland

6.91 We provisionally recommend that an SI created by an English company over assets in Scotland should be subject to the scheme, including the normal rules of perfection. An SI created by a company registered in Scotland over assets in England and Wales, or to which the law of England and Wales would apply for the purposes of determining questions of perfection and priority, should also be subject to the scheme. (Paragraph 3.383.)

Transitional provisions

6.92 We provisionally recommend 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 SIs. As against post-commencement SIs their priority should depend on the normal rules of priority of the new scheme. (Paragraph 3.393.)

6.93 We ask consultees whether there should be a transitional period during which pre-commencement charges that are not registrable under current law should have to be registered. (Paragraph 3.397.)

6.94 We provisionally recommend that:

(1) Pre-commencement sales of receivables should retain their existing effectiveness and priority for a transitional period of [five] years. If they are perfected by filing within that period they will retain their priority (as from the date of creation). If by the end of that period they have not been perfected by filing they will cease to be effective in insolvency and will lose their priority as against other post-commencement SIs.

(2) We ask consultees whether they agree with our conclusion that a similar scheme should apply to post-commencement title-retention transactions and, if so, how long the transitional period should be. (Paragraph 3.409.)

PART 4 – FINANCIAL COLLATERAL AND PROCEEDS OF LETTERS OF CREDIT

Basic principles

6.95 We provisionally recommend that our scheme for financial collateral should adopt as basic principles that:

(1) a secured party, or with investment property an outright buyer, should be treated as having sufficient 'control' to perfect its SI if it has taken all the steps that it reasonably can 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;

(2) a secured party who perfects by control should take priority over an SI perfected by any other method (or that is unperfected);

(3) a bona fide purchaser for value who takes control of investment property in such a way that no one else can also have control of it should take free of other SIs; and

(4) otherwise, as between SIs perfected by control, priority should (unless agreed otherwise) be in the order that the secured parties obtained control. (Paragraph 4.29.)

Investment property

6.96 We provisionally recommend the definitions explained in the paragraphs shown of:

(1) investment property (paragraph 4.31);

(2) security (paragraph 4.32);

(3) securities accounts (paragraph 4.34); and

(4) financial assets (paragraph 4.35). (Paragraph 4.37.)

Investment securities

CONTROL

6.97 Do consultees agree that it is unnecessary for the draft regulation dealing with control to refer to someone 'holding on behalf of' the purchaser? (Paragraph 4.48.)

6.98 Do consultees agree that an agreement between the intermediary and the secured party, rather than simply a notice of assignment, should be a condition of 'control' and its consequences? (Paragraph 4.54.)

6.99 We provisionally recommend that with investment securities, a secured party or other purchaser will have control:

(1) With a certificated security in bearer form, if it takes possession of the certificate;

(2) With a certificated security which is in registered form if it:

(a) takes delivery of the certificate with a signed transfer form made out to him or in blank, or

(b) is registered with the issuer as the holder;

(3) With an uncertificated security if:

(a) in systems in which it is entry in the register of the operator of the settlement system that determines legal title, either-

(i) the purchaser is entered in the register of the operator as the holder, or

(ii) the operator, on the instructions of the registered holder, has placed the security into a sub-account in the holder's own name but has given the purchaser a power of attorney over the security, or

(b) in systems in which it is entry in the register of the issuer that determines legal title, either –

(i) the purchaser is entered in the register of the issuer as the holder, or

(ii) the issuer has entered into a control agreement with the purchaser;

(4) With a security entitlement, if it-

(a) becomes the entitlement holder; or

(b) has entered into a control agreement with the intermediary; or

(c) is the entitlement holder's own securities intermediary, to whom the entitlement holder has granted an SI.

Control over a securities account amounts to control over the security entitlements carried in the securities account. (Paragraph 4.57.)

6.100 We ask whether the issuer or intermediary should be obliged to disclose what control agreements exist if required to do so by the registered holder or entitlement holder. (Paragraph 4.58.)

6.101 We provisionally recommend that an SI in investment property created by a securities intermediary is treated as perfected when it attaches, without further steps being required. (Paragraph 4.61.)

6.102 We provisionally recommend that a secured party may have control of indirectly-held securities whether or not the entitlement holder retains the right to deal with the entitlement. (Paragraph 4.64.)

6.103 We provisionally recommend that control over uncertificated securities or indirectly held securities (that is, those covered by the FCAR) should not be

effective to perfect an SI unless the security agreement is evidenced in writing. (Paragraph 4.67.)

6.104 We provisionally recommend that a secured party that has control of investment property should have the right to create a further SI in it and, if agreed, to sell it. (Paragraph 4.68.)

6.105 We provisionally recommend that an SI that is perfected by control should remain perfected even though the secured party itself relinquishes control, until such time as the debtor recovers the equivalent of control. (Paragraph 4.69.)

PRIORITY AS BETWEEN COMPETING SIS OVER INVESTMENT SECURITIES

6.106 We provisionally recommend that a secured party who takes control of a certificated or uncertificated security or, in the case of a security entitlement, has the entitlement transferred into its own name, for value and without knowledge that the sale or acquisition constitutes a breach of the security agreement creating or providing for a competing SI, should take free of that SI. (Paragraph 4.73.)

6.107 Do consultees agree that an SI held by an intermediary in an entitlement or account maintained by the intermediary should have priority over any other SI over the same assets? (Paragraph 4.75.)

6.108 We provisionally recommend that where competing SIs granted by securities intermediaries are perfected otherwise than by control they should rank equally. (Paragraph 4.76.)

BUYERS OF INVESTMENT SECURITIES

6.109 We provisionally recommend that a buyer who takes control of a certificated or uncertificated security or, in the case of a security entitlement, has the entitlement transferred into its own name, for value and without knowledge that the sale or acquisition constitutes a breach of a security agreement creating or providing for a competing SI, should take free of that SI. (Paragraph 4.81.)

6.110 We ask whether the draft regulations should include a provision to the effect that where a security is certificated, an SI is treated as temporarily perfected, without filing or taking possession, for 20 days, provided that new value was given. (Paragraph 4.83.)

THE 'BROKER'S LIEN'

6.111 Do consultees think that it is necessary or desirable for the scheme we propose to include an automatic SI in favour of a securities intermediary who has credited the entitlement holder's account before receiving payment? (Paragraph 4.87.)

Commodities

6.112 We provisionally recommend that the scheme for SIs over investment property should cover commodity contracts and commodity accounts. We ask whether these should be treated separately, as in the draft regulations, or should simply be brought within the definition of a financial asset and thus within the rules

governing SIs over what is currently termed a 'security entitlement'. (Paragraph 4.92.)

Bank accounts

6.113 We provisionally recommend that SIs created over a bank account should in principle be within the proposed scheme of notice-filing (though filing would not necessarily be required in all cases) and priority of SIs. (Paragraph 4.105.)

6.114 We provisionally recommend that SIs created over bank accounts should be brought within the provision for perfection by control and the associated priority rules. (Paragraph 4.110.)

WHAT AMOUNTS TO CONTROL OF A BANK ACCOUNT

6.115 We provisionally recommend that a secured party should be able to perfect an SI over a bank account by 'control', by:

(1) becoming the account holder; or

(2) entering an agreement with the debtor and the bank that the bank will accept directions from the secured party without further reference to the debtor; or

(3) where the secured party is the bank at which the account is held, without any further steps being required.

There may be perfection by control even though the debtor retains the right to dispose of funds in the account. (Paragraph 4.119.)

6.116 We ask whether a bank that has entered a control agreement with a secured party should have to disclose it to a third party if required to do so by the customer/debtor. (Paragraph 4.121.)

Priority

6.117 We provisionally recommend that as between competing SIs over a bank account:

(1) an SI perfected by control should take priority over one perfected by other means;

(2) as between SIs perfected by control, priority should depend on the date of control, except that where one of the secured parties is the bank itself, the bank should have priority unless the other secured party has become the account holder. (Paragraph 4.126.)

TRANSFERABILITY OF FUNDS

6.118 Should a transferee be protected:

(1) unless it did not give value or it knew that the transfer was in breach of the security agreement, or, alternatively,

(2) whether or not it gave value or had knowledge, unless it colluded with the debtor? (Paragraph 4.129.)

Bank's right of set-off

6.119 We provisionally recommend that the existence of a control agreement with a third party secured party should not prevent the bank exercising defences and set-offs that it has against the debtor, but it should not be able to raise or exercise a right of set-off that it has against the debtor against a secured party who has taken control by becoming the customer of the bank. (Paragraph 4.130.)

Bank's obligations to debtor

6.120 We ask whether consultees consider it necessary or desirable to include a provision in the draft regulations providing that, unless agreed otherwise, the bank will continue to have its normal obligations to the debtor despite an SI in the bank account perfected by control. (Paragraph 4.132.)

Proceeds of letters of credit

6.121 Do consultees agree that:

(1) an SI over the proceeds of a letter of credit should be regarded as perfected by control if the SP has obtained the bank's agreement to the assignment, and

(2) an SI over the proceeds of a letter of credit that is perfected by control should take priority over one that is not, and that SIs perfected by control should rank according to priority in time of obtaining control? (Paragraph 4.150.)

PART 5 - A STATEMENT OF THE RIGHTS AND REMEDIES UNDER A SECURITY AGREEMENT

Scope of the statement of rights and remedies

6.122 We provisionally recommend that the statement of rights and remedies should not, in general, apply to 'deemed' SIs. (Paragraph 5.11.)

Limitations on the scope of the statement

SIS OVER BOTH PERSONAL PROPERTY AND LAND

6.123 We ask whether the scheme should provide that, if the same obligation is secured by an interest in land and an SI to which the draft regulations apply, the secured party may either proceed under Part 5 as to the collateral, as to both the land and the personal property. (Paragraph 5.16.)

Essential provisions: surplus and deficit

6.124 We provisionally recommend that the draft regulations contain a provision setting out expressly how, unless otherwise provided by law or the agreement of all interested parties, the secured party must apply the proceeds of any disposition of the collateral. (Paragraph 5.21.)

6.125 We provisionally recommend that any surplus be accounted for and paid over in the following order:

(1) to a person who has a subordinate SI in the collateral and who has given written notice of the interest to the secured party prior to the distribution, and

(2) to the debtor or any other person known by the secured party to be an owner of the collateral. (Paragraph 5.26.)

6.126 We ask consultees whether the secured party should have to pay any surplus proceeds only to those subordinate secured parties who have given it a written notice of their interests, or also to any subordinate creditor who has filed against the collateral before the date of distribution. (Paragraph 5.27.)

6.127 We provisionally recommend that, as an alternative to paying over any surplus in the order specified in the draft regulations, the secured party should have an unqualified right to pay it into court. (Paragraph 5.28.)

6.128 We provisionally recommend that our scheme should provide that, unless otherwise agreed or provided for by statute, the debtor is liable to pay the amount of any deficiency to the secured party. (Paragraph 5.29.)

Desirable provisions

Effect of prohibition on assignment

6.129 We provisionally recommend that in a contract between a company and a third party creating an account 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 5.39.)

Duties of parties under the security agreement but before default

CARE IN CUSTODY AND PRESERVATION OF COLLATERAL

6.130 We provisionally recommend that the secured party who has possession of the collateral should be under a duty to take reasonable care of it and should be able to insure it at the debtor's expense. (Paragraph 5.41.)

6.131 We provisionally recommend that an outright buyer of accounts or of a promissory note should be under a duty to take necessary steps to preserve rights against other parties unless the sale was on a non-recourse basis. (Paragraph 5.42.)

INCOME, ETC. FROM COLLATERAL

6.132 We provisionally recommend that the secured party who has possession or control of collateral should apply any money received from the collateral to reduction of the obligation secured or remit it to the debtor; and in the case of other proceeds should be entitled to hold them as additional collateral. (Paragraph 5.43.)

RIGHT OF USE

6.133 We provisionally recommend that, unless otherwise agreed, the secured party who has possession of collateral should be permitted to use it for the purpose of preserving the collateral or to the extent authorised by the security agreement or the court; may create an SI in it, and, where the secured party has possession or control of collateral that is investment property, and the parties so agree, sell it. (Paragraph 5.46.)

Rights and remedies on default

COLLECTION RIGHTS

6.134 We provisionally recommend that the statement of rights and remedies provide that where the collateral is an account and the debtor defaults, the secured party may:

(1) notify the account debtor to make payment to the secured party, whether or not the secured party was making collections on the collateral before the notification by the secured party;

(2) take any proceeds of collateral to which it is entitled; and

(3) apply the money received, or any account, instrument or security in the form of a debt obligation taken as collateral to the satisfaction of the secured obligation.

There should be similar provisions for bank accounts. (Paragraph 5.51.)

6.135 We provisionally recommend that a secured party who buys receivables on a recourse basis should be required, if it collects on the receivables, to proceed in a commercially reasonable manner. (Paragraph 5.52.)

6.136 We provisionally recommend that the secured party should be able to defer applying or paying over non-cash proceeds, provided that it is not commercially unreasonable; and that where a secured party does apply or pay over non-cash proceeds, it must do so in a commercially reasonable manner. (Paragraph 5.53.)

TAKING POSSESSION ON DEFAULT

6.137 We provisionally recommend that the secured party should have an implied right to enter the debtor's premises in order to repossess collateral on the debtor's default, but should have to obtain a court order to enter the premises of a third party. (Paragraph 5.57.)

6.138 We provisionally recommend that on default the secured party should have the right to disable equipment collateral that is on the debtor's premises and to sell it from there, provided that the secured party does not cause the person in possession of the premises any greater inconvenience and cost than is necessary. (Paragraph 5.60.)

6.139 We ask whether the secured party should be able to require the debtor to assemble the collateral and make it available to the secured party at a place to be designated by the secured party which is reasonably convenient to both parties. (Paragraph 5.61.)

POWER OF SALE

6.140 We provisionally recommend that the secured party should have the power to dispose of collateral on default by the debtor. (Paragraph 5.63.)

6.141 We provisionally recommend that the scheme should incorporate a provision to the effect that:

(1) The sale may be by public sale (including auction or competitive tender) or private sale.

(2) The secured party may buy the collateral, but only at a public sale, and only for a price that bears a reasonable relationship to its market value.

(3) Collateral may be sold in its existing condition or after 'repair, processing or preparation for distribution'.

(4) Collateral may be sold as a whole or in commercial units.

(5) The secured party may delay disposition of all or some of the collateral.

(6) If the agreement so provides, payment for the collateral may be deferred or the collateral may be disposed of by lease. (Paragraph 5.67.)

6.142 We provisionally recommend that a secured party need not apply or pay over non-cash proceeds of disposition unless the failure to do so would be commercially unreasonable, but where a secured party does apply or pay over such non-cash proceeds, it must do so in a commercially reasonable manner. (Paragraph 5.70.)

6.143 We provisionally recommend that the secured party should be permitted to buy the collateral:

(1) at a public sale, or

(2) at a private sale if the collateral is of a kind that is customarily sold on a recognised market or the subject of widely distributed standard price quotations, subject to special rules about calculating the surplus or deficiency after such sales. (Paragraph 5.72.)

6.144 We ask consultees whether, where there is no organised market (or where the collateral is neither perishable nor likely to decline rapidly in value if not disposed of immediately), the secured party should have to give notice a reasonable time before the sale or disposition. If so, do they agree that 10 business days' notice should be sufficient? (Paragraph 5.83.)

6.145 If there is to be a notice requirement, we provisionally recommend that the notice should have to be 'sufficient', and that it will be sufficient if it indicates:

(1) the debtor (or party who owns the collateral);

(2) the secured party, and gives an address at which it may be contacted in sufficient time;

(3) the collateral to be sold or disposed of;

(4) the intended method of disposition;

(5) the time and date of any sale or after which any other disposition will be made.

We would welcome views on whether it would be useful to provide a standard form of notice in the draft regulations. (Paragraph 5.84.)

6.146 We provisionally recommend that, when a notice is required before collateral is disposed of, it should be sent to:

(1) the debtor or any other person who is known by the secured party to be an owner of the collateral;

(2) a person with an SI in the collateral if, before the day on which the notice of disposition is given to the debtor, that person has filed a financing statement;

(3) any person who has given an indemnity or guarantee for the debt, if the secured party knows that one exists and knows the name and address of the person, and

(4) any other person with an interest in the collateral who has given a written notice to the secured party of that person's interest in the collateral prior to the day on which the notice of disposition is given to the debtor. (Paragraph 5.86.)

6.147 We provisionally recommend including a provision on the effect of disposition. (Paragraph 5.87.)

RETENTION OF COLLATERAL BY SECURED PARTY ('FORECLOSURE')

6.148 We provisionally recommend that the statement of remedies should include provisions for the secured party, on the initiative of either party, to take the collateral in full or partial satisfaction of the obligation secured, provided that the debtor has agreed in writing and other interested parties have been notified and have not objected within 20 business days. (Paragraph 5.93.)

REDEMPTION

6.149 We provisionally recommend that a person entitled to notice of disposition under DR 63 may, unless otherwise agreed in writing after default, redeem the collateral by tendering fulfilment of the obligations secured by the collateral and paying a sum equal to the reasonable expenses incurred by the secured party in preparing etc. the collateral for disposition and enforcing the security agreement. (Paragraph 5.95.)

CUMULATIVE REMEDIES

6.150 We provisionally recommend that it be provided that the rights and remedies of each party against the other are cumulative, and may be exercised simultaneously so long as they are not mutually incompatible and simultaneous exercise is not commercially unreasonable. (Paragraph 5.97.)

6.151 We also provisionally recommend that it be provided that the secured party may enforce its personal rights under the obligation secured by the SI, and may seek to execute any judgment against the debtor's property, including the collateral, without extinguishing the SI. (Paragraph 5.98.)

APPOINTMENT OF RECEIVER AND SECURED PARTY ACTING THROUGH RECEIVER

6.152 We provisionally recommend that it be stated specifically that a security agreement may provide for the appointment of a receiver and for the rights and duties of a receiver (save as provided for by the draft regulations or another enactment). We also provisionally recommend that the rights, powers and duties of a secured party under Part 5 and DR 17 of the draft regulations should apply equally when the secured party acts through a receiver. (Paragraph 5.101.)

Provisions not recommended

6.153 We provisionally recommend that the scheme should not contain a provision relating to the interpretation of an acceleration clause. (Paragraph 5.104.)

6.154 We provisionally recommend that the scheme should not contain a provision dealing with the measure of damages relating to leases or consigned goods seized when the lessor's or consignor's interest is ineffective because it is unperfected. (Paragraph 5.109.)

6.155 We provisionally recommend that the secured party should not be under an obligation to give other secured parties a written account of the nature of the disposition, the amount raised and how it was distributed. (Paragraph 5.110.)

6.156 We provisionally recommend that the scheme should not contain a provision dealing with reinstatement of the security agreement. (Paragraph 5.113.)

6.157 We provisionally recommend that the statement of rights and remedies should not contain provisions relating to the powers of receivers. (Paragraph 5.118.)

Applications to court

6.158 We provisionally recommend that there be a provision relating to court orders to ensure compliance, enforcement, stay etc. (Paragraph 5.119.)

Financial Collateral

Security financial collateral arrangements

6.159 We provisionally recommend that the statement of rights and remedies set out in the draft regulations should be without prejudice to any agreement in a financial collateral arrangement within the meaning of the FCAR. (Paragraph 5.125.)

Title transfer financial collateral arrangements

6.160 We ask whether in respect of a title transfer financial collateral arrangement:

(1) the statement of remedies should be without prejudice to any contractual right to retain, appropriate or dispose of financial collateral under a title transfer financial collateral arrangement, within the meaning of the FCAR; or

(2) whether title transfer financial collateral arrangements should be exempted from the statement of remedies in Part 5 of the draft regulations; or

(3) whether title transfer financial collateral arrangements should be exempted from the scheme as a whole. (Paragraph 5.133.)

Good faith and commercial reasonableness

6.161 We provisionally recommend that there be no general requirement of good faith included in the draft regulations, but that a specific requirement of commercial reasonableness be included in relation to DRs 59(1)-(2), 60(5)-(6), 62(6) and 65(5). (Paragraph 5.135.)

6.162 We provisionally recommend that the parties to a security agreement should be able to determine the standards which fulfil the rights of a debtor or obligations of a secured party under any provision mentioned in DR 59(3), provided that the standards are not manifestly unreasonable. (Paragraph 5.137.)

6.163 We provisionally recommend that the scheme should include guidance on steps that are sufficient to ensure that particular methods of collection, enforcement, disposition or acceptance are 'commercially reasonable' within the meaning of the draft regulations. (Paragraph 5.141.)

Mandatory or default rules?

6.164 We provisionally recommend that the requirements to act in a commercially reasonable manner should be mandatory. (Paragraph 5.156.)

6.165 We provisionally recommend that the parties should be free to set standards as to the notice to be given before disposal of collateral, provided that the standards set are not wholly unreasonable; but, subject to that, even as between debtor and secured party any notice requirements should be mandatory. (Paragraph 5.159.)

6.166 We provisionally recommend that the provisions on surplus should be mandatory. (Paragraph 5.163.)

6.167 We provisionally recommend that the provisions on acceptance of collateral in full or partial satisfaction of the obligation secured should be mandatory. (Paragraph 5.164.)

6.168 We provisionally recommend that the provisions on redemption should be mandatory. (Paragraph 5.165.)

6.169 We seek consultees' views as to whether the draft regulations should deny effect to any provision in a security agreement or other agreement purporting to exclude or limit the secured party's liability for failure to comply with any provision of the scheme of rights and remedies. Should any other provision in the draft regulations that gives rise to a duty be capable of being excluded or limited? (Paragraph 5.169.)

6.170 We ask whether it is necessary or desirable for the draft regulations to contain provisions setting out when a debtor may waive its mandatory rights or agree to

an exclusion or restriction of liability as part of a settlement agreement. (Paragraph 5.171.)

APPENDIX B - CHANGES NEEDED TO THE DRAFT REGULATIONS TO OMIT TITLE-RETENTION DEVICES

6.171 If the draft regulations were amended to apply only to traditional securities and sales of accounts, and not to title-retention devices, we ask whether consultees think that the draft regulations should continue to contain:

(1) provisions relating to PMSIs,

(2) the statement of the rights and remedies set out in Part 5 of the draft regulations. (Appendix B.9.)

APPENDIX A
DRAFT REGULATIONS

Material shown below in a box like this indicates the paragraph of the consultative report at which the particular topic is discussed and provides cross-references to other draft regulations (DRs) that are directly relevant, and other information.

S T A T U T O R Y I N S T R U M E N T S

[200X No. XXXX]

COMPANIES

The Companies (Personal Property Security) Regulations [200X]

Made

Laid before Parliament

Coming into force

ARRANGEMENT OF REGULATIONS

PART 5

RIGHTS AND REMEDIES ON DEFAULT

PART 6

SUPPLEMENTARY PROVISIONS

The Secretary of State in exercise of the powers conferred on him by sections [x, y and z] of the Companies Act [200X] hereby makes the following Regulations:

PART 1

INTRODUCTION

Citation and commencement

Citation and commencement

1.—(1) These Regulations may be cited as the Companies (Personal Property Security) Regulations [200X].

(2) These Regulations shall come into force on [date].

Interpretation

Interpretation

2.—(1) In these Regulations, unless the context otherwise requires—

"account" means a monetary obligation, whether or not it has been earned by performance, but does not include—

(a) a monetary obligation evidenced by an instrument,

(b) investment property,

(c) a bank account, or

(d) a right to payment for money or funds advanced or sold, other than a right arising out of the use of a credit or charge card or information contained on or for use with the card;

Paragraph 3.21. Accounts are a distinct type of collateral principally because outright sales of accounts are 'deemed' SIs: see paragraphs 2.87-2.88, 3.34-3.36; DR 3(3), 5(1)(d). With one exception (DR 60(5)), Part 5 does not apply to sales of accounts. Other provisions that apply only to accounts are DRs 42(6) (Priority: PSMIs) and 45 (Rights of assignees).

"account debtor" means a person who is obligated under an account;

Paragraph 3.12.

"advance" means the payment of money, the provision of credit or other giving of value, and includes any liability of the debtor to pay interest, credit costs and other charges or costs payable by the debtor in connection with an advance or the enforcement of a security interest securing the advance, and reasonable costs incurred and expenditures made for the protection, maintenance, preservation or repair of collateral;

DR 33(6) and (7).

"bank" means—

(a) the Bank of England,

(b) a person who has permission under Part 4 of the Financial Services and Markets Act 2000(**a**) to accept deposits,

(c) an EEA firm of the kind mentioned in paragraph 5(b) of Schedule 3 to that Act which has permission under paragraph 15 of that Schedule (as a result of qualifying for authorisation under paragraph 12(1) of that Schedule) to accept deposits or other repayable funds from the public;

See below, 'bank account'. This definition of 'bank' has been taken from the definition of 'bank' in the Agricultural Credits Act 1928, as amended in the light of the Financial Services and Markets Act 2000. We would welcome views on whether a different definition would be more appropriate.

"bank account" means a deposit held on behalf of a person by a bank, but does not include investment property or a monetary obligation evidenced by an instrument;

Paragraphs 4.93-4.132. Bank accounts are a distinct type of collateral because an SI over a bank account may be perfected by control: see DRs 7, 14(2), 35 and 60(3). These provisions do not apply to bank accounts that are represented by negotiable certificates of deposit, which are 'instruments' under the draft regulations.

"business day" means any day except—

(a) Saturday or Sunday, or

(b) a bank holiday (including Christmas Day and Good Friday);

This concept of the 'business' day is used in the CPR, Rule 6.7. We could equally use 'working day' if this were thought preferable.

"cash" means money, cheques and bank accounts;

Paragraph 3.232 note 285. The draft regulations distinguish between proceeds that are 'cash' and those that are 'non-cash', see below. See also DR 29(4)(c), which in effect covers 'cash proceeds'.

"certificated security" means a security which is represented by a certificate;

Paragraph 4.7. Securities (such as shares or debt obligations) that are represented by a certificate are treated differently to uncertificated securities: see, for example, DRs 6, 26, 28, 32(1) and 34.

(**a**) 2000 c. 8.

"collateral" means personal property which is subject to a security interest, and includes proceeds to which a security interest attaches and goods which are the subject of a consignment;

Paragraph 1.12(4).

"commercial consignment" has the meaning given in regulation 9;

See DR 9.

"commodity account" means an account maintained by a commodity intermediary in which a commodity contract is carried for a commodity customer;

"commodity contract" means a commodity futures contract, a commodity futures option or other similar contract which is—

(a) traded on or subject to the rules of a commodity futures exchange regulated under […], or

(b) traded on a foreign commodities futures exchange and is carried on the books of a commodity intermediary for a commodity customer;

"commodity customer" means a person for which a commodity intermediary carries a commodity contract on its books;

"commodity intermediary" means a person who—

(a) is registered as a dealer permitted to trade in commodity contracts, whether as principal or agent, under […], or

(b) in the ordinary course of business provides clearance or settlement services for a commodity futures exchange recognised or otherwise regulated under […];

The draft regulations treat commodity contracts held in a commodity account as a distinct form of investment property (over which an SI may be perfected by control, see 'investment property' below): see paragraphs 4.36, 4.88-4.92 and, for example, DRs 6(11)-(12), 15(13), 21(2) and (5) and 34 rules 5-7.

"company" has the meaning given in the Companies Act [200X];

Paragraph 3.7; DR 11

"control" and "control agreement" have the meanings given—

(a) in regulation 6, in relation to investment property, and

(b) in regulation 7, in relation to bank accounts;

See DRs 6 and 7; also DR 36 on the proceeds of a letter of credit.

"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;

Paragraphs 3.269-3.273; DR 40.

"debtor" has the meaning given in regulation 5;

See DR 5.

"default" means—

(a) the failure to pay or otherwise perform any obligation secured when due, or

(b) the occurrence of any event or set of circumstances on which, under the terms of the security agreement, the secured party is entitled to enforce the security interest;

The security agreement may provide that the secured party is entitled to enforce the SI in circumstances in which it cannot be said that the debtor has failed to pay or perform the obligation secured when it was due. For the purposes of the draft regulations either case is treated as a default.

"document", except in the definitions of "document of title" and "instrument", includes a message recorded by electronic means which is retrievable;

"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 fungible 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;

Paragraph 3.20. For the avoidance of doubt, the draft regulations provide that a document, other than a 'document of title' or an 'instrument', can be in electronic format. 'Documents of title' and 'instruments' must be paper documents. Although there exist so-called electronic bills of lading, these appear to be direct attornments by the relevant registry, on behalf of the carrier, to the holder. See generally Electronic Commerce: Formal Requirements in Commercial Transactions (Advice from the Law Commission, December 2001).

"entitlement holder" means a person identified in the records of a securities intermediary as having a security entitlement against the securities intermediary;

Paragraph 4.9.

"equipment" means goods which are held by a debtor other than as inventory;

Paragraph 3.18. Under the draft regulations, a company's goods are either equipment or inventory. SIs over equipment are treated differently to those over inventory. The principal difference lies in the steps that have to be taken to preserve PMSI-priority: see paragraphs 3.211-3.219; DR 42. On the time as of which it is to be determined whether goods are equipment or inventory, see DR 2(2).

"filing" means the filing of a financing statement; and "file" has a corresponding meaning;

Filing is the means of perfecting a non-possessory SI over collateral other than financial collateral: paragraphs 3.113-3.181; DRs 23, 46-55. The draft regulations refer to 'filing' rather than registration simply to emphasise that the system is not transaction-based: filing may take place before any security agreement has been made. See paragraphs 3.138-3.139.

"financial asset" means—

(a) a security,

(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—

(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, or

(c) any property which is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under these Regulations,

(d) a credit balance in a securities account;

Paragraph 4.35.

"financing change statement" means data which is transmitted to the Registry in accordance with Part 4 and the Rules to amend a financing statement or discharge a filing;

Paragraphs 3.154-3.162; DRs 52, 53-55.

"financing statement" means data which is transmitted to the Registry in accordance with Part 4 and the Rules and, if the context permits, includes a financing change statement;

Paragraphs 3.118-3.134; and see principally DRs 23(a) and 47. The Rules that will supplement these draft regulations will provide the exact detail as to the data required in a financing statement.

"financing statement number" means the public registration number assigned to a financing statement by the Registrar under regulation 48 (time of filing);

The electronic filing system envisaged in the consultative report will allocate a number to each financing statement. The number can be used for searching (paragraph 3.171) and filing financing change statements (paragraph 3.155). 'Public' number is used to avoid any confusion with any 'internal' numbers that the electronic system may use for other purposes.

"foreign company" means a company incorporated elsewhere than Great Britain;

Paragraphs 3.364-3.272; DR 13(3). The draft regulations draw a distinction between companies registered in England and Wales or in Scotland under the Companies Act and companies incorporated outside Great Britain. Companies incorporated in Northern Ireland will fall into the latter category. "Foreign company" is not limited to a company incorporated outside Great Britain that has a place of business in Great Britain: compare Companies Act 1985, s 744.

"goods" means tangible personal property, fixtures, crops, trees which have been severed and the unborn offspring of animals, but does not include a document of title, an 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**);

Paragraph 3.18, and see 'equipment', above. The references to the Land Registration Act 2002 and the Land Charges Act 1972 are made because minerals that have been extracted – and which might otherwise appear to be goods – can fall within the definition of 'land' under those statutes.

"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;

Paragraph 3.20, and see 'document', above. Several provisions in the draft regulations apply to instruments in particular: for example, DRs 17(3), 20(5) and especially 38.

"intangible" means all personal property which is not tangible, and includes a licence;

Paragraph 3.22. 'Intangible' forms a general category that includes several types of intangible collateral that are treated specifically, for example, accounts, bank accounts and some forms of investment property.

"inventory" means goods which are—

(a) held by a person for sale or lease, or which have been leased by that person as lessor,

(b) to be furnished by or on behalf of a person, or which have been furnished by or on behalf of that person, under a contract of service,

(c) raw materials or work in progress, or

(d) materials used or consumed in a business;

See 'equipment', above.

"investment property" means a security, whether certificated or uncertificated, security entitlement, securities account, commodity contract or commodity account;

SIs over investment property are the subject of special rules described in Part 4 of the consultative report; see in particular paragraphs 4.30-4.37; and, for example, DRs 6, 27 and 34.

"lease for a term of more than one year" has the meaning given in regulation 8;

(**a**) 2002 c. 9.
(**b**) 1972 c. 61.
(**c**) 1882 c. 61.

See DR 8.

"money" means notes and coins which are legal tender in any currency;

Paragraph 3.23 and also 'cash', above; DR 38(1) and compare DR 28(4)(c). The definition of money is widely drawn. We would welcome views on it.

"non-cash proceeds" means proceeds other than money, cheques, deposits in or money credited to a bank account , or insurance payments;

Paragraphs 5.53 and 5.69; DRs 60(6) and 65(5).

"personal property" includes goods, documents of title, instruments, accounts, bank accounts, money, investment property and intangibles;

Paragraph 3.17.

"prescribed" means prescribed by the Rules;

"proceeds" means—

(a) whatever is acquired on the sale, lease, licence, exchange or other disposition of collateral,

(b) whatever is collected on, or distributed on account of, collateral,

(c) rights arising out of collateral,

(d) to the extent of the value of collateral, claims arising out of—

(i) the loss of, or damage to, the collateral,

(ii) the interference with use of, or infringement of rights in, the collateral, or

(iii) defects in, or nonconformity of, the collateral,

(e) to the extent of the value of collateral, and to the extent payable to the debtor or secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral;

but does not include products made from collateral, or animals merely because they are the offspring of animals which are collateral;

Paragraphs 3.182-3.187. The inclusion of proceeds within the definition of 'collateral' has the result that 'the proceeds of proceeds are proceeds'.

"promissory note" has the meaning given in the Bills of Exchange Act 1882(**a**),

Promissory notes are treated as a distinct form of instrument in that sales of promissory notes are 'deemed' SIs, though an SI over a promissory note does not need to be perfected by filing or possession: paragraph 3.46; DRs 3(3)(b), 5(1)(d) and 21(7), but see also DR 12(1)(d) and (e).

(**a**) 1882 c. 61.

"purchase" means take by sale, lease, discount, assignment, negotiation, mortgage, pledge, security interest, issue, reissue, gift or any other consensual transaction that creates an interest in personal property; and "purchaser" has a corresponding meaning;

Paragraphs 3.199 and 3.230.

"purchase-money security interest" has the meaning given in regulation 4;

See DR 4.

"register" means the register of financing statements established for the purposes of these Regulations;

Paragraphs 3.113-3.115; DR 46.

"registered number", in relation to a company, has the meaning given in the Companies Act [200X];

Paragraphs 3.119 and 3.171-3.172; DRs 47(7)(b) and 54(1)(b).

"Registrar" means the Registrar of Companies;

Paragraphs 2.24 and 2.75.

"Rules" means the rules made by the Registrar in accordance with section [xx] of the Companies Act [200X];

Paragraph 3.115

"secured party" means a person in whose favour a security interest is created or provided for under a security agreement, including a party who holds a security interest for the benefit of another person and, if a security interest is embodied in a security trust deed, a trustee;

Paragraphs 2.12 and 3.16; DR 3 (Meaning of "security interest"). It should be noted that the holder of a 'deemed' SI is a secured party. The legal personality of the secured party, unlike that of the debtor, does not determine the application of the draft regulations. A secured party may be an individual, a partnership or a corporate body.

"securities account" means 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;

This is the term used to designate the account in which indirect holdings of 'financial assets' are maintained by the intermediary for the 'entitlement holder': see paragraph 4.34.

"securities intermediary" means a clearing agency, or a person, including a broker, bank or trust company, which in the ordinary course of its business maintains securities accounts for others and is acting in that capacity;

Paragraph 4.9 and 'securities account', above.

"security" means an obligation of an issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer—

(a) which is represented by a certificate in bearer or registered form, or the transfer of which may be registered in books maintained for that purpose by or on behalf of the issuer, or, where the primary record of entitlement to the asset as against the issuer is the register of the operator of a settlement system, on the operator's register,

(b) which is one of a class or series, or by its terms is divisible into a class or series of shares, participations, interests or obligations, and

(c) which—

(i) is, or is of a type, dealt in or traded on securities exchanges or securities markets, or

(ii) is a medium for investment and by its terms expressly provides that it is to be treated as a security governed by these Regulations;

Paragraphs 4.9 and 4.32. 'Security' refers to forms of investment property such as shares or debt obligations; securities may be certificated or uncertificated. A 'security' may be used as collateral; it should not be confused with a 'security interest' over collateral.

"security agreement" means an agreement which creates or provides for a security interest;

Paragraphs 3.75-3.81. Note that a security agreement need not be in writing or evidenced in writing: DR 14, unless it is for financial collateral: DRs 6(7) and 7(3)(b).

"security certificate" means a certificate representing a security;

Paragraphs 4.40-4.46; DRs 26 and 27(2)(a).

"security entitlement" means the rights and property interest of an entitlement holder with respect to a financial asset;

Paragraph 4.34, and see 'securities account', above.

"security interest" has the meaning given in regulation 3;

See DR 3.

"security trust deed" means a deed, indenture or document (however designated) by the terms of which a person issues or guarantees, or provides for the issue or guarantee of, debt obligations secured by a security interest and in connection with which a person is appointed as trustee for the holders of the debt obligations issued, guaranteed or provided for under the deed, indenture or document;

Paragraph 3.16; DR 3(2)(b)

"supporting obligation" means a right to the proceeds of a letter of credit or a guarantee or indemnity which supports the payment or performance of the principal obligation under an account, document, intangible, instrument or investment property;

Paragraphs 3.51-3.55; DRs 15(11), 21(6) and 33 rule 5.

"uncertificated security" means a security which is not represented by a certificate;

Paragraphs 4.8, 4.49-4.50, 4.72-4.73 and 4.78; DRs 6(5) and 32(1).

"unique identifying number" means the serial or other identifying number prescribed in relation to prescribed types of goods;

Paragraphs 2.92-2.95, 3.129 and 3.176-3.181; DRs 31(7) and (8), 33(4) and 47(8). The draft regulations provide for the unique identifying number of goods to be included in a financing statement, and for searching by this number. The Rules that are to supplement these draft regulations will set out which types of goods are classed as having unique identifying numbers. At this stage, we anticipate that they will be only motor vehicles and the like.

"value" means any consideration which is sufficient to support a simple contract, and includes an antecedent debt or other obligation.

Paragraphs 2.14, 3.229-3.236, 4.21 and 4.72; and, for example, DRs 15(3), 20(4), 31(5) and (6), 32(1) and (2) and 38.

(2) Unless otherwise provided in these Regulations, any determination of whether goods are inventory or equipment is to be made as of the time when the security interest in the goods attaches.

See 'equipment', above.

(3) Proceeds are traceable whether or not there is a fiduciary relationship between the person who has a security interest in the proceeds, as provided in regulation 29 (perfection: proceeds), and the person who has rights in or has dealt with the proceeds.

Paragraph 3.185; compare 'proceeds', above.

Meaning of "security interest"

3.—(1) "Security interest" means an interest in personal property which secures payment or performance of an obligation without regard—

(a) to the form of the transaction which creates or provides for the interest,

(b) to the person who has title to the collateral.

(2) For the avoidance of doubt, and without limiting paragraph (1), "security interest" includes—

(a) charges, mortgages, pledges, hire-purchase agreements and conditional sales (including agreements to sell subject to retention of title), and

(b) the following arrangements if they secure payment or performance of an obligation, namely: leases, consignments, security trust deeds, trust receipts, transfers of accounts and transfers of promissory notes.

(3) "Security interest" also means—

(a) sales of accounts,

(b) sales of promissory notes,

(c) leases for a term of more than one year which do not secure payment or performance of an obligation, and

(d) commercial consignments which do not secure payment or performance of an obligation;

but see regulation 56(1) which provides that Part 5 (rights and remedies on default) does not apply to security interests falling within this paragraph.

(4) "Security interest" does not include the interest of a seller who has shipped goods to a buyer under a negotiable bill of lading or its equivalent to the order of the seller or to the order of an agent of the seller, unless the parties have otherwise evidenced an intention to create or provide for a security interest in the goods.

(5) For the avoidance of doubt, a security interest may exist whether or not an obligation is outstanding and whether or not the security interest has attached.

3. Meaning of "security interest"
See paragraphs 3.26-3.49. For the avoidance of doubt we have added a cross-reference to DR 56 to make it clear that Part 5 of the draft regulations, dealing with rights and remedies on default, does not in general apply to the 'deemed' SIs.

DR 3(4) follows our recommendation in CP para 7.26, which was supported by a large majority of those who responded on the issue.

DR 3(5) is also included for the avoidance of doubt: attachment or an outstanding debt is not a necessary requirement for there to be an SI under the draft regulations: see paragraphs 3.68-3.69.

Meaning of "purchase-money security interest"

4.—(1) "Purchase-money security interest" means—

(a) a security interest taken in collateral, other than investment property, to the extent that it secures all or part of the collateral's purchase price,

(b) a security interest taken in collateral, other than investment property, by a person who gives value for the purpose of enabling the debtor to acquire rights in the collateral, to the extent that the value is applied to acquire those rights,

(c) the interest of a lessor of goods under a lease for a term of more than one year, or

(d) the interest of a consignor who delivers goods to a consignee under a commercial consignment,

but does not include the interest of a lessor under a transaction of sale and lease back to the seller.

(2) If the purchase-money security interest is taken in inventory, references in paragraphs (1)(a) and (b) to securing the purchase price of, or acquiring rights in,

collateral include securing the purchase price of, or acquiring rights in, other inventory in which the secured party holds or held a purchase-money security interest.

(3) For the purposes of paragraph (1), "purchase price" and "value" include credit charges and interest payable for the purchase or loan credit.

(4) A purchase-money security interest does not lose its status as such even if there is a renewal, refinancing, consolidation or restructuring of the obligation.

4. Meaning of "purchase-money security interest"
On PMSIs in general, see paragraphs 3.204-3.210. On DR 4(2) see paragraph 3.220 and on DR 4(4) see paragraph 3.210.

Meaning of "debtor"

5.—(1) "Debtor" means—

(a) a person who owes payment or performance of an obligation secured by a security interest whether or not the person owns or has rights in the collateral,

(b) a person who receives goods under a commercial consignment;

(c) a lessee under a lease for a term of more than one year;

(d) a seller of an account or promissory note, or

(e) a transferee of, or successor to, a person referred to in any of the preceding sub-paragraphs.

(2) If the person mentioned in paragraph (1)(a) and the person who has rights in the collateral are not the same person, "debtor" means—

(a) the person who has rights in the collateral, where the term is used in a provision dealing with the collateral,

(b) the person who owes the obligation, where the term is used in a provision dealing with the secured obligation, and

(c) both of those persons, where the context permits.

5. Meaning of Debtor
Paragraphs 3.9-3.14; compare DR 3 (Meaning of "security interest"). DR 5 should be read in conjunction with DR 11, which determines the scope of application of the draft regulations as a whole.

Meaning of "control": investment property

6.—(1) This regulation sets out the circumstances in which a purchaser (including a secured party) has control of investment property for the purposes of these Regulations.

(2) A purchaser has control of a certificated security in bearer form if he has possession of the certificate.

(3) A purchaser has control of a certificated security which is in registered form if the purchaser—

(a) takes delivery of the certificate appropriately endorsed, or

(b) is registered with the issuer as the holder.

(4) For the purposes of paragraph (3)(a), a certificated security is appropriately endorsed if it is—

(a) endorsed to the purchaser or in blank by the debtor's signature, or

(b) accompanied by a transfer form signed by the debtor and made out to the purchaser or in blank.

(5) A purchaser has control of an uncertificated security if—

(a) in systems in which it is entry in the register of the operator of the settlement system that determines legal title, either—

(i) the purchaser is entered in the register of the operator as the holder, or

(ii) the operator, on the instructions of the registered holder, has placed the security into a sub-account in the holder's own name but has given the purchaser a power of attorney over the security, or

(b) in systems in which it is entry in the register of the issuer that determines legal title, either—

(i) the purchaser is entered in the register of the issuer as the holder, or

(ii) the issuer has entered into a control agreement with the purchaser.

(6) A purchaser has control of a security entitlement if—

(a) the purchaser becomes the entitlement holder,

(b) the intermediary has entered into a control agreement with the purchaser, or

(c) another person has control of the security entitlement on behalf of the purchaser or, having previously acquired control of it, acknowledges that he has control on behalf of the purchaser.

(7) Paragraphs (5) and (6) apply—

(a) to a purchaser under a security agreement only if the security agreement is evidenced in writing, and

(b) to an arrangement to which section 53(1)(c) of the Law of Property Act 1925(**a**) applies (transfer of equitable interest to be in writing and signed), only if the requirements of that provision are satisfied.

(8) For the purposes of paragraphs (5)(b)(ii) and (6)(b), an issuer or 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.

(9) If an interest in a security entitlement is granted by an entitlement holder to the entitlement holder's own securities intermediary, the securities intermediary has control.

(10) An issuer or intermediary who has entered into a control agreement must confirm the existence of the agreement to another person if required to do so by the registered holder or entitlement holder.

(11) If an interest in a commodity contract is granted by a commodity customer to his own commodity intermediary, the commodity intermediary has control of the commodity contract.

(12) A purchaser has control of a commodity contract if the purchaser, the commodity customer and the commodity intermediary have agreed that the commodity intermediary will apply any value distributed on account of the commodity

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(**a**) 1925 c. 20.

contract as directed by the purchaser without further consent by the commodity customer.

(13) If a purchaser has control of all security entitlements or commodity contracts held or carried in a securities account or commodity account, the purchaser has control over the securities account or commodity account.

(14) An issuer or intermediary need not enter into a control agreement with a secured party even if the debtor directs it to do so.

6. Meaning of "control": investment property
Control' as a method of perfecting an SI over investment property is explained in Part 4, see particularly paragraphs 4.15-4.29 and 4.38-4.69; DRs 23(g), 27, 32 and 34.

On DR 6(2), see paragraphs 4.40-4.41; on DR 6(3) and (4) see paragraphs 4.42-4.48; on DR 6(5) see paragraphs 4.49-4.50; on DR 6(6) see paragraphs 4.51-4.54; on DR 6(7) see paragraphs 4.66-4.67; on DR 6(8) see paragraphs 4.15-4.18, 4.44 and 4.53; on DR 6(9) see paragraph 4.55; on DR 6(10) see paragraph 4.58; on DR 6(10)-(12) see paragraphs 4.88-4.92; on DR 6(13) see paragraph 4.56; and on DR 6(14) see paragraph 4.53 and compare UCC Section 8-106(g).

Meaning of "control": bank accounts

7.—(1) This regulation sets out the circumstances in which a secured party has control of a bank account.

(2) If the bank itself is the secured party it has control.

(3) Any other secured party has control if—

(a) the bank enters into a control agreement with the secured party and the debtor, or

(b) if the secured party, with the written agreement of the bank and the debtor, becomes the account holder, whether solely or jointly with any other person (including the debtor).

(4) For the purposes of paragraph (3)(a), a bank enters into a control agreement if it agrees in writing with the secured party and the debtor that it will comply with the instructions of the secured party directing the transfer or redemption of property held in the account without further consent from the debtor.

(5) A secured party may have control under this regulation even if the debtor retains the right to dispose of funds in the bank account.

(6) A bank need not enter into a control agreement with a secured party even if the debtor directs it to do so.

(7) A bank which has entered into a control agreement must confirm the existence of the agreement to another person if required to do so by the debtor.

7. Meaning of "control": bank accounts
'Control' as a method of perfecting an SI over a bank account is explained in Part 4, see particularly paragraphs 4.106-4.121; DRs 23(g) and 35.

On DR 7(2) see paragraph 4.117; on DR 7(3) and (4) see paragraph 4.116; on DR 7(5) see paragraph 4.118; on DR 7(6) see paragraph 4.120; on DR 7(7) see paragraph 4.121.

Meaning of "lease for a term of more than one year"

8.—(1) "Lease for a term of more than one year" means a lease of goods for a term of more than one year and includes—

(a) a lease for an indefinite term, including a lease for an indefinite term that is determinable by one or both of the parties not later than one year after the day of its execution,

(b) a lease initially for a term of one year or less than one year, if the lessee, with the consent of the lessor, retains uninterrupted or substantially uninterrupted possession of the leased goods for a period of more than one year after the day on which the lessee, with the consent of the lessor, first acquired possession of them, but the lease does not become a lease for a term of more than one year until the lessee's possession extends for more than one year, and

(c) a lease for a term of one year or less if—

(i) the lease provides that it is automatically renewable or that it is renewable at the option of one of the parties or by agreement of the parties for one or more terms, and

(ii) the total of the terms, including the original term, may exceed one year.

(2) The following are not leases for a term of more than one year for the purpose of these Regulations—

(a) a lease involving a lessor who is not regularly engaged in the business of leasing goods, or

(b) a lease of household furnishings or appliances as part of a lease of land if the goods are incidental to the use and enjoyment of the land,

regardless of the length of the lease term.

8. Meaning of "lease for a term of more than one year"
A lease for a term of more than one year that does not have a security purpose is a 'deemed' SI; compare DRs 3(3)(c), 4(1)(c) and 5(1)(c). On the definition in DR 8 see paragraphs 3.37-3.39.

Meaning of "commercial consignment"

9.—(1) "Commercial consignment" means a consignment under which goods are delivered for sale, lease, or other disposition to a consignee who, in the ordinary course of the consignee's business, deals in goods of that description, by a consignor who—

(a) in the ordinary course of the consignor's business deals in goods of that description, and

(b) reserves an interest in the goods after they have been delivered.

(2) But "commercial consignment" does not include an agreement under which goods are delivered to an auctioneer for sale.

9. Meaning of "commercial consignment"
Commercial consignments that do not have a security purpose are 'deemed' SIs: see paragraphs 3.34-3.36 and 3.41-3.43. DR 9(2) excludes an agreement under which goods are delivered to an auctioneer for sale. We have not followed the SPPSA, NZPPSA or UCC in also excluding from the definition agreements to deliver to a consignee where that consignee is generally known by its creditors to be 'substantially engaged' in selling the goods of others. This seemed to us to be unnecessary and an invitation to litigation.

Knowledge

10.—(1) An individual's knowledge includes knowledge which he might reasonably have been expected to acquire from facts observed or ascertained by him.

(2) A person is treated as having knowledge of a fact if an agent of his who is under a duty to communicate that fact to him has actual knowledge of that fact.

(3) A relevant body is treated as having knowledge of a fact if—

(a) the relevant body is treated as having knowledge of that fact by virtue of paragraph (2), or

(b) a qualifying individual has knowledge of that fact.

(4) "Relevant body" means—

(a) a body corporate,

(b) a corporation sole,

(c) a partnership, or

(d) any other body of persons which is capable of suing and being sued in its own name.

(5) "Qualifying individual", in relation to a relevant body, means an individual—

(a) who is an officer or partner of the body, or

(b) who is an employee of the body and is under a duty to communicate the fact referred to in paragraph (3)(b) to any other employee of the body or to an officer or partner of the body.

(6) The filing of a financing statement under Part 4 does not constitute constructive notice or knowledge of its existence or contents to any person.

(7) A purchaser of collateral is not required to enquire whether—

(a) a security interest has been created or provided for in the collateral, or

(b) whether the sale constitutes a breach of a security agreement.

10. Knowledge
The draft regulations frequently refer to whether or not a party knew of a fact, for example that an SI existed or that a disposition was in breach of an SI. The reference is to actual knowledge; in particular see DR 10(6) and (7). We were asked by consultees to provide a definition of actual knowledge, particularly as it applies to organisations. DR 10 draws on the SPPSA, section 10 and the definition of knowledge recommended by the Law Commission in its draft Limitation Bill, clause 5: see its Report on Limitation of Actions (2001) Law Com No 270. This provision may be moved to the main Companies Bill: see above, paragraph 1.22.

Scope of Regulations

11.—(1) These Regulations apply to security interests created or provided for by a security agreement made by a debtor who is—

(a) a company, or

(b) a foreign company.

(2) This regulation is subject to regulations 12 (exceptions) and 13 (territorial application).

11. Scope of Regulations
Paragraphs 3.6-3.8.

Exceptions

12.—(1) Except as otherwise provided, these Regulations do not apply to—

(a) liens, charges or other interests arising under an enactment or rule of law,

(b) rights of set-off,

(c) interests created or provided for by the transfer of an unearned right to payment under a contract to a person who is to perform the transferor's obligations,

(d) the assignment of accounts or promissory notes solely to facilitate collection on behalf of the person making the assignment,

(e) the assignment of a single account or promissory note to an assignee in full or partial satisfaction of a pre-existing indebtedness,

(f) the sale of accounts or promissory notes as part of the sale of a business,

(g) the creation or transfer of any interest in land, including a lease,

(h) any interest in a registered ship,

(i) any interest in a registered aircraft,

(j) any interest in registered intellectual property,

(k) [Lloyd's trust deeds.]

(2) In paragraph (1)(h), "registered ship" means a ship which is—

(a) registered in the United Kingdom in the General Register of Shipping and Seamen maintained under the Merchant Shipping (Registration of Ships) Regulations 1993(**a**), other than a ship to which the provisions of Schedule 1 to the Merchant Shipping Act 1995(**b**) concerning the registration of mortgages do not apply (small ships, fishing vessels with simple registration and certain bareboat charters), or

(b) registered anywhere else in the world.

(3) In paragraph (1)(i), "registered aircraft" means an aircraft which is—

(a) registered in the United Kingdom in the aircraft register maintained by the Civil Aviation Authority under the Air Navigation Order 2000(**c**), or

(b) registered anywhere else in the world.

(4) In paragraph (1)(j), "registered intellectual property" means any patent, trade mark or design which is—

(a) registered under any enactment in the United Kingdom, or

(b) registered anywhere else in the world.

12. Exceptions
On DR 12(1)(a) – (f) and (k) see paragraphs 3.58-3.67; on (g) – (j) and 12(2)-(4), see paragraphs 3.293-3.309.

Territorial application

13.—(1) These Regulations apply to security interests created by companies registered in England and Wales over any of their personal property, wherever it is located.

(**a**) S.I. 1993/3138.
(**b**) 1995 c. 21.
(**c**) S.I. 2000/1562.

(2) Paragraph (1) is without prejudice to regulation 19 of the Financial Collateral Arrangements (No. 2) Regulations 2003(**a**) (standard test regarding the applicable law to book entry securities financial collateral arrangements).

(3) These Regulations also apply to security interests created by companies registered in Scotland and foreign companies over personal property which is—

(a) tangible property located in England and Wales, or

(b) other property to which, under the rules of private international law, the law of England and Wales would apply for the purposes of determining questions of perfection and priority.

(4) Paragraph (5) applies to a security interest in goods—

(a) created by a company registered in Scotland or a foreign company, and

(b) which is perfected under the law of the jurisdiction in which the goods are located when the security interest attaches ("the first jurisdiction") and before the goods are brought into England and Wales.

(5) The security interest remains perfected for the purposes of these Regulations if it is perfected in accordance with these Regulations—

(a) not later than [60] business days after the day on which the goods are brought into England and Wales, or

(b) before perfection ceases under the law of the first jurisdiction,

whichever is the earliest.

(6) But a security interest which remains perfected under paragraph (5) is subordinate to the interest of a buyer or lessee of the goods who acquires the interest—

(a) after the goods have been brought into England and Wales,

(b) without knowledge of the security interest, and

(c) before it is perfected under regulation 24 (possession) or by filing under Part 4.

13. Territorial Application
Paragraphs 3.343-3.383.

(**a**) S.I. 2003/3226.

PART 2

EFFECTIVENESS OF SECURITY AGREEMENTS

Effectiveness of security agreement

14.—(1) Except as provided in these Regulations or any other enactment, a security agreement is effective according to its terms between the parties, against purchasers of the collateral and other creditors, and against an administrator or liquidator.

(2) An account debtor who is obligated under an account may take a security interest in the account, and a bank which is obligated under a bank account maintained with itself may take a security interest in that bank account.

(3) Section 53(1)(c) of the Law of Property Act 1925(**a**) (disposition of equitable interest to be in writing and signed) does not apply (if it would otherwise do so) to a security agreement.

14. Effectiveness of security agreement
Paragraphs 3.68-3.70. DR 14(1) is qualified by the reference to other draft regulations: see in particular DRs 15 (Attachment of security interest), 19 (Perfection of security interest) and 20 (Consequences of not perfecting).

Attachment of security interest

15.—(1) A security interest attaches to collateral when conditions A, B and C are satisfied, regardless of the order of occurrence.

(2) Condition A is that there is a security agreement and the collateral is sufficiently identified in the security agreement or by subsequent appropriation.

(3) Condition B is that value is given.

(4) Condition C is that the debtor has rights in the collateral or power to transfer rights in the collateral to a secured party.

(5) But the parties may agree that the security interest attaches at a later specified time, in which case it attaches at that specified time.

(6) For the avoidance of doubt, a reference in a security agreement to a floating charge is not an agreement that the security interest created by the security agreement attaches at a later time than the time specified in paragraph (1).

(7) For the purposes of paragraph (4), a debtor has rights in goods that are leased or consigned to the debtor, or sold to the debtor under a hire-purchase agreement or conditional sale agreement (including an agreement to sell subject to retention of title) no later than when the debtor obtains possession of the goods.

(8) For the purposes of paragraph (4), a debtor has no rights in—

(a) crops until they become growing crops,

(b) the young of animals until they are conceived,

(c) petroleum, gas or other minerals until they are extracted, or

(d) trees until they are severed.

(9) For the avoidance of doubt, a security interest may attach even if the debtor is permitted by the security agreement to dispose of the collateral free of the security interest.

(**a**) 1925 c. 20.

(10) If a security agreement provides for a security interest in after-acquired property, the security interest attaches in accordance with this regulation without specific appropriation by the debtor.

(11) When a security interest attaches to collateral which is an account, a document, an intangible, an instrument or investment property, it also attaches to any supporting obligation.

(12) The attachment of a security interest in a securities account is also attachment of a security interest in the security entitlements carried in the securities account.

(13) The attachment of a security interest in a commodity account is also attachment of a security interest in the commodity contracts carried in the commodity account.

15. Attachment of security interest
Paragraphs 2.14, 3.71-3.74. On DR 15(11) see DR 2(1), 'supporting obligation', above.

DR 15 will affect what are currently known as 'floating' charges: see paragraphs 2.56-2.59 and 3.74.

Automatic security interest in favour of securities intermediary etc

16.—(1) A security interest in favour of a securities intermediary arises and attaches to a person's security entitlement if—

(a) the person buys a financial asset through the securities intermediary in a transaction in which the person is obligated to pay the purchase price to the securities intermediary at the time of the purchase, and

(b) the securities intermediary credits the financial asset to the buyer's securities account before the buyer pays the securities intermediary.

(2) The security interest described in paragraph (1) secures the person's obligation to pay for the financial asset.

(3) A security interest in favour of a person who delivers a certificated security or other financial asset represented by a paper document arises and attaches to the security or other financial asset if—

(a) the security or other financial asset is—

(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 securities or financial assets, and

(b) the agreement calls for delivery against payment.

(4) The security interest described in paragraph (3) secures the obligation to make payment for the financial asset.

16. Automatic security interest in favour of securities intermediary etc.
Paragraphs 4.84-4.87.

Preservation and use of collateral

17.—(1) In this regulation, "secured party" includes a receiver.

(2) A secured party must use reasonable care in the custody and preservation of collateral in its possession.

(3) Unless the parties agree otherwise, "reasonable care" includes, in the case of an instrument, taking necessary steps to preserve rights against other persons.

(4) Unless the parties agree otherwise, if collateral is in the secured party's possession—

(a) reasonable expenses, including the cost of insurance and payment of taxes or other charges incurred in obtaining and maintaining possession of the collateral, are chargeable to the debtor and are secured by the collateral,

(b) the risk of loss or damage, except where caused by the negligence of the secured party, is on the debtor to the extent of any deficiency in any insurance coverage,

(c) the secured party must keep the collateral identifiable, but fungible collateral may be commingled;

and, subject to paragraph (2), a secured party may use the collateral in the manner and to the extent provided in the security agreement, for the purpose of preserving the collateral or its value, or in accordance with an order of the court.

(5) Unless the parties agree otherwise, if collateral is in the secured party's possession or control, the secured party—

(a) may hold as additional collateral any increase or profits, except money, received from the collateral, and must apply any money so received, unless remitted to the debtor, immediately on its receipt in reduction of the obligation secured,

(b) may create a security interest in the collateral, and

(c) if the collateral is investment property and the parties so agree, may sell it.

(6) If the secured party is a buyer of accounts or promissory notes—

(a) paragraph (2) does not apply, unless the secured party is entitled under an agreement—

(i) to charge back uncollected collateral, or

(ii) otherwise to full or limited recourse against the debtor or a guarantor of the debt based on the non-payment or other default of an account debtor or person liable to pay on an instrument or investment property, and

(b) paragraphs (4) and (5) do not apply.

17. Preservation and use of collateral
Paragraphs 5.41-5.46. Note that DR 17(6) applies to sales of accounts and promissory notes, which are 'deemed' SIs; compare DR 65(5).

Request for information from secured party

18.—(1) This regulation does not apply if a security interest falls within regulation 3(3) (certain arrangements which do not secure payment or performance of an obligation treated as security interests).

(2) A debtor may by notice in writing (an "information request") require a secured party to make available any of the information specified in paragraph (3) in relation to a security agreement identified in the information request.

(3) The information is—

(a) a statement in writing of, or written approval or correction of, the amount of the indebtedness, and

(b) a written approval or correction of an itemised list of any personal property attached to the information request indicating which items are collateral,

as at a date chosen by the secured party which is not before the date of the information request and not later than the date on which the secured party must comply with it.

(4) The information request may specify that the information is to be given to the debtor or to another person and, in either case, must contain an address for reply.

(5) The secured party must comply with the information request not later than [10] business days after receiving it.

(6) If, without reasonable excuse, the secured party fails to comply with an information request (whether in whole or in part), the debtor may apply to the court for an order requiring the secured party to comply with it.

(7) Where a person who receives an information request no longer has an interest in the obligation or property of the debtor which is the subject of the request, the person must, not later than [10] business days after receiving the request, disclose the name and address of the immediate successor in interest and, if known, the current successor in interest.

(8) If, without reasonable excuse, the person who receives an information request fails to comply with paragraph (7), the debtor, in addition to any other remedy provided by these Regulations, may apply to the court for an order requiring the person who receives the demand to comply with that paragraph.

(9) On application by a secured party or debtor, the court may—

(a) extend the time for compliance with an information request,

(b) make an order requiring a person to comply with an information request and any other order that it considers necessary to ensure compliance with the request, and

(c) make an order declaring that, in the event of a secured party's non-compliance with the order of the court to respond to an information request—

(i) the security interest of the secured party with respect to which the request was made is unperfected or extinguished, and

(ii) any related filing is discharged.

(10) A secured party or a successor in interest mentioned in paragraph (7) who replies to an information request is estopped for the purposes of these Regulations as against—

(a) the debtor, or

(b) any other person who can reasonably be expected to rely on the reply,

from denying the accuracy of the information contained in the reply to the extent that the debtor or other person reasonably relies on it.

(11) The person to whom an information request is made under this regulation may require payment in advance of the prescribed fee for each request.

18. Request for information from secured party
Paragraphs 3.188-3.197. Note that a secured party who fails to comply with its duties under this regulation may be liable in damages: DR 71 (Entitlement to damages for breach of obligations).

PART 3

PERFECTION AND PRIORITIES

Perfection

Perfection of security interest

19. A security interest is perfected when—

(a) it has attached (see regulation 15), and

(b) all the steps (if any) required for perfection by one of the methods listed in regulation 23 have been completed,

regardless of the order of occurrence.

19. Perfection of security interest
Paragraphs 3.86-3.91; on 'regardless of the order of occurrence', compare DR 48(2), which provides that a filing may be made before or after the making of a security agreement or attachment of an SI, see paragraphs 2.53-2.54 and 3.138-3.139.

Consequences of not perfecting

20.—(1) A security interest in collateral is not effective against an administrator or liquidator if it is not perfected before the onset of insolvency.

(2) "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.

(3) A security interest in collateral 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,

if the security interest is not perfected at the time that person's interest arises.

(4) A security interest in collateral is subordinate to the interest of a transferee who—

(a) acquires the interest under a transaction which is not a security agreement,

(b) gives value,

(c) if the collateral is tangible, takes possession or delivery of it, and

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(**a**) 1986 c. 45.

(d) acquires the interest without knowledge of the security interest,

before the security interest is perfected.

(5) For the purposes of paragraph (4), a purchaser of an instrument or the holder of a negotiable document of title, who acquired the instrument or negotiable document of title in a transaction which was in the ordinary course of the transferor's business has knowledge of the security interest only if the purchaser or holder acquired the interest with knowledge—

(a) of the existence of the security interest, and

(b) that the transaction violates the terms of the security agreement creating or providing for the security interest.

20. Consequences of not perfecting
Paragraphs 3.151-3.153; see also DR 33 (Residual priority rules). On DR 20(3) see paragraphs 3.250-3.252. Note that DR 20(4) deals with priority of an unperfected SI against a transferee; compare DRs 31 and 32, which deals also with perfected SIs and transferees.

Perfection: additional provisions about investment property, supporting obligations and promissory notes

21.—(1) Perfection of a security interest in a securities account also perfects a security interest in the security entitlements carried in the securities account.

(2) Perfection of a security interest in a commodity account also perfects a security interest in the commodity contracts carried in the commodity account.

(3) A security interest arising in the delivery of a financial asset under regulation 16(3) (automatic security interest in favour of securities intermediary etc) is perfected when it attaches.

(4) A security interest created by a securities intermediary in investment property is perfected when it attaches.

(5) A security interest in a commodity contract or a commodity account created by a commodity intermediary is perfected when it attaches.

(6) Perfection of a security interest in collateral also perfects a security interest in a supporting obligation for the collateral.

(7) The sale of a promissory note is perfected when it attaches.

21. Perfection: additional provisions about investment property, supporting obligations and promissory notes
DRs 21(1), (2) and (6) deal with cases in which perfection of an SI over one piece of collateral results in an SI being perfected over another – though in the case of (1) and (2), securities and commodities accounts are really no more than shorthand for the assets held in the account: see paragraph 4.34 note 38. On DR 21(5) see DR 2(1), 'supporting obligations', above.

DR 21(3), (4), (5) and (7) are other instances of 'automatic perfection': see paragraph 3.96. On DR 21(3) see DR 16 above; on DR 21(4) see paragraphs 4.59-4.61; on DR 21(5) see paragraph 4.90; and on DR 21(7) see paragraphs 3.44-3.48.

Continuity of perfection

22. A security interest is continuously perfected if it is—

(a) originally perfected, and

(b) later perfected in another way,

without an intermediate period when it is unperfected.

22. Continuity of perfection
Paragraph 3.91. Continuity of perfection relates to priority, see, for example, DR 33 (Residual priority rules).

Methods of perfection

23. Subject to these Regulations, a security interest may be perfected by any of the following methods—

(a) by filing a financing statement under Part 4 (filing),

(b) under regulation 13 (territorial application: security interest in certain goods brought into jurisdiction),

(c) under regulation 21 (perfection: additional provisions about investment property, supporting obligations and promissory notes),

(d) by possession under regulation 24 (possession),

(e) under regulation 25 (perfection: goods in possession of bailee),

(f) by delivery under regulation 26 (perfection of certificated security by delivery),

(g) by control under regulation 6 and 27 (investment property) or under regulation 7 (bank accounts),

(h) under regulation 28 (perfection by possession or delivery continues temporarily if collateral made available to debtor),

(i) under regulation 39 (perfection: proceeds).

23. Methods of perfection
Paragraphs 3.92-3.113. This draft regulation acts in part as an index to other provisions that deal with the particular methods of perfection.

Perfection by possession

24.—(1) A security interest in—

(a) goods,

(b) an instrument,

(c) a negotiable document of title, or

(d) money,

may be perfected by possession of the collateral by a secured party or its agent.

(2) But a secured party does not have possession of collateral if it is in the possession of the debtor or debtor's agent.

24. Perfection by possession
Paragraphs 3.99-3.102. 'Possession' is not defined: it will include cases in which the secured party has various forms of constructive possession, such as when it is given the keys to a warehouse where collateral is stored. However, attornment to the secured party by a bailee does not amount to possession: see DR 25. A party in possession of collateral may be under various duties to preserve it, etc.: see DR 17 (Preservation and use of collateral).

Perfection: goods in possession of bailee

25.—(1) A security interest in goods in the possession of a bailee may be perfected by—

(a) the bailee's attorning to the secured party,

(b) the issue of a document of title by the bailee in the name of the secured party, or

(c) the perfection of a security interest in a negotiable document of title to the goods where the bailee has issued one.

(2) The issue of a negotiable document of title covering goods does not preclude any other security interest in the goods from arising during the period that the negotiable document of title is outstanding.

(3) A perfected security interest in a negotiable document of title covering goods takes priority over a security interest in the goods otherwise perfected after the goods become covered by the negotiable document of title.

25. Perfection: goods in possession of bailee
Paragraphs 3.103-3.104.

Perfection of certificated security by delivery

26.—(1) A secured party may perfect a security interest in a certificated security by taking delivery of the security certificate.

(2) A security interest in a certificated security remains perfected by delivery until the debtor obtains possession of the security certificate.

(3) A purchaser takes delivery of a certificated security when—

(a) the purchaser acquires possession of the security certificate,

(b) another person, other than a securities intermediary, either—

(i) acquires possession of the security certificate on behalf of the purchaser, or

(ii) having previously acquired possession of the security certificate, acknowledges that the person holds the certificate for the purchaser, or

(c) a securities intermediary acting on behalf of the purchaser acquires possession of the security certificate, only if the security certificate is in registered form and is—

(i) registered in the name of the purchaser,

(ii) payable to the order of the purchaser, or

(iii) specially endorsed to the purchaser by an effective endorsement, and has not been endorsed to the securities intermediary or in blank.

26. Perfection of certificated security by delivery
Paragraphs 4.40-4.47; and on DR 26(2), paragraph 4.69.

Perfection by control of investment property

27.—(1) A security interest in investment property may be perfected by control of the collateral, if the security agreement which creates or provides for the security interest is evidenced in writing.

(2) A security interest in investment property is perfected by control from the time the secured party obtains control and remains perfected by control until the secured party does not have control and one of the following occurs—

(a) if the collateral is a certificated security, the debtor has or acquires possession of the security certificate,

(b) if the collateral is an uncertificated security, the issuer or operator has registered or registers the debtor as the registered owner, or

(c) if the collateral is a security entitlement, the debtor is or becomes the entitlement holder.

27. Perfection by control of investment property
An SI over investment property may be perfected by control: paragraph 4.29.

Perfection by possession or delivery continues temporarily if collateral made available to debtor

28.—(1) This regulation applies to a security interest perfected under regulation 24 or 26 (by possession or delivery) in an instrument or a certificated security which a secured party 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 security interest perfected under regulation 25 (perfection: good is possession of bailee) in—

(a) a negotiable document of title, or

(b) goods held by a bailee that are not covered by a negotiable document of title,

if the secured party 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) A security interest to which this regulation applies remains perfected for [15] business days after the collateral is made available to the debtor.

(5) After the expiry of that period, perfection depends on compliance with the other provisions of these Regulations relating to the perfection of a security interest.

28. Perfection by possession or delivery continues temporarily if collateral made available to debtor
Paragraphs 3.108-3.112.

Perfection: proceeds

29.—(1) Subject to these Regulations, if collateral is dealt with or otherwise gives rise to proceeds, the security interest—

(a) continues in the collateral, unless the secured party authorises the dealing free of the security interest (whether expressly or impliedly), and

(b) attaches to the proceeds.

(2) But where the secured party enforces a security interest against both the collateral and the proceeds, the amount secured by the security interest in the collateral and the proceeds is limited to the market value of the collateral at the date of the dealing.

(3) Paragraph (2) does not apply if both the collateral and proceeds are investment property.

(4) A security interest in proceeds is continuously perfected if the security interest in the original collateral is perfected by the filing of a financing statement which—

(a) contains a description of the proceeds that would be sufficient to perfect a security interest in original collateral of the same kind,

(b) covers the original collateral, if the proceeds are of a kind that are within the description of the original collateral, or

(c) covers the original collateral, if the proceeds consist of money, cheques, deposits in or money credited to a bank account, or insurance payments.

(5) If the security interest in the original collateral is perfected in a manner other than a manner described in paragraph (4), the security interest in the proceeds is a continuously perfected security interest and remains perfected for [10] business days after the security interest in the original collateral attaches to the proceeds.

(6) But after the expiry of that period, the security interest in the proceeds is subject to the provisions of these Regulations relating to the perfection of a security interest in original collateral of the same kind as the proceeds.

29. Perfection: proceeds
Paragraphs 3.182-3.187. On DR 29(2) and (3) see paragraph 3.184: we would welcome views on whether DR 29(2) and (3) are necessary or desirable.

Goods returned or repossessed

30.—(1) Where a debtor sells or leases goods which are subject to a security interest in circumstances in which the buyer or lessee takes free of the security interest in accordance with regulation 29(1)(a) (perfection: proceeds) or 31 (circumstances in which buyer or lessee takes free of security interest), the security interest reattaches to the goods if—

(a) the goods are returned to, seized or repossessed by the debtor, and

(b) the obligation secured remains unpaid or unperformed.

(2) Where a security interest reattaches under paragraph (1), the perfection of the security interest and the time of filing or perfection are determined as if the goods had not been sold or leased, if—

(a) the security interest was perfected by filing at the time of the sale or lease, and

(b) the filing is effective at the time of the return, seizure or repossession.

(3) Where a sale or lease of goods creates an account and—

(a) the account is transferred to a secured party, and

(b) the goods are returned to, seized or repossessed by the debtor,

the transferee of the account has a security interest in the goods which attaches when the goods are returned, seized or repossessed.

(4) A security interest in goods which a transferee of an account has under paragraph (3) is subordinate to a perfected security interest arising under paragraph (1).

(5) A security interest in goods given by a buyer or lessee of the goods mentioned in paragraph (1) which—

(a) attaches while the goods are in the possession of the buyer, lessee or debtor, and

(b) is perfected when the goods are returned, seized or repossessed,

has priority over a security interest in the goods arising under this regulation.

30. Goods returned or repossessed
Paragraphs 3.83-3.85. We would welcome views on whether this draft regulation is necessary or desirable.

Circumstances in which buyer or lessee takes free of security interest

31.—(1) In this regulation—

(a) "buyer" includes a person who obtains vested rights in goods under a contract to which the person is a party, as a consequence of the goods becoming a fixture or an accession to property in which the person has an interest, and

(b) "seller" includes a person who supplies goods that become a fixture or an accession under a contract with a buyer of goods or with a person who is party to a contract with a buyer of goods.

(2) Paragraph (3) applies to goods sold by a seller or leased by a lessor—

(a) in the ordinary course of business, and

(b) whose business normally involves selling or (as the case may be) leasing goods of the type in question.

(3) A buyer or lessee of goods who obtains possession of the goods takes free of any perfected or unperfected security interest—

(a) which is given by the seller or lessor, or

(b) which arises under regulation 29 (perfection: proceeds) or 30 (goods returned or repossessed),

unless the buyer or lessee knows that the sale or lease constitutes a breach of the security agreement under which the security interest was created.

(4) Paragraph (5) applies if a person—

(a) buys goods for a purchase price of [£1000] or less, or

(b) leases goods with a market value of [£1000] or less,

primarily for personal, family or household purposes.

(5) The person takes free of a perfected or unperfected security interest in the goods if the person takes possession of the goods and—

(a) gave value for the interest acquired, and

(b) bought or leased the goods without knowledge of the security interest.

(6) A buyer or lessee of goods who obtains possession of the goods takes free of a security interest which remains perfected for a period of [15] business days under regulation 28(4) (perfection by possession continues temporarily if collateral made available to debtor) or 29(5) (perfection: proceeds) if, during that period, the buyer or lessee—

(a) gave value for the interest acquired, and

(b) bought or leased the goods without knowledge of the security interest.

(7) Paragraph (8) applies only to goods which are equipment of a type in relation to which a unique identifying number has been prescribed.

(8) A buyer or lessee of goods who obtains possession of the goods takes free of any security interest in the goods which is perfected by filing under Part 4 if—

(a) the buyer or lessee bought or leased the goods without knowledge of the security interest, and

(b) the goods were not described by unique identifying number in the filing relating to the security interest.

(9) A sale or lease to which any of the preceding paragraphs applies may be—

(a) for cash,

(b) by exchange for other property, or

(c) on credit,

and includes delivering goods or a document of title under a pre-existing contract for sale, but does not include a transfer which secures, or which is in total or partial satisfaction of, a money debt or antecedent liability.

31. Circumstances in which buyer or lessee takes free of security interest
Paragraphs 3.257-3.263. On DR 31(2)-(3) see paragraphs 3.258-3.260; on DR 31(4)-(5) see paragraphs 3.261-3.262; on DR 31(6) see paragraph 3.109; on DR 31(7)-(8) see paragraph 3.263.

See also DR 20(4), which has the effect that a buyer or lessee for value and without knowledge of an unperfected SI will take free of it.

Purchaser takes free: additional provisions about investment property

32.—(1) A purchaser of a certificated security or an uncertificated security who—

(a) gives value,

(b) does not know that the sale constitutes a breach of a security agreement in which a security interest was created or provided for in the security, and

(c) obtains control of the security,

acquires the security free of the security interest.

(2) A person who acquires a security entitlement in a financial asset and becomes the entitlement holder—

(a) for value, and

(b) who does not know that the acquisition constitutes a breach of a security agreement that creates or provides for a security interest in the financial asset or in a security entitlement in the financial asset,

acquires the security entitlement free of such security interest.

(3) A person who acquires a security entitlement in a financial asset is not required to enquire whether—

(a) a security interest has been granted in the financial asset or in a security entitlement in the financial asset, or

(b) the acquisition constitutes a breach of a security agreement.

32. Purchaser takes free: additional provisions about investment property
Paragraphs 4.21-4.24, 4.72 and 4.80.

Priorities

Residual priority rules

33.—(1) The following rules apply if these Regulations do not otherwise determine priority between conflicting security interests.

Rule 1: a perfected security interest has priority over an unperfected security interest.

Rule 2: priority between perfected security interests is determined by the first to file or perfect.

Rule 3: priority between unperfected security interests is determined by the order of attachment.

Rule 4: a transferee of a security interest has the same priority with respect to perfection of the security interest as the transferor had at the time of transfer.

Rule 5: a security interest in a supporting obligation has the same priority as the security interest in the principal obligation which it supports.

(2) For the purposes of rules 1 and 2, a continuously perfected security interest is to be treated at all times as perfected by the method by which it was originally perfected.

(3) For the purposes of rules 1 and 2, the time of filing, possession or perfection of a security interest in original collateral is also the time of filing, possession or perfection of its proceeds, subject to regulation 29 (perfection: proceeds).

(4) For the purposes of rules 1 and 2, a security interest in equipment of a type which has a unique identifying number is not filed or perfected by filing unless a financing statement relating to the security interest and containing a description of the equipment by unique identifying number is filed.

(5) For the purposes of rules 1 and 2, the time of filing or perfection of a security interest in collateral supported by a supporting obligation is also the time of filing or perfection of a security interest in the supporting obligation.

(6) The priority that a security interest has under the rules applies to all advances, including future advances, whether or not made under an obligation.

(7) Paragraph (6) applies to give a perfected security interest priority over the interests of persons mentioned in regulation 20(3) (judgment creditors etc) only to the extent of—

(a) advances made before the interests of those persons arise or made before those persons seize the collateral or obtain a right to it,

(b) advances made before the secured party acquires knowledge of the interests of those persons,

(c) advances made under—

(i) a statutory requirement, or

(ii) a legally binding obligation owing to a person other than the debtor which was entered into by the secured party before acquiring the knowledge mentioned in sub-paragraph (b), and

(d) reasonable costs and expenses incurred by the secured party for the protection, preservation, maintenance or repair of the collateral.

33. Residual property rules
Paragraphs 3.198-3.203. DR 33(2) provides that a continuously perfected SI is to be treated as perfected by the method by which it was originally perfected. It should be noted that certain later specific priority rules modify the effect of this rule. In particular, an SI that has been perfected initially by filing but is perfected subsequently by control will not lose the advantages of being perfected by control by being treated as if it were perfected by filing.

On DR 33(4), see paragraph 3.203; on DR 33(1) Rule 5 and (5), see paragraphs 3.51-3.57; on DR 33(1) Rule 7, see paragraphs 3.250-3.252.

Priority rules: investment property

34. Subject to regulation 32 (purchaser takes free: additional provisions about investment property), the following rules govern priority between conflicting security interests in the same investment property.

Rule 1: a security interest perfected by control has priority over a security interest which is not perfected by control.

Rule 2: a security interest in a certificated security in registered form which is perfected by delivery (but not by control) has priority over a security interest perfected by any method except control.

Rule 3: subject to rules 4 and 5, conflicting security interests perfected by control rank according to the order in which control was obtained.

Rule 4: a security interest held by a securities intermediary in a security entitlement or a securities account maintained with the securities intermediary has priority over a security interest held by any other secured party.

Rule 5: a security interest held by a commodity intermediary in a commodity contract or a commodity account maintained with the commodity intermediary has priority over a conflicting security interest held by any other secured party.

Rule 6: conflicting security interests granted by a securities intermediary or commodity intermediary which are perfected otherwise than by control rank equally.

Rule 7: in all other cases, priority among conflicting security interests in investment property is governed by regulation 33 (residual priority rules).

34. Priority rules: investment property
Special rules apply to the priority of SIs over investment property that are perfected by delivery (DR 26) or by control (DR 6): see paragraphs 4.19-4.26, 4.70-4.76 and, for commodities, 4.90. DR 34 must be read with DR 32, since as a 'protected purchaser' a secured party may take free of an earlier SI under DR 32.

Priority rules: bank accounts

35.—(1) The following rules govern priority between conflicting security interests in the same bank account.

Rule 1: a security interest perfected by control has priority over a security interest which is not perfected by control.

Rule 2: subject to rule 3, conflicting security interests perfected by control rank according to the order in which control was obtained.

Rule 3: if the bank itself is a secured party, the bank has priority over any other secured party except one which has taken control by becoming the account holder (see regulation 7(3)(b)).

Rule 4: in all other cases, priority among conflicting security interests in bank accounts is governed by regulation 33 (residual priority rules).

(2) A bank may exercise any right of set-off against a secured party which holds a security interest in a bank account held with the bank unless—

(a) the secured party has taken control of the bank account by becoming the account holder, and

(b) the set-off is based on a claim against the debtor.

35. Priority rules: bank accounts
SIs over bank accounts may be perfected by control under DR 7; DR 35(1) provides special rules of priority. See paragraphs 4.19-4.26 and 4.122-4.126. On DR 35(2) see paragraph 4.130.

Priority rules: proceeds of letters of credit

36.—(1) The following rules govern priority between conflicting security interests in the same proceeds of a letter of credit.

Rule 1: a security interest held by a secured party which has control of the proceeds of the letter of credit under paragraph (2) has priority to the extent of its control over a conflicting security interest held by a secured party which does not have control.

Rule 2: security interests perfected by control rank according to priority in time of obtaining control.

Rule 3: in all other cases, priority among conflicting security interests in the same proceeds of a letter of credit is governed by regulation 33 (residual priority rules).

(2) A secured party has control of the proceeds of a letter of credit to the extent of any right to payment or performance by the issuer or any nominated person if the issuer or nominated person has consented to an assignment of proceeds of the letter of credit.

(3) "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.

36. Priority rules: proceeds of letters of credit
Paragraphs 4.145-4.150. On DR 36(2), see paragraph 4.141.

Priority of security interests in transferred collateral

37. A security interest created by a debtor is subordinate to a security interest in the same collateral created by another person ("the earlier security interest") if—

(a) the debtor acquired the collateral subject to the earlier security interest,

(b) the earlier security interest was perfected when the debtor acquired the collateral, and

(c) there is no period after the debtor acquired the collateral when the earlier security interest is unperfected.

37. Priority of security interests in transferred collateral
Paragraphs 3.238-3.246.

Protection of transferees of negotiable collateral

38.—(1) A holder of money has priority over any perfected or unperfected security interest in it if the holder—

(a) acquires the money without knowledge that it is subject to a security interest, or

(b) is a holder for value, whether or not the holder acquires the money without knowledge that it is subject to a security interest.

(2) A creditor who receives payment of a debt owing by a debtor through a debtor-initiated payment has priority over a security interest in—

(a) the funds paid,

(b) the intangible which was the source of the payment, and

(c) any instrument used to effect the payment,

whether or not the creditor has knowledge of the security interest at the time of the payment.

(3) "Debtor-initiated payment" means a payment made by the debtor through the use of—

(a) an instrument or electronic funds transfer, or

(b) a debit, transfer order, authorisation or similar written payment mechanism executed by the debtor when the payment is made.

(4) A purchaser of an instrument has priority over any perfected or unperfected security interest in the instrument if the purchaser—

(a) gave value for the instrument,

(b) acquired the instrument without knowledge that it is subject to a security interest, and

(c) took possession of the instrument.

(5) A holder to whom a negotiable document of title is negotiated has priority over a perfected or unperfected security interest in the document of title if the holder—

(a) gave value for the document of title, and

(b) acquired the document of title without knowledge that it is subject to a security interest.

(6) For the purposes of paragraphs (4) and (5), a purchaser of an instrument or a holder of a negotiable document of title who acquired it under a transaction entered into in the ordinary course of the transferor's business has knowledge only if the purchaser acquired the interest with knowledge that the transaction violates the terms of the security agreement that creates or provides for the security interest.

38. Protection of transferees of negotiable collateral
Paragraphs 3.229-3.236. On DR 38(1), see paragraph 3.323; on DR 38(2)-(3), see paragraph 3.233; on DR 38(4), see paragraphs 3.230-3.231; on DR 38(5), see paragraph 3.236.

Priority: liens

39. If a person in the ordinary course of business supplies materials or services with respect to goods which are subject to a security interest, a lien that the person has with respect to those materials or services has priority over a perfected or unperfected security interest.

39. Priority: liens
Paragraph 3.249.

Priority: crops

40. A perfected security interest in 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.

40. Priority: crops
Paragraphs 3.269-3.273.

Alienation of rights of debtor

41.—(1) In this regulation, "transfer" includes—

(a) sale,

(b) creation of a security interest, and

(c) transfer pursuant to judgment enforcement proceedings.

(2) The rights of a debtor in collateral may be transferred consensually or by operation of law, even if a provision in the security agreement prohibits transfer or declares a transfer to be a default.

(3) But a transfer by the debtor does not prejudice the rights of the secured party under the security agreement or otherwise, including the right to treat a prohibited transfer as an act of default.

41. Alienation of rights of debtor
Paragraph 2.109 note 140. Under current law a mortgagor remains the owner of mortgaged property and is free to deal with it, subject to the rights of the mortgagee. It also constitutes property that may be available to satisfy other creditors. Under the scheme, the debtor has similar rights under any SI. Thus if collateral is hired to the debtor by a finance company under a hire-purchase agreement, the finance company's interest is treated as an SI only; the debtor is treated as having a property right in the collateral such that, if the SI is not perfected when the debtor becomes insolvent, the collateral may be taken by the liquidator: see DR 20(1). Similarly, quite apart from insolvency, the collateral may be seized by an execution creditor (see DR 20(3)); and the debtor may create a second SI in the collateral – an SI that, if the first SI has not been perfected by filing, will take priority but that otherwise will be junior to the earlier SI (see DR 33(1) rule 2). DR 41(2) ensures that these effects are not negated by a prohibition on transfer. As DR 41(3) provides, this does not mean that a transfer by the debtor may not be a breach of the security agreement that would enable the finance company to exercise remedies for default under Part 5 of the draft regulations.

Priority: purchase-money security interests

42.—(1) Paragraphs (2) to (4) are subject to regulation 29 (perfection: proceeds) and paragraphs (2) and (3) are also subject to paragraph (5).

(2) A purchase-money security interest in—

(a) collateral or its proceeds, other than intangibles or inventory, which is perfected not later than [10] business days after the day on which the debtor, or (if earlier) another person at the request of the debtor, obtains possession of the collateral, or

(b) an intangible or its proceeds which is perfected not later than [10] business days after the day on which the security interest in the intangible attaches,

has priority over any other security interest in the same collateral given by the same debtor.

(3) A purchase-money security interest in inventory or its proceeds has priority over any other security interest in the same collateral given by the same debtor if—

(a) the purchase-money security interest in the inventory is perfected at the time when the debtor, or (if earlier) another person at the request of the debtor, obtains possession of the collateral,

(b) the secured party gives a notice to any other secured party who has, before the time of filing of the purchase-money security interest, filed a financing statement containing a description which includes the same item or kind of collateral, and

(c) the notice—

(i) states that the person giving the notice expects to acquire a purchase-money security interest in inventory of the debtor and describes the inventory by item or kind, and

(ii) is given before the debtor, or (if earlier) another person at the request of the debtor, obtains possession of the collateral.

(4) A notice under paragraph (3) may be given by sending it by registered mail to the address of the person to be notified as it appears in the financing statement mentioned in paragraph (3)(b).

(5) A purchase-money security interest in goods and their proceeds, taken by a seller, lessor or consignor of the collateral, which is perfected—

(a) in the case of inventory, not later than [10] business days after a debtor, or (if earlier) another person at the request of a debtor, obtains possession of the collateral, and

(b) in any other case, at the time at which a debtor, or (if earlier) another person at the request of the debtor, obtains possession of the collateral,

has priority over any other purchase-money security interest in the same collateral given by the same debtor.

(6) A security interest in accounts as original collateral has priority over a purchase-money security interest in the accounts as proceeds of inventory if a financing statement relating to the security interest in the accounts is filed before—

(a) the purchase-money security interest is perfected, or

(b) a financing statement relating to it is filed.

(7) A purchase-money security interest in original collateral has priority over a purchase-money security interest in the same collateral as proceeds, if the purchase-money security interest in original collateral is perfected—

(a) in the case of inventory, at the day on which a debtor, or another person at the request of a debtor, obtains possession of the collateral, whichever is earlier, and

(b) in any other case, not later than [10] business days after a debtor, or another person at the request of a debtor, obtains possession of the collateral, whichever is earlier.

(8) A purchase-money security interest in an item of collateral does not extend to or continue in the proceeds of the item after the obligation to pay the purchase price of the item or to repay the value given for the purposes of enabling the debtor to acquire rights in it has been discharged.

42. Priority: purchase-money security interests
Paragraphs 3.204-3.228. On DR 42(2), see paragraph 3.215-3.219; on DR 42(3)-(4), see paragraphs 3.213-3.214; on DR 42(5), see paragraph 3.221; on DR 42(6), see paragraphs 3.222-3.223.

Effect on priority of mistaken discharge of filing etc

43.—(1) This regulation applies if the filing of a financing statement—

(a) lapses as a result of failure to renew it, or

(b) is discharged by mistake or without authorisation.

(2) If the secured party reactivates the filing in accordance with the Rules within [30] business days after the lapse or discharge, the lapse or discharge does not affect the priority ranking of the security interest to which the lapsed or discharged filing relates as against a competing perfected security interest which, immediately before the lapse or discharge, had a subordinate priority ranking.

(3) But paragraph (2) does not apply to the extent that the competing security interest secures advances made or contracted for after the lapse or discharge and before the reactivation of the filing.

43. Effect on priority of mistaken discharge of filing etc.
Paragraphs 3.169-3.170.

Voluntary subordination

44.—(1) A secured party may, in a security agreement or otherwise, subordinate its security interest to any other interest.

(2) An agreement to subordinate is effective according to its terms between the parties.

(3) An agreement or undertaking to postpone or subordinate—

(a) the right of a person to performance of all or any part of an obligation to the right of another person to the performance of all or any part of another obligation of the same debtor, or

(b) all or any part of the rights of a secured party under a security agreement to all or any part of the rights of another secured party under another security agreement with the same debtor,

does not, by virtue of the postponement or subordination alone, create a security interest.

44. Voluntary subordination
Paragraph 5.144. In the CP we discussed the position of subordination agreements, and noted that under English law in a subordination simpliciter, or complete subordination, no question of an SI arises. The undertaking to subordinate is purely personal and does not involve rights over any sums themselves: CP para 6.52.

Rights of assignees

45.—(1) In this regulation, "assignee" includes a secured party 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 account 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) If collateral which is an account is assigned, the account debtor may make payments under the contract to the assignor—

(a) before the account debtor receives a notice which—

(i) states that the amount payable or to become payable under the contract has been assigned and that payment is to be made to the assignee, and

(ii) identifies the contract under which the amount payable is to become payable, or

(b) after—

(i) the account debtor requests the assignee to supply proof of the assignment, and

(ii) the assignee fails to supply reasonable proof within [15] business days after the date of the request.

(4) Payment by an account debtor to an assignee under a notice mentioned in paragraph (3)(a) 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 account 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 unenforceable against third parties.

45. Rights of assignees
Paragraphs 5.31-5.39.

PART 4

FILING

The Register

46.—(1) There is to be a register of financing statements maintained by the Registrar.

(2) Subject to these Regulations and the Rules, the filing of a financing statement is effective for the purposes of perfecting a security interest and determining priority.

(3) The filing of a financing statement does not create a presumption that these Regulations apply to the transaction to which the filing relates.

> **46. The Register**
> Paragraphs 3.113-3.115. The register should operate on a wholly electronic basis, see paragraph 3.114. On DR 46(3) see paragraph 3.37 note 36.

Financing statement

47.—(1) A financing statement must be filed in accordance with the Rules.

(2) The filing of a financing statement is ineffective unless the debtor consents to the filing.

(3) The filing of a financing change statement which adds to the collateral covered by a financing statement is ineffective unless the debtor consents to the filing.

(4) The filing of a financing change statement which adds a debtor to a financing statement is ineffective unless that debtor consents to the filing.

(5) A debtor who enters into a security agreement is treated as consenting to the filing of a financing statement which relates to the collateral mentioned in the security agreement and its proceeds.

(6) A debtor may consent to the filing of a financing statement, or be treated as consenting under paragraph (5), with retrospective effect.

(7) Subject to regulation 51 (errors in financing statement), a financing statement must contain the following information to be effective—

(a) the name of the debtor,

(b) the debtor's registered number (if any),

(c) the name and address of the secured party or its agent (if any),

(d) a description of the collateral,

(e) whether the filing is to continue indefinitely or for a specified period, and

(f) such other matters as may be prescribed by the Rules.

(8) If the collateral is of a type which has a unique identifying number, that number may also be included in the financing statement; and see regulation 33(4) (which modifies the residual priority rules if the unique identifying number is not included in the filing).

47. Financing statement
Paragraphs 3.118-3.136. On DR 47(2)-(6) see paragraph 3.140.

DR 47(7)-(8) need to be read in conjunction with DRs 48(5) and 51, which deals with the effect of errors. To be 'accepted' by the system and added to the register, the financing statement must contain information relating to each of the listed categories in DR 47(7). It will displayed on the register even if the information submitted is not correct. Questions relating to the accuracy of that information go to the effectiveness of a filing, rather than to whether it is accepted onto the register, see paragraph 3.135. The debtor may demand that an incorrect financing statement be corrected or removed, DR 55.

Time of filing

48.—(1) Filing of a financing statement is effective when a date, time and financing statement number are assigned to it by the Registrar.

(2) A financing statement may be filed—

(a) before or after a security agreement is made, and

(b) before or after a security interest attaches.

(3) A financing statement may relate to one or more security agreements.

(4) The Registrar must not accept a filing until any prescribed fees are paid.

(5) The Registrar must not accept a filing which does not provide information relating to each category listed in regulation 47(7).

(6) The Registrar may remove an entry from the register if he is satisfied that it was not filed in accordance with, or for the purposes of, these Regulations.

48. Time of filing
Paragraphs 3.316 and 3.318-3.319. On DR 48(5), see paragraphs 3.118 and 3.135; on DR 48(6), see paragraph 3.136.

Duration of filing

49.—(1) Subject to paragraph (2), a filing continues to have effect—

(a) indefinitely, or

(b) if a specified period is indicated on the financing statement, for that specified period.

(2) But a filing ceases to have effect when it is discharged.

49. Duration of filing
Paragraphs 3.130-3.132; compare DR 43 (Effect on priority of mistaken discharge of filing etc.), which applies to filings that lapse through non-renewal.

Registrar to issue verification statement

50.—(1) As soon as reasonably practicable after the filing of a financing statement the Registrar must send a verification statement to the person making the filing.

(2) "Verification statement" means a statement containing—

(a) the information contained in the financing statement,

(b) the financing statement number,

(c) the date and time of filing, and

(d) any other prescribed data which is required to confirm the filing of a financing statement.

(3) The secured party or person named as the secured party in the financing statement must [send] to the debtor a copy of the verification statement within [10] business days of receiving it, unless the debtor has waived in writing the right to receive a copy.

50. Registrar to issue verification statement
Paragraphs 3.147-3.150. The debtor may demand that an incorrect financing statement be corrected, or that one which does not cover a current SI be removed, DR 55.

Errors in financing statement

51.—(1) A financing statement is not effective if it contains a defect, irregularity, omission or error such that the existence of the security interest would not be discovered by a reasonable search under regulation 54.

(2) A financing statement is not effective to the extent that it purports to include collateral not mentioned in any security agreement to which it may relate.

(3) But the effectiveness of a financing statement is not otherwise affected by any defect, irregularity, omission or error.

(4) Nothing in paragraph (1) requires a search actually to have been carried out.

(5) Failure to provide a description in a financing statement in relation to any item or kind of collateral does not make the filing ineffective with respect to other collateral described in the financing statement.

(6) Without limiting the generality of paragraph (1), a buyer of goods with a unique identifying number who searches the register using that number alone is taken to have made a reasonable search.

51. Errors in financing statement
Paragraphs 3.163 - 3.168; and see DR 47(7) and (8) above.

Renewal and amendment of filing

52.—(1) A filing may be renewed by filing a financing change statement at any time before the filing expires and, subject to the Rules, the period of time for which the filing is effective is extended by the renewal period indicated on the financing change statement.

(2) An amendment to a filing may be effected by filing a financing change statement at any time before the filing expires, and the amendment is effective from the time when the financing change statement is filed to the expiry of the filing which is being amended.

52. Renewal and amendment of filing
Paragraph 3.156.

Filing of transfers and subordinations

53.—(1) If a secured party with a security interest perfected by filing transfers the security interest or a part of it, a financing change statement may be filed disclosing the transfer.

(2) If a financing change statement is filed under paragraph (1) and an interest in part of the collateral is transferred, the financing change statement must contain a description of the collateral in which the interest is transferred.

(3) If a secured party transfers an interest in collateral and the security interest of the secured party is not perfected by filing, a financing statement may be filed in which the transferee is disclosed as the secured party.

(4) A financing statement disclosing a transfer of a security interest may be filed before or after the transfer.

(5) After the filing of a financing change statement disclosing a transfer of a security interest, the transferee is the secured party for the purposes of these Regulations.

(6) Where a security interest has been subordinated by the secured party to the interest of another person, a financing change statement may be filed to disclose the subordination at any time during the period that the filing of the subordinated interest is effective.

(7) For the avoidance of doubt, the transferee of a security interest is not required to file a financing change statement in order to continue the perfected status of the security interest against purchasers or in the event of insolvency.

53. Filing of transfers and subordinations
Paragraph 3.237. DR 53(6) permits the parties to a subordination agreement to amend the financing statement so that notices etc. will be sent to the (now) senior party. It is not normally necessary to perfect a subordination agreement, since it will not in itself normally amount to an SI: see DR 44.

Searches

54.—(1) 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,

(d) the collateral's unique identifying number (if any),

and any additional criteria permitted by the Rules.

(2) A search result that purports to be authorised by the Registrar, whether printed by the Registrar or by any other person, is receivable as evidence as prima facie proof of its contents, including—

(a) the date of filing of a financing statement to which the search result refers, and

(b) the order of filing of the financing statement as indicated by the financing statement number.

(3) The Registrar must not authorise a search result until any prescribed fee is paid.

54. Searches
Paragraphs 3.171-3.174 and, on collateral with a unique identifying number, 3.176-3.180. The criteria in DR 54(1) will affect the operation of DR 51 (Errors in a financing statement).

Debtor may require financing change statement

55.—(1) If—

(a) a financing statement is filed, and

(b) one of the conditions set out in column 1 of Table 1 is satisfied,

the debtor, or any person with an interest in property which falls within the collateral description on the financing statement, may give a notice in writing (a "requirement notice") to the secured party.

(2) The requirement notice must—

(a) specify the condition which is satisfied,

(b) require the secured party to file a financing change statement with the effect indicated in column 2 of Table 1 relating to that condition, and

(c) inform the secured party that failure to comply with the requirement notice may result in the person who gives the notice filing the appropriate financing change statement.

Table 1

Financing change statements

1. Condition	*2. Secured party may be required to file financing change statement as shown*
That the obligations under all of the security agreements to which the financing statement relates have been performed.	To discharge the filing.
That the secured party has agreed to release part or all of the collateral described in the financing statement.	To amend or discharge the filing (as the case may be) so as to reflect the terms of the agreement.
That the description of the collateral contained in the financing statement includes an item or kind of property that is not collateral under a security agreement between the secured party and the debtor.	To amend the collateral description in the financing statement to exclude items or kinds of property that are not collateral under a security agreement between the secured party and the debtor.
That no security agreement exists between the persons named in the financing statement as the secured party and the debtor.	To discharge the filing.

(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 the secured party.

(4) The person who gives a requirement notice may file a financing change statement as requested in the requirement notice if the secured party does not, within [15] business days after the notice is issued, either—

(a) comply with the requirement notice, or

(b) commence proceedings for a court order to maintain the filing of the financing statement to which the notice relates and notify the person who gave the requirement notice and the Registrar accordingly.

(5) If the Registrar receives notification under paragraph (4)(b) of the commencement of proceedings, he must as soon as reasonably practicable amend

the entry on the register relating to the financing statement in question to show that it is the subject of a dispute.

(6) On application to the court by a secured party, the court may order that the filing—

(a) be maintained on any condition and for any period of time that the court considers appropriate, subject to regulations 49 and 52 (duration, renewal and amendment of filing), or

(b) be discharged or amended;

and the Registrar must amend the entry on the register relating to the financing statement accordingly.

(7) If a court order maintaining the filing is not obtained with [90] business days of the commencement of proceedings, the person who gave the requirement notice may file a financing change statement as requested in the requirement notice as if the secured party did not comply with paragraph (4).

(8) Notices under this regulation must be given in the prescribed manner.

55. Debtor may require financing change statement
Paragraphs 3.157-3.160. If the Registrar receives notification that court proceedings have been commenced, an indication that the financing statement is the subject of a dispute will be entered on the register. How this is done is left to the Rules. We anticipate that, when a search is made, a warning box will appear that the status of the financing statement is disputed. Further enquiries should then be made, see paragraph 3.159. The effectiveness of the filing is not otherwise affected by the fact that there is a dispute.

PART 5

RIGHTS AND REMEDIES ON DEFAULT

Application of this Part

56.—(1) This Part, except regulation 60(5) (duty to act in commercially reasonable manner as to collection of outright sales of receivables on a recourse basis etc), does not apply to security interests falling within regulation 3(3) (certain arrangements which do not secure payment or performance of an obligation).

(2) A secured party may enforce its personal rights under the obligation secured by the security interest, and may seek to execute any judgment against the debtor's property, including the collateral over which it has the security interest, without extinguishing the security interest; and a secured party who obtains collateral in this way is treated, for the purposes of determining priority, as if it had obtained the collateral by enforcing its security interest.

(3) This Part is without prejudice—

(a) to any agreement in a financial collateral arrangement, within the meaning of the Financial Collateral Arrangements (No. 2) Regulations 2003(**a**), which enables the collateral-taker to act as envisaged by regulation 17 of those Regulations (no requirement to apply to court to appropriate financial collateral under a security financial collateral arrangement), provided that regulation 18 of those Regulations (duty to value collateral and account for any difference in value on appropriation) is complied with, and

(b) to any contractual right to retain, appropriate or dispose of financial collateral under a title transfer financial collateral arrangement, within the meaning of those Regulations.

(4) This Part is also without prejudice to—

(a) judicial remedies otherwise available to enforce the rights of the parties, and

(b) Admiralty practice relating to the enforcement of mortgages of, and charges on, ships and interests in ships.

56. Application of this Part
Part 5 of the draft regulations do not apply to 'deemed' SIs, save for DR 60(5), which deals with the obligation to act in a commercially reasonable manner when collecting on an outright sale of a receivable, see paragraph 5.10. On DR 56(2), see paragraph 5.96. Part 5 of the draft regulations is without prejudice to certain financial collateral arrangements: DR 56(3), see paragraphs 5.121-5.125. On DR 56(4) see paragraphs 3.334-3.336, 5.14 and 5.48.

Overlap with security over land

57.—(1) Subject to any other enactment or rule of law to the contrary, if the same obligation is secured by an interest in land and a security interest to which these Regulations apply, the secured party may—

(a) proceed under this Part as to the collateral, without limiting the secured party's rights, remedies and duties with respect to the land, or

(b) proceed as to both the land and the collateral, in which case—

(**a**) S.I. 2003/3226.

(i) the secured party's rights, remedies and duties with respect to the land apply to the collateral, with any necessary modification, as if the collateral were land, and

(ii) this Part does not apply.

(2) Paragraph (1)(b) does not limit the rights of a secured party who has a security interest in the collateral which is taken before or after the security interest mentioned in paragraph (1), and the secured party—

(a) has standing in proceedings taken in accordance with paragraph (1)(b), and

(b) may apply to the court for the conduct of a judicially supervised sale under paragraph (1)(b), and the court may grant the application.

(3) Paragraph (4) applies for the purpose of distributing the amount received from the sale of the land and collateral if the purchase price is not allocated to the land and the collateral separately.

(4) The amount of the total price which is attributable to the sale of the collateral is the proportion of the total price that the market value of the collateral at the time of sale bears to the market value of the land and the collateral at the time of the sale.

57. Overlap with security over land
Paragraphs 5.15-5.16.

Receivers

58.—(1) A security agreement may provide for the appointment of a receiver and, except as provided in these Regulations or any other enactment, for the rights and duties of a receiver.

(2) The rights, powers and duties of a secured party under this Part and regulation 17 (preservation and use of collateral) apply equally when the secured party acts through a receiver.

58. Receivers
Paragraphs 5.99-5.101. The draft regulations do not otherwise include rules about the powers of receivers: paragraphs 5.114-5.118.

Rights and remedies

59.—(1) If the debtor is in default under a security agreement then, except as provided in paragraphs (3) to (5), the secured party has only—

(a) the rights and remedies provided in the security agreement,

(b) the rights, remedies and obligations provided in this Part, and

(c) the rights, remedies and obligations provided in regulation 17 (preservation and use of collateral) if the secured party is in possession or control of the collateral;

and these rights and remedies are cumulative, and may be exercised simultaneously so long as they are not mutually incompatible and simultaneous exercise is not commercially unreasonable.

(2) If the debtor is in default under a security agreement, the debtor has as against the secured party—

(a) the rights and remedies provided in the security agreement,

(b) the rights and remedies provided in this Part and in regulation 17, and

(c) the rights and remedies provided by any other enactment which is not inconsistent with these Regulations;

and these rights and remedies are cumulative, and may be exercised simultaneously so long as they are not mutually incompatible and simultaneous exercise is not commercially unreasonable.

(3) The following provisions, to the extent that they give rights to the debtor or impose obligations on the secured party, cannot be waived or varied by agreement or otherwise—

paragraph (5) of this regulation (provision void if purports to exclude duty or limit liability)

regulation 60(5) (duty to act in commercially reasonable manner as to collection of outright sales of receivables etc)

regulation 60(6) (duty to apply non-cash proceeds in commercially reasonable manner)

regulation 62 (disposal of collateral)

regulation 63 (disposal of collateral: requirement to give notice)

regulation 64 (calculation of surplus or deficiency in disposition to secured party etc)

regulation 65(1) and (2) (distribution of surplus)

regulation 67 (acceptance of collateral in full or partial satisfaction of obligation)

regulation 68 (redemption).

(4) The parties to a security agreement may, by agreement, determine the standards which fulfil the rights of a debtor or obligations of a secured party under a provision mentioned in paragraph (3), provided that the standards are not manifestly unreasonable.

(5) Except as otherwise provided in these Regulations, a provision in a security agreement or any other agreement is void if it purports—

(a) to exclude any duty or obligation imposed by these Regulations, or

(b) to limit the liability of, or the amount of damages recoverable from, a person who has failed to discharge any duty or obligation imposed by these Regulations.

59. Rights and Remedies
Paragraphs 5.96-5.97. Certain provisions of Part 5 are mandatory, as set out in DR 59(3): see paragraphs 5.156-5.171. The parties may nonetheless agree the standards which fulfil the rights of the debtor or the obligations of the secured party under those mandatory provisions, provided that the standards agreed are not manifestly unreasonable (DR 59(4)): paragraphs 5.136-5.137. On DR 59(5) see paragraphs 5.166-5.169; DR 71(1).

Collection rights of secured party

60.—(1) In this regulation, "relevant debtor" means an account debtor or person liable to pay on an instrument or investment property.

(2) In the event of default under a security agreement, a secured party is entitled—

(a) to notify the relevant debtor to make payment to the secured party, whether or not the secured party was making collections on the collateral before the notification,

(b) to any proceeds to which the secured party is entitled under regulation 29 (perfection: proceeds), and

(c) to apply any money, account or instrument in the form of a debt obligation taken as collateral to the satisfaction of the obligation secured by the security interest,

and any surplus must be dealt with in accordance with regulation 65 (distribution of surplus).

(3) In the event of default under a security agreement, a secured party who holds a security interest in a bank account—

(a) perfected by control under regulation 7(2) (secured party is bank), may apply the balance of the bank account to the obligation secured by the bank account, or

(b) perfected by control under regulation 7(3) (control agreement or secured party has become account holder), may instruct the bank to pay the balance of the bank account to or for the benefit of the secured party.

(4) A secured party may deduct reasonable expenses of collection from—

(a) amounts collected under paragraph (2) or (3) from a relevant debtor, or

(b) money held as collateral.

(5) A secured party must proceed in a commercially reasonable manner if the secured party—

(a) undertakes to collect from or enforce an obligation of a relevant debtor, and

(b) is entitled to charge back uncollected collateral or is otherwise entitled to full or limited recourse against the relevant debtor or a guarantor of the debt.

(6) A secured party need not apply or pay over for application non-cash proceeds of collection and enforcement under this regulation unless the failure to do so would be commercially unreasonable; but a secured party who does apply or pay over for application non-cash proceeds must do so in a commercially reasonable manner.

60. Collection rights of secured parties
Paragraphs 5.49-5.53. The obligation, imposed by DR 60(5), to collect from an account debtor or person liable to pay on an instrument or investment property in a commercially reasonable manner, applies to both 'in-substance' SIs and 'deemed' SIs: see DR 56(1).

Rights of secured party

61.—(1) This regulation applies on default under a security agreement, subject to any other enactments requiring prior notice.

(2) The secured party has, unless otherwise agreed, the right to take possession of the collateral or otherwise enforce the security agreement.

(3) The secured party may—

(a) disable equipment without removing it from the debtor's premises, and

(b) may dispose of collateral on the debtor's premises.

(4) Disposal under paragraph (3) must not cause the person in possession of the premises any greater inconvenience and cost than is necessarily incidental to the disposal.

(5) If so agreed, and in any event after default, a secured party may require the debtor to assemble the collateral and make it available to the secured party at a place to be designated by the secured party which is reasonably convenient to both parties.

(6) Without prejudice to any other enactment, if the exercise of the powers under this regulation requires the secured party to enter premises occupied by a person

other than the debtor, the secured party must obtain a court order permitting entry, unless the occupier consents.

(7) If the collateral is a document of title, the secured party may proceed either as to the document of title or as to the goods covered by it, and a method of enforcement which is available with respect to the document of title is also available, with any necessary modification, with respect to the goods covered by it.

61. Rights of secured party
On DR 61(2) and (7), see paragraphs 5.54-5.57; on DR 61(3)-(4), and (6)), see paragraphs 5.58-5.60; on DR 61(5), see paragraph 5.61.

Disposal of collateral

62.—(1) On default under a security agreement, a secured party may dispose of collateral—

(a) in its existing condition, or

(b) after repair, processing or preparation for disposition.

(2) Collateral may be disposed of—

(a) by public sale, including public auction or competitive tender, or

(b) by private sale.

(3) Collateral may be disposed of—

(a) as a whole or in commercial units or parts,

(b) by lease, licence or other disposition.

(4) The secured party may delay disposition of the collateral in whole or in part.

(5) The payment for the collateral being disposed of may be deferred.

(6) Every aspect of a disposition of collateral must be commercially reasonable, including—

(a) any repair, processing or preparation carried out before disposition, and

(b) the method, manner, time, place and other terms.

(7) The secured party may purchase collateral—

(a) at a public sale, or

(b) at a private sale only if the collateral is of a kind which is customarily sold on a recognised market or the subject of widely distributed standard price quotations;

and regulation 64 (calculation of surplus or deficiency in disposition to secured party etc) applies in relation to such a purchase.

(8) If a secured party disposes of collateral to a purchaser who acquires the interest for value and in good faith without notice, the purchaser acquires the collateral free of—

(a) the interest of the debtor;

(b) an interest subordinate to that of the debtor, and

(c) an interest subordinate to that of the secured party,

whether or not the requirements of this regulation and regulation 63 (disposal of collateral: requirement to give notice) have been complied with by the secured party, and all obligations secured by the subordinate interests are deemed to be performed for the purposes of regulation 55 (debtor may require financing change statement).

(9) The proceeds of the disposition must be applied consecutively to—

(a) the reasonable expenses of seizing, repossessing, holding, repairing, processing or preparing for disposition and disposing of the collateral and any other reasonable expenses incurred by the secured party, and

(b) the satisfaction of the obligations secured by the security interest of the party making the disposition,

and any surplus must be dealt with in accordance with regulation 65 (distribution of surplus).

(10) A person—

(a) who is liable to a secured party pursuant to a guarantee, endorsement, covenant, repurchase agreement or the like, and

(b) who receives a transfer of collateral from the secured party or who is subrogated to the rights of the secured party,

has thereafter the rights and duties of the secured party, and the transfer of collateral is not a disposition of the collateral.

(11) Notwithstanding any other provision of this Part, where the collateral is a licence, the collateral may be disposed of only in accordance with the terms and conditions under which the licence was granted or which otherwise pertain to it.

62. Disposal of collateral
Paragraphs 5.62-5.72 and 5.87. On DR 62(6) see paragraphs 5.65-5.66. The secured party itself may purchase collateral in certain cases (DR 62(7)); in this case DR 64 (Calculation of surplus or deficiency in disposition to secured party) applies, see paragraphs 5.71-5.72. On DR 62(8) see paragraph 5.87; on DR 62(9), see paragraph 5.20 note 22.

Disposal of collateral: requirement to give notice

63.—(1) Prior to disposing of collateral the secured party must give reasonable written notice to—

(a) the debtor or any other person who is known by the secured party to be an owner of the collateral,

(b) a person with a security interest in the collateral if, before the day on which the notice of disposition is given to the debtor, that person has filed a financing statement covering the relevant collateral according to—

(i) the name of the debtor, or

(ii) the collateral's unique identifying number (if any),

(c) any person who has given an indemnity or guarantee for the debt, if the secured party knows that one exists and knows the name and address of the person, and

(d) any other person with an interest in the collateral who has given a written notice to the secured party of that person's interest in the collateral prior to the day on which the notice of disposition is given to the debtor.

(2) For the purposes of paragraph (1), a notice is sufficient if it states—

(a) the name of the debtor or party who owns the collateral,

(b) the name of the secured party and an address at which it may be contacted before the disposition,

(c) the collateral to be sold or otherwise disposed of,

(d) the intended method of disposition,

(e) the time and date of any sale or after which any other disposition will be made.

(3) For the purposes of paragraph (1), a notice is sufficient if given at least [10] business days prior to the proposed disposition of collateral.

(4) Notice is not required under paragraph (1) if—

(a) the collateral is perishable or will quickly depreciate,

(b) the cost of care and storage of the collateral is disproportionately large in relation to its value,

(c) the collateral is fungible and of a type customarily sold on an organised market,

(d) the collateral is money authorised or adopted by a foreign government as part of its currency, or

(e) for any other reason, a court is satisfied that a notice under paragraph (1) is not required.

(5) The secured party need not notify a person who would otherwise be entitled to receive a notice under paragraph (1) if, after default, that person consents in writing to the disposition of the collateral without compliance with the notice requirements of this regulation.

(6) An application to court for the purposes of paragraph (4)(e) may be made without notice.

63. Disposal of collateral: requirement to give notice
Paragraphs 5.73-5.86.

Calculation of surplus or deficiency in disposition to secured party etc

64.—(1) This regulation applies if—

(a) collateral is transferred to the secured party or a related person or a guarantor of the debt, and

(b) the amount of the proceeds of the disposition is significantly below the amount that a disposition under regulation 62 (disposal of collateral) to a person other than a secured party or related person would have brought.

(2) The surplus or deficiency following a disposition must be calculated based on the amount of proceeds that would have been realised in a disposition under regulation 62 to a transferee other than a secured party or related person or a guarantor of the debt.

(3) "Related person" means—

(a) a person connected with a secured party which is a company, or

(b) an associate of a secured party which is not a company;

and "person connected" and "associate" have the meanings given in the Insolvency Act 1986(**a**).

64. Calculation of surplus or deficiency in disposition to secured party etc.
Paragraph 5.171.

(**a**) 1986 c. 45.

Distribution of surplus

65.—(1) Paragraph (2) applies if—

(a) a security agreement secures an indebtedness, and

(b) the secured party has collected on the collateral under regulation 60 (collection rights of secured party) or has disposed of it in accordance with regulation 62 (disposal of collateral) or otherwise.

(2) Any surplus must, unless otherwise provided by law or by the agreement of all interested parties, be accounted for and paid in the order set out in Table 2 or be paid into court.

Table 2

Order of priority for distribution of surplus

Priority	*Description*
1st	A person who has a subordinate security interest in the collateral and who has given a written notice of the interest to the secured party prior to the distribution.
2nd	The debtor or any other person who is known by the secured party to be an owner of the collateral.

(3) But the priority of the claim of any person is not prejudiced by payment to anyone under this regulation.

(4) If the surplus has been paid into court, a person who claims an entitlement to it may make an application to court for payment.

(5) A secured party need not apply or pay over for application non-cash proceeds of disposition under regulation 62 (disposal of collateral) unless the failure to do so would be commercially unreasonable; but a secured party who does apply or pay over for application non-cash proceeds must do so in a commercially reasonable manner.

65. Distribution of surplus.
Paragraphs 5.18-5.28; compare DR 62(7), above.

Deficiency

66. Except as otherwise agreed or as otherwise provided in these Regulations or any other enactment, the debtor is liable to pay the amount of any deficiency to the secured party.

66. Deficiency
Paragraph 5.29.

Acceptance of collateral in full or partial satisfaction of obligation

67.—(1) A secured party may accept collateral in full or partial satisfaction of the obligation secured by it if—

(a) the secured party gives reasonable written notice to the debtor and the interested parties,

(b) the debtor consents under paragraph (4) or (5), and

(c) the secured party does not receive effective notice of objection to the proposal from—

(i) any of the interested parties, or

(ii) any other person holding an interest in the collateral subordinate to the interest which is the subject of the proposal.

(2) The "interested parties" are—

(a) any person known by the secured party to be an owner of the collateral (other than the debtor),

(b) any person who has given written notice of an interest in the collateral to the secured party before the debtor consented to the acceptance,

(c) any other secured party who, at least [10] business days before the debtor consented to the acceptance, filed a financing statement using the name of the debtor, the collateral or the collateral's unique identifying number (if any), and

(d) a guarantor of a debt, if the proposed acceptance of collateral is in partial satisfaction of the obligation secured by the guarantee.

(3) For the purposes of paragraph (1), a notice is sufficient if it states—

(a) the name of the debtor or party who owns the collateral,

(b) the name of the secured party and an address at which it may be contacted before it accepts the collateral in full or partial satisfaction under this regulation,

(c) the collateral to be so accepted,

(d) the amount secured by the collateral, where the secured party proposes to accept the collateral in full satisfaction,

(e) the amount of the obligation secured which will be discharged, where the secured party proposes to accept the collateral in partial satisfaction.

(4) A debtor consents to the acceptance of collateral in full or partial satisfaction of the obligation secured by it if he agrees to the terms of the acceptance in writing after default.

(5) A debtor is taken to consent to the acceptance of collateral in full satisfaction of the obligation secured by it if the secured party—

(a) sends to the debtor after default a proposal which is unconditional or subject only to a condition that collateral not in possession of the secured party be preserved or maintained,

(b) proposes to accept collateral in full satisfaction of the obligation it secures, and

(c) does not receive written notice of objection from the debtor within [20] business days after the proposal is sent.

(6) For the purposes of paragraph (1)(c)—

(a) notice of objection sent by an interested party is effective if it is received by the secured party within [20] business days after the notice was sent to the interested party under paragraph (1)(a), and

(b) notice of objection sent by any other person is effective if it is received by the secured party—

(i) within [20] business days after the last notice was sent to an interested party under paragraph (1)(a), or

(ii) if no such notices were sent, before the debtor consents to the acceptance under paragraph (4) or (5).

(7) A purported or apparent acceptance of collateral under this regulation is ineffective unless—

(a) the secured party consents to the acceptance in writing or sends a proposal to the debtor, and

(b) the conditions of paragraph (1) are met.

(8) Acceptance by a secured party of collateral in full or partial satisfaction of the obligation it secures—

(a) discharges the obligation to the extent consented to by the debtor,

(b) transfers to the secured party all of the debtor's rights in the collateral,

(c) discharges the security interest which is the subject of the debtor's consent and any subordinate security interest, and

(d) terminates any other subordinate interest,

whether or not the requirements of this regulation have been complied with by the secured party, and all obligations secured by the subordinate interest are deemed to be performed for the purposes of regulation 55 (debtor may require financing change statement).

67. Acceptance of collateral in full or partial satisfaction of obligation
Paragraphs 5.88-5.93.

Redemption

68.—(1) Paragraph (2) applies at any time before—

(a) the secured party has disposed of the collateral or contracted for disposition under regulation 61 (rights of secured party) or 62 (disposal of collateral), or

(b) the secured party is deemed to have elected irrevocably to accept the collateral under regulation 67 (acceptance of collateral in full or partial satisfaction of obligation).

(2) A person who is entitled to receive a notice of disposition under regulation 63 may, unless that person has agreed otherwise in writing after default, redeem the collateral by—

(a) tendering fulfilment of the obligations secured by the collateral, and

(b) paying a sum equal to the reasonable expenses of seizing, repossessing, holding, repairing, processing and preparing the collateral for disposition, if those expenses have actually been incurred by the secured party, and any other reasonable expenses incurred by the secured party in enforcing the security agreement.

68. Redemption
Paragraphs 5.94-5.95

Determination as to whether conduct was commercially reasonable

69.—(1) The fact that a greater amount could have been obtained by a collection, enforcement, disposition or acceptance at a different time or by a different method from that chosen by a secured party is not of itself sufficient to preclude the secured party from establishing that the collection, enforcement, disposition or acceptance was made in a commercially reasonable manner.

(2) A disposition of collateral is made in a commercially reasonable manner if it is made—

(a) in the usual manner on any recognised market,

(b) at the price current in any recognised market at the time of the disposition, or

(c) otherwise in conformity with reasonable commercial practices among dealers in the type of property which was the subject of the disposition.

(3) A collection, enforcement, disposition or acceptance is made in a commercially reasonable manner if it has been approved—

(a) in judicial proceedings,

(b) by a creditors' committee (as provided for in the Insolvency Act 1986(**a**)),

(c) by a representative of creditors, or

(d) by an assignee for the benefit of creditors.

(4) But approval under paragraph (3) need not be obtained, and lack of approval does not mean that the collection, enforcement, disposition or acceptance is not commercially reasonable.

69. Determination as to whether conduct was commercially reasonable
Paragraphs 5.136-5.141.

Applications to court

70. On application by a debtor, a creditor of a debtor, a secured party or other person with an interest in the collateral, the court may make one or more of the following orders—

(a) an order, including a binding declaration of a right and an order for injunctive relief, that is necessary to ensure compliance with this Part or regulation 17 (preservation and use of collateral),

(b) an order giving directions to any person regarding the exercise of rights or the discharge of obligations pursuant to this Part or regulation 17,

(c) an order relieving a person from compliance with the requirements of this Part or regulation 17,

(d) an order staying enforcement of rights provided in this Part or regulation 17, or

(e) any order that is necessary to ensure protection of the interest of any person in the collateral.

70. Applications to court
Paragraph 5.119.

(**a**) 1986 c. 45.

PART 6

SUPPLEMENTARY PROVISIONS

Entitlement to damages for breach of obligations

71.—(1) If a person without reasonable excuse fails to discharge any duties or obligations imposed on that person by these Regulations—

(a) the person to whom the duty or obligation is owed, and

(b) any other person who can reasonably be expected to rely on the performance of the duty or obligation,

has a right to recover damages for any loss or damage that was reasonably foreseeable as likely to result from that failure.

(2) If a person files a financing statement—

(a) without obtaining the consent of the debtor as required by regulation 47 and

(b) without an honest belief that the debtor has consented,

the debtor has a right to recover damages for any loss or damage that was reasonably foreseeable as likely to result from the filing.

(3) Nothing in this regulation limits or affects any liability which a person may incur under any other enactment or rule of law.

71. Entitlements to damages for breach of obligations
Paragraphs 3.283-3.288. Compare DRs 17, 18, 47 and Part 5.

Principles of common law etc and law of sale and supply of goods continue to apply

72.—(1) The principles of the common law, equity and the law merchant, except to the extent that they are inconsistent with these Regulations, supplement these Regulations and continue to apply.

(2) If a security interest arises in connection with the supply of goods, the law applicable to the sale or supply of goods is not displaced by these Regulations, except to the extent that it is inconsistent with these Regulations.

72. Principles of common law etc and law of sale and supply of goods continue to apply
Paragraphs 2.106 and 5.6.

Consequential amendments

73.—(1) …

73. Consequential amendments
Paragraphs 3.7(2) note 4 and 3.410-3.412.

Transitional provisions, savings and revocations

74.—(1) In this regulation—

"1985 Act" means the Companies Act 1985(**a**);

"charge" includes mortgage;

"commencement" means the date of commencement of these Regulations;

"pre-commencement interest" means an interest, other than a charge, created before commencement which, had it been created after commencement, could have been perfected under these Regulations;

"pre-commencement registered charge" means a charge which was registered at Companies House under section 395 of the 1985 Act (certain charges void if not registered);

"pre-commencement unregistrable charge" means a charge created before commencement which was not registrable at Companies House under section 395 of the 1985 Act, but which had it been created after commencement, could have been perfected under these Regulations;

"transitional period" means the period beginning with the date of commencement and ending [five] years later.

(2) These Regulations apply to security interests created after commencement.

(3) A pre-commencement registered charge, including a floating charge, is treated for the purposes of these Regulations as a security interest perfected by filing on commencement.

(4) On commencement a pre-commencement registered charge—

(a) retains its pre-commencement priority as against other pre-commencement registered charges, pre-commencement unregistrable charges and pre-commencement interests, and

(b) is subject to the priority rules in these Regulations as against other security interests.

(5) If, on or after commencement, a pre-commencement unregistrable charge is perfected by filing a financing statement which specifies the date of its creation, that date is treated as the date of filing.

(6) These Regulations, except as provided in this regulation, do not apply to a pre-commencement interest until after the end of the transitional period.

(7) During the transitional period, a pre-commencement interest has priority over any conflicting security interest, including a purchase-money security interest, which is created after commencement and whether or not it is perfected.

(8) If, before the end of the transitional period, a pre-commencement interest is perfected by filing a financing statement which specifies the date of its creation, that date is treated as the date of filing.

74. Transitional provisions, savings and revocations
Paragraphs 3.384-3.409.

(**a**) 1985 c. 6.

The Companies (Personal Property Security) Regulations [200X]

Table of Derivations

The following abbreviations are used in this table:

LC	Law Commission draft Limitation Bill, published 2001
LRA	Land Registration Act 2002 (c. 9)
NB	Personal Property Security Act 1993, New Brunswick, Canada
NZ	Personal Property Securities Act 1999, New Zealand
OPPSA	Ontario Personal Property Security Act 1993, Canada
S	Personal Property Security Act 1993, Saskatchewan, Canada
SR	Personal Property Security Regulations, Saskatchewan, Canada
UCC	Uniform Commercial Code (US)
WG	Uniform Law Conference of Canada, Civil Law Section Working Group Proposals 2004 for amendments in light of Uniform Securities Transfer Act (Canadian Securities Administrators' Task Force draft) 2004
s.	section
r.	rule
§	article

DR and Heading	Paragraph	Derivation
PART 1 – INTRODUCTION		
1 Citation and commencement		
2 Interpretation	(1)	various: S s.2(1); UCC §8-102
	(2)	S s.2(3)
	(3)	S s.2(4)
3 "Security interest"		S s.2(1)(qq); S s.3(1), (2)
	(1)	S s.2(1)(qq)(i) part; S s.3(1)(a)
	(2)	S s.3(1)(b)
	(3)	S s.2(1)(qq)(ii); S s.3(2)
	(4)	S s.2(1)(qq)(i) part
	(5)	new

DR and Heading	Paragraph	Derivation
4 “PMSI”	(1)	S s.2(1)(jj) part
	(2)	UCC §9-103(b)(2)
	(3)	S s.2(1)(jj) part
	(4)	UCC §9-103(f)(3)
5 “Debtor”	(1)	S s.2(1)(m)(i)-(v)
	(2)	S s.2(1)(m)(vi)
6 “Control”: investment property	(1)	
	(2)	UCC §8-106(a)
	(3)	UCC §8-106(b) part
	(4)	UCC §8-106(b)(1)
	(5)	UCC §8-106(c)
	(6)	UCC §8-106(d)
	(7)	
	(8)	UCC §8-106(d)(2) and (f)
	(9)	UCC §8-106(e)
	(10)	UCC §8-106(g) part
	(11)	UCC §9-106(b)(1)
	(12)	UCC §9-106(b)(2)
	(13)	UCC §9-106(c)
	(14)	UCC §8-106(g) part
7 “Control”: bank accounts	(1)	
	(2)	UCC §9-104(a)(1)
	(3)	UCC §9-104(a)(2) part, (3)
	(4)	UCC §9-104(a)(2) part
	(5)	UCC §9-104(b)
	(6)	UCC §8-106(g) part
	(7)	UCC §8-106(g) part
8 “Lease more than one year”	(1)	S s.2(1)(y)(i)-(iii)
	(2)	S s.2(1)(y)(iv)-(v)
9 “Commercial consignment”	(1)	S s.2(1)(h) part
	(2)	S s.2(1)(h)(iii)

DR and Heading	Paragraph	Derivation
10 Knowledge	(1)	LC clause 4(1)(a) part
	(2)	LC clause 4(3) part
	(3)	LC clause 5(1) part
	(4)	LC clause 5(2)
	(5)	LC clause 5(3)
	(6)	S s.47
	(7)	WG s.30A(2); new
11 Scope of regs	(1)-(2)	new
12 Exceptions		S s.4
	(1)	S s.4 part; new
	(2)-(4)	new
13 Territorial application	(1)-(6)	S s.5; new
PART 2 – EFFECTIVENESS OF SECURITY AGREEMENTS		
14 Effectiveness of agreement	(1)	S s.9(1)
	(2)	S s.9(4)
	(3)	new
15 Attachment of security interest	(1)-(4)	S s.10(1)(part); S s.12(1)(part)
	(5)	S s.12(1)(part)
	(6)	NZ s.40(4)
	(7)	NZ s.40(3)
	(8)	S s.12(3)
	(9)	new
	(10)	S s.13(1)
	(11)	UCC §9-203(f)
	(12)	WG s.12.1
	(13)	WG s.12.1
16 Attachment: securities intermediary's lien	(1)-(4)	WG s.12.1

DR and Heading	Paragraph	Derivation
17 Preservation of collateral	(1)	S s.17(1)
	(2)-(3)	S s.17(2)
	(4)	S s.17(3)-(4)
	(5)	WG 17.1(1)
	(6)	UCC §9-207
18 Request for info from secured party	(1)	UCC §9-210(b)
	(2)	S s.18(1); UCC §9-210(a) and (b)
	(3)	S s.18(2)(b)-(d); UCC §9-210(a) and (b); new
	(4)	S s.18(1) part
	(5)	S s.18(6)
	(6)	S s.18(8) part
	(7)	S s.18(9)
	(8)	S s.18(10)
	(9)	S s.18(11),(12), (13)(b)
	(10)	S s.18(15)
	(11)	S s.18(17)
PART 3 – PERFECTION & PRIORITIES		
19 Perfection of security interest		S s.19
20 Consequences of not perfecting	(1)	S s.20(2)
	(2)	
	(3)	S s.20(1)(a)
	(4)	S s.20(3)
	(5)	S s.20(4)
21 Perfection: investment property, supporting obligations & promissory notes	(1)	WG 19.1(1)
	(2)	WG 19.1(2)
	(3)	WG 19.2(1)
	(4)	WG 19.2(2)
	(5)	WG 19.2(3)
	(6)	UCC §9-308(d)
	(7)	UCC §9-309(4)
22 Continuity of perfection		S s.23(1)
23 Methods of perfection		S s.25; UCC §9-310

DR and Heading	Paragraph	Derivation
24 Perfection by possession	(1)	S s.24(1)(part)
	(2)	S s.24(2)
25 Perfection: goods in possession of bailee	(1)	S s.27(1)
	(2)	S s.27(2)
	(3)	S s.27(3)
26 Perfection of certificated security by delivery	(1)-(3)	UCC §8-301, 9-313(a)
27 Perfection by control of investment property	(1)	WG s.24.1(1)
	(2)	WG s.24.1(2)
28 Perfection by possession continues temporarily…	(1)	S s.26(1)(a)
	(2)-(3)	S s.26(1)(b)
	(4)	S s.26(1) part
	(5)	S s.26(2)
29 Perfection: proceeds	(1)-(2)	S s.28(1)
	(3)	WG 28(1.1)
	(4)	S s.28(2)
	(5)-(6)	S s.28(3)
30 Goods returned or repossessed	(1)	S s.29(1)
	(2)	S s.29(2)
	(3)	S s.29(3)
	(4)	S s.29(5)
	(5)	S s.29(7)
31 Circs in which buyer or lessee takes free of security interest	(1)	S s.30(1)(a)(c)
	(2)-(3)	S s.30(2); part new
	(4)-(5)	S s.30(3)-(4)
	(6)	S s.30(5)
	(7)	S s.30(7)
	(8)	S s.30(6)
	(9)	S s.30(8)
32 Purchaser takes free: IP	(1)	WG s.30(9); UCC §8-303.
	(2)	WG s.30(11); UCC §8-501, 502
	(3)	WG s.30(12)

DR and Heading	Paragraph	Derivation
33 Residual priority rules	(1)	S s.35(1) part
	R. 1	S s.35(1)(b)
	R. 2	S s.35(1)(a)
	R. 3	S s.35(1)(c)
	R. 4	S s.23(2)
	R. 5	UCC §9-322(c)(1)
	(2)	S s.35(2)
	(3)	S s.35(3)
	(4)	S s.35(4)
	(5)	UCC §9-322(b)(2)
	(6)	S s.35(5)
	(7)	S s.35(6)
34 Priority rules: IP	Chapeau	WG s.35.1(1)
	R. 1	WG s.35.1(2)
	R. 2	WG s.35.1(3)
	R. 3	WG s.35.1(4) part
	R. 4	WG s.35.1(5)
	R. 5	WG s.35.1(6)
	R. 6	WG s.35.1(7)
	R. 7	WG s.35.1(8)
35 Priority rules: bank accounts	(1)	UCC §9-327 part
	R. 1	UCC §9-327(1)
	R. 2	UCC §9-327(2)
	R. 3	UCC §9-327(3),(4)
	R. 4	
	(2)	UCC §9-340
36 Priority rules: proceeds of letters of credit	(1)	UCC 9-329
	R. 1	UCC 9-329(1)
	R. 2	UCC 9-329(2)
	R. 3	
	(2)	UCC §9-107
	(3)	UCC §5-102(a)(11)
37 Priority of security interests in transferred collateral		UCC §9-325
38 Protection of transferees of negotiable collateral	(1)	S s.31(1)
	(2)	S s.31(2)
	(3)	S s.31(3)
	(4)	S s.31(4)
	(5)	S s.31(5)
	(6)	S s.31(6)

DR and Heading	Paragraph	Derivation
39 Priority: liens		S s.32; UCC §9-333
40 Priority: crops		UCC §9-334(I)
41 Alienation of rights of debtor	(1)	S s.33(1)
	(2)-(3)	S s.33(2)
42 Priority: PMSIs	(1)	S s.34(2), (3), (5) part
	(2)	S s.34(2)
	(3)	S s.34(3)
	(4)	S s.34(4)
	(5)	S s.34(5)
	(6)	S s.34(6)
	(7)	S s.34(8)
	(8)	S s.34(10)
43 Effect on priority of mistaken discharge of filing etc	(1)-(3)	NB s.35
44 Voluntary subordination	(1)-(2)	S s.40(1)(part)
	(3)	S s.40(2)
45 Rights of assignees	(1)	S s.41(1)(b)
	(2)	S s.41(2)
	(3)	S s.41(7)
	(4)	S s.41(8)
	(5)	S s.41(9)
PART 4 - FILING		
46 The Register	(1)-(2)	drafting
	(3)	OPPSA s.46(5)(b)
47 Financing statement	(1)	SR r.6
	(2)	UCC §9-509(a), 510(a)
	(3)	UCC §9-509(a), 510(a)
	(4)	UCC §9-509(a)
	(5)	UCC §9-509(b)
	(6)	new
	(7)	new
	(8)	new

DR and Heading	Paragraph	Derivation
48 Time of filing	(1)	S s.43(2)
	(2)	S s.43(4)
	(3)	S s.43(5)
	(4)	S s.43(3)
	(5)	UCC §9-509(b)
	(6)	S s.43(10); new
49 Duration of filing	(1)-(2)	SR r.4
50 Registrar to issue verification statement	(1)-(3)	S s.43(12); new
51 Errors in financing statement	(1)	S s.43(6) part
	(2)	new
	(3)	S .43(6) part
	(4)	S s.43(8)
	(5)	S s.43(9)
	(6)	new
52 Renewal and amendment of filing	(1)	S s.44(2)
	(2)	S s.44(3)
53 Filing of transfers and subordination	(1)	S s.45(1)
	(2)	S s.45(2)
	(3)	S s.45(3)
	(4)	S s.45(4)
	(5)	S s.45(5)
	(6)	S s.45(6)
	(7)	UCC §9-310(c)
54 Searches	(1)	S s.48(1) (part); new
	(2)	S s.48(2)
	(3)	S. s.43(3)
55 Debtor may require financing change statement	(1)-(2)	S s.50(1),(3),(4); new
	(3)	new
	(4)	S s.50(5) (part); new
	(5)	new
	(6)	S s.50(7)
	(7)	new
	(8)	new

DR and Heading	Paragraph	Derivation
PART 5 - RIGHT & REMEDIES ON DEFAULT		
56 Application of this Part	(1)	S s.55(2)(a); part new
	(2)	S s.55(7); UCC §9-601(e)
	(3)	UCC §9-601(a)(1)
	(4)	new
57 Overlap with security over land	(1)	S s.55(4)
	(2)	S s.55(5)
	(3)-(4)	S s.55(6)
58 Receivers	(1)	S s.64(2)
	(2)	S s.56(1), S s.57(1), S s.58(1), S s.59(1), S s.60(1), S s.63(1)
59 Rights and remedies	(1)	S s.56(2)(a),
	(2)	S s.56(2)(b)
	(3)	UCC §9-602 part
	(4)	UCC §9-603(a)
	(5)	S s.65(10)
60 Collection rights of secured party	(1)	
	(2)	S s.57(2)
	(3)	UCC §9-607(a)(4)(5)
	(4)	S s.57(4)
	(5)	UCC §9-607(c)
	(6)	UCC §9-608(a)(3)
61 Rights of secured party on default	(1)	S s.58(2) part
	(2)	S s.58(2)(a)
	(3)	UCC §9-609(a)(2)
	(4)	S s.58(2)(c) part; new
	(5)	UCC §9-609(c)
	(6)	New
	(7)	S s.58(2)(d)

DR and Heading	Paragraph	Derivation
62 Disposal of collateral	(1)	S s.59(2) part
	(2)-(3)	S s.59(3)
	(4)	S s.59(5)
	(5)	S s.59(4)
	(6)	UCC §9-610(a)(b)
	(7)	S s.59(13); UCC §9-610(c)
	(8)	S s.59(14)
	(9)	S s.59(2) part
	(10)	S s.59(15)
	(11)	S s.59(18)
63 Disposal: requirement to give notice	(1)	S s.59(6); UCC §9-611(c)
	(2)	new
	(3)	S s.59(11); UCC §9-612(b); new
	(4)	S s.59(16) part; UCC 9-611(d)
	(5)	s s.59(16)(f)
	(6)	S s.59(16)(g) part
64 Calculation of surplus or deficiency	(1)-(3)	UCC §9-615(f)
65 Distribution of surplus	(1)-(3)	S s.60(2)
	(4)	S s.60(4)
	(5)	UCC §9-608(a)(3)
66 Deficiency		S s.60(5)
67 Acceptance of collateral in full or partial satisfaction	(1)	UCC §9-620(a), §9-621
	(2)	UCC §9-621
	(3)	new
	(4)	UCC §9-620(c)(1),(2)
	(5)	UCC §9-620(c)(2)(A)-(C)
	(6)	UCC §9-620(d)
	(7)	UCC §9-620(b)
	(8)	UCC §9-622
68 Redemption	(1)	S s.62(1) part
	(2)	S s.62(1)(a)

DR and Heading	Paragraph	Derivation
69 Determination of whether conduct was commercially reasonable	(1)	UCC §9-627(a)
	(2)	UCC §9-627(b)
	(3)	UCC §9-627(c)
	(4)	UCC §9-627(d)
70 Applications to court		S s.63(2)
PART 6 - SUPPLEMENTARY PROVISIONS		
71 Entitlement to damages for breach of obligations	(1)-(2)	NZ s.176(1)
	(3)	NZ s.176(2)
72 Principles of common law etc continue to apply	(1)	S s.65(2)
	(2)	S s.15; new
73 Consequential amendments		*[to follow]*
74 Transitional provisions etc	(1)-(8)	new

APPENDIX B
CHANGES NEEDED TO THE DRAFT REGULATIONS TO OMIT TITLE RETENTION DEVICES

B.1 In this consultative report we have provisionally recommend the introduction of a scheme that will go beyond charges and other 'traditional' securities. It should include at least sales of receivables, for which there was strong support. We have asked consultees whether they agree with our provisional recommendation that the scheme should also include title-retention devices; this is much more controversial.

B.2 The scheme set out in Parts 3-5 and the draft regulations covers all these elements, so that consultees can evaluate the scheme in full detail. It is not, however, a question of 'all or nothing.' We would recommend a limited reform rather than none at all. In this Appendix we indicate what changes would be needed, or might be made, to the draft regulations were title-retention devices to be excluded from the scheme, so that it would apply only to traditional securities and sales of receivables.

B.3 A limited scheme would not necessarily look very different from that set out in Appendix A. The vast majority of the individual provisions in the current draft could nonetheless apply even if title-retention devices were excluded.

NECESSARY CHANGES

B.4 The main change that would be necessary would be to DR 3, and the meaning of 'security interest'. Although we would continue to use the term 'security interest', the definition would in effect be limited to mortgages, charges, pledges and sales of accounts. Thus DR 3(1), (2), (3)(b)-(d) and (4) would be removed, and a limitation to charges, mortgages and pledges, together with DR 3(a), drafted. DR 3(5) would remain.

B.5 The removal of leases (both finance and operating) and consignments from the definition of an SI would bring a number of consequential changes, by removing references to these concepts or the parties to these transactions in the following provisions:

(1) DR 2(1) (Interpretation),

(2) DR 4(1)(c)-(d) (Meaning of PMSI),

(3) DR 5(1)(b)-(d) (Meaning of debtor),

(4) DR 8 (Meaning of 'lease for a term of more than one year'), and

(5) DR 9 (Meaning of 'commercial consignment').

B.6 In addition, DR 12(1)(b) (rights of set-off) would be removed. DR 56(1) would have to be amended to match the new provision relating to the definition of SI. Sales of accounts would still be excluded from the statement of rights and

remedies. There would also need to be consequential amendments to the transitional provisions in DR 74.

PROVISIONS THAT MIGHT BE OMITTED

PMSIs

B.7 The main application of the provisions relating to PMSIs is to title-retention devices, although their impact would be reduced. Were the provisions on PMSIs retained, specific loans for the acquisition of new assets, secured by a charge on the asset itself, would still amount to PMSIs; but these are relatively rare. We would welcome views on whether the retention of specific provisions on interpretation and priority of PMSIs would be justified in a scheme that did not include title-retention devices.

The statement of rights and remedies

B.8 All of the provisions contained in the statement of rights and remedies (Part 5 of the draft regulations) would still be appropriate in a scheme that covered traditional securities and sales of accounts. However, one of the main reasons for including it was to make it clear which rules applied to quasi-securities, and to provide a single set of remedies for title-retention devices and traditional securities. Were title-retention devices to be excluded, the remedies provisions, which in broad terms replicate the law applicable to traditional securities, would have less impact. Sales of accounts, though within the scheme for the purposes of perfection and priority, would (with the exception of DR 60(5)) continue to be outside the statement of rights and remedies. However, we think a statement of the rights and remedies would still be useful. It would make clear which provisions apply to mortgages, pledges and charges and which to sales of accounts; and it would provide an up-to-date and somewhat simplified statement of the law. We would welcome the views of consultees as to whether 'Part 5' would be worth retaining in a scheme that did not include title-retention devices.

CONSULTATION QUESTION

B.9 **If the draft regulations were amended to apply only to traditional securities and sales of accounts, and not to title-retention devices, we ask whether consultees think that the draft regulations should continue to contain:**

(1) provisions relating to PMSIs,

(2) the statement of the rights and remedies set out in Part 5 of the draft regulations.