of many of these financings means that the absence of a requirement to register is useful, and the trust receipt enables the pledged assets to be realised in the most effective way.

2.89 The other type of case in which pledges can be useful is much less common in practice. Where creditors wish to take a mortgage or charge over goods owned by an individual, they need to comply with the provisions of the Bills of Sale Acts 1878–1891. The requirements of these Acts are discussed in part 6 of Chapter 6 (**6.128**ff) but, in essence, they make it impracticable, in most cases, for lenders to take such security over goods owned by individuals. If a pledge can be taken over the assets concerned, the restrictions contained in the Bills of Sale Acts 1878–1891 can be avoided and a relatively simple form of security structure can be effected. The creditor is still required to take possession of the assets concerned, but this can frequently be done by means of an attornment. For example, if the individual debtor is an art dealer, it is possible for works of art owned by him which are in the physical possession of an auction house to be pledged to a creditor by means of an attornment by the auction house.

2.90 Although pledges have, to a very large extent, now been superseded in practice by mortgages and (to an even greater extent) by charges, there are still some circumstances in which they can provide more cost-effective security than other forms of security interest.

CHAPTER 3

MORTGAGES AND CHARGES

PART 1: INTRODUCTION

3.01 It has been seen in Chapter 2 that the requirement of a pledge that the creditor has possession of the pledged asset severely limits its use in commercial transactions. But this limitation is of little practical importance because of the availability of two other forms of security – mortgages and charges. Although they are conceptually different, they will be treated together because, in practice, the distinctions between them are not great. More important are the factors which link mortgages and charges. They are both created by evidence of the intention of the debtor, they are both effective without any necessity for the creditor to obtain possession of the secured asset and they both give the creditor a proprietary interest in the secured asset which (although the nature of the interest varies depending on whether the security is a legal mortgage, an equitable mortgage or a charge) is effective in the debtor's insolvency.

What is a mortgage?

3.02 A mortgage involves the transfer of the title to an asset as security for a liability.

3.03 The nature of a legal mortgage is described by Lindley MR in *Santley v Wilde*:[1]

> 'The principle is this: a mortgage is a conveyance of land or an assignment of chattels as a security for the payment of a debt or the discharge of some other obligation for which it is given. This is the idea of a mortgage: and the security is redeemable on the payment or discharge of such debt or obligation ....'

3.04 An equitable mortgage has similar characteristics, the main differences being that it involves the transfer of beneficial (rather than legal) title and that it is available in respect of assets other than land or chattels.

3.05 There are therefore two elements of a mortgage:

- In the first place, title to an asset must be transferred to the creditor or to someone on his behalf. If it is legal title which is transferred, the mortgage is a legal mortgage. If beneficial title is transferred, it is an equitable

[1] [1899] 2 Ch 474 at 474.

mortgage. Either way, the creditor obtains a proprietary interest which remains effective in the insolvency of the debtor. It is not necessary for the creditor to take possession of the asset.

- The second element is that the transfer must be by way of security. The creditor is not intended to have the absolute entitlement to the asset concerned. It has been transferred to secure a liability and, once that liability has been discharged, the debtor is entitled to have the asset re-transferred to him. This right, which is itself a proprietary interest, is generally referred to as an 'equity of redemption'. It is considered further in part 6 of this chapter (**3.301**ff).

What is a charge?

3.06 A charge is less easy to define. In distinction from a mortgage, the creditor does not obtain either legal or beneficial title to the charged asset. But what he does obtain is an equitable proprietary interest in the asset by way of security.

3.07 There have been a number of attempted definitions of a charge in the cases but, in one of the most recent, *Re Bank of Credit and Commerce International (No 8)*,[2] Lord Hoffmann recognised the difficulty of providing an exhaustive definition. He contented himself with describing a charge as being a proprietary interest granted by way of security without a transfer of title or possession. It is also common to describe a charge as the appropriation of an asset in discharge of a liability. An example of such a description is that given by Peter Gibson J in *Carreras Rothmans v Freeman Mathews Treasure*.[3] He said that a charge is created 'by an appropriation of specific property to the discharge of some debt or other obligation without there being any change in ownership either at law or in equity …'.

3.08 These descriptions show that there are two elements of a charge:

- The creditor obtains an equitable proprietary interest in the secured asset, but does not obtain either legal or beneficial title to it. Nor is it required that the creditor takes possession of it.
- The creditor's interest is given to him by way of security for the discharge of a liability so that, when the liability has been discharged, the charge terminates.

3.09 The second element is common to all types of security, but the first has caused more difficulty. It is easy to state what a charge does not involve: it does not involve the transfer of legal or beneficial title to the asset concerned, nor does it require possession to be transferred. But it is much more difficult to

[2] [1998] AC 214 at 226.
[3] [1985] 1 Ch 207 at 227.

define the precise nature of the interest obtained by the creditor in the asset concerned. Two things are, however, clear:

- A charge is an equitable concept, and the creditor's interest is therefore equitable. The creditor does not obtain any common law rights in the asset concerned.
- The creditor's right is proprietary, rather than merely personal, and is therefore effective in an insolvency of the debtor. For the same reason, it will bind the charged asset in the hands of third parties, subject to the rules concerning priorities, which are discussed in Chapter 7.

Does the distinction matter?

3.10 It has been seen that the main distinction between a mortgage and a charge is that a mortgagee obtains legal or beneficial title to the asset concerned, whereas a charge does not. Is the distinction important?

3.11 There have been cases where the distinction between a mortgage and a charge has been important. During the First World War, for instance, there was legislation in force which provided for security to have a different effect depending on whether it was a mortgage or a charge. The Court of Appeal had to consider that legislation in *London County & Westminster Bank v Tompkins*,[4] and the requirement to do so led that eminent common lawyer, Scrutton LJ, to say[5] that, although there was a distinction between a mortgage and a charge, 'equity judges appear to use the terms with no such precise distinction'.

3.12 This failure to distinguish between mortgages and charges is understandable. They both give the creditor a proprietary interest in the asset concerned which is effective in the debtor's insolvency. As far as rights against subsequent encumbrancers are concerned, the important distinction is not between mortgages and charges but between legal mortgages, on the one hand, and equitable mortgages and charges, on the other. It is generally easier to enforce legal rights against third parties than equitable rights (not least because of the principle that a person who acquires a legal interest in an asset for value and without notice of an earlier equitable interest will take free of that equitable interest).

3.13 Mortgages and charges are also generally treated in the same way in the relevant legislation. In the Companies Act 2006, which provides for the registration of charges created by companies, the expression 'charge' includes a

[4] [1918] 1 KB 515. The legislation is no longer in force.
[5] [1918] 1 KB 515 at 528.

mortgage.[6] The Law of Property Act 1925, which is the key legislation concerning security over land, conversely (but to the same effect) defines 'mortgage' to include a charge.[7]

3.14 There are two minor differences between mortgages and charges. First, because a chargee does not obtain legal or beneficial title to the asset concerned, his powers of enforcement are more circumscribed than those of a mortgagee. Unlike a mortgagee, a chargee does not have a right of foreclosure or, in the absence of express provision in the charge document, a right to possession of the charged asset. In practice, however, charges invariably contain extensive powers of enforcement which give the chargee substantially the same powers as those of a mortgagee. These limitations on a chargee's powers of enforcement are therefore of little relevance in practice. The powers of enforcement of secured creditors are considered in more detail in Chapter 8.

3.15 Secondly, it has been seen that a mortgagor's equity of redemption enables the mortgagor to require the re-transfer of the asset to him on payment of the secured debt. This is not necessary where the creditor only has a charge over the asset concerned, because the charge terminates as soon as the secured liability has been paid. In the words of Stuart V-C in *Kennard v Futvoye*:[8]

> 'If there be a simple charge without an equity of redemption, that is, if there be nothing more than a debt charged upon an estate, without any conveyance of the estate to the creditor, or any right or equity of redemption reserved, such a security is not a mortgage ... because a charge is at once extinguished by payment of the debt, and from its nature must subsist till the debt is satisfied.'

3.16 Although there is a conceptual distinction between a mortgage and a charge, the practical differences between them are therefore insufficiently important to require them to be considered separately.[9] There is, however, an important distinction between:

- legal mortgages; and
- equitable mortgages and charges.

3.17 One of these distinctions has already been mentioned – the fact that it is generally easier to enforce a legal proprietary interest against third parties than an equitable one. This issue is considered further in Chapter 7. The distinction between legal and equitable interests is also very important when it comes to creating the security. There are more formal requirements for the creation of a legal mortgage than an equitable mortgage or a charge. It is also possible to create security over more types of asset in equity than it is at law. These issues are discussed further in this chapter. For all these reasons, it will be the distinction between legal and equitable security interests, rather than that between mortgages and charges, which will be pursued in this chapter.

6 Companies Act 2006, s 859A(7)(a).
7 Law of Property Act 1925, s 205(1)(xvi).
8 (1860) 2 Giff 81 at 92–93.
9 There is also a potential difference in relation to what are often known as 'charge-backs'. These are described in Chapter 12 (**12.183–12.185**).

Statutory intervention

3.18 Although the basic principles relating to the creation of security have been developed by the common law and equity, there has been a substantial amount of statutory intervention. In the business context, the most important effect of statute on the law of security is the requirement to register most mortgages and charges against the debtor and, in some cases, against the asset over which the security has been taken.

3.19 In practice, the main registration requirement is that contained in the Companies Act 2006, which requires most mortgages and charges created by companies to be registered, failing which they will be void for most purposes. The companies legislation was foreshadowed by the bills of sale legislation, which requires certain types of mortgage and charge created by individuals to be registered, with similar consequences for failure to do so. Registration against the debtor is discussed in Chapter 6.

3.20 Other legislation has provided for the registration of mortgages and charges created over particular types of asset, such as land, ships and aircraft and certain types of intellectual property. Failure to register in these asset registries only affects the priority of the mortgage or charge concerned, rather than its effectiveness in an insolvency. These statutory provisions are considered in part 8 of Chapter 7 (**7.255**ff).

3.21 Legislation has also affected the way in which some types of mortgage and charge are created. Before the 1925 property legislation, legal mortgages of land were effected by the conveyance of the land to the creditor, on terms that it was to be re-conveyed to the debtor on payment of the secured liability. As a result of the Law of Property Act 1925, legal mortgages of land are now normally created by the execution of a document described as a 'charge by way of legal mortgage', rather than by the transfer of the legal title to the land to the creditor. This has had no practical impact on the effect of a legal mortgage. The creditor continues to have the same powers he would have had if the property had been transferred to him. It is simply the form of the transaction which has changed. This is discussed further in part 2 of this chapter (**3.25**ff).

3.22 Legislation has also had an effect on the creation of security over intangibles. The Judicature Act 1873 provided a statutory means of creating security over intangibles, without having to rely on an equitable mortgage or charge. The relevant legislation is now contained in s 136 of the Law of Property Act 1925. But, again, the practical effect of the legislation is relatively minor. It is considered in part 5 of this chapter (**3.177**ff).

5.06 The prerequisites of the creation of an effective charge are:

- the execution of a document creating the charge (again, a document is not always required, but is invariably taken in practice); and
- registration against the debtor, if required under the Companies Act 2006 or the Bills of Sale Acts 1878–1891.

5.07 If these steps are complied with, the security is effective not only against the debtor whilst it remains solvent, but also in the event that the debtor goes into insolvency proceedings, such as liquidation, administration or bankruptcy. This is because the mortgage or charge creates a proprietary interest in the secured asset, which binds the debtor's insolvency officer as much as it binds the debtor itself.

5.08 It has been seen in Chapter 3 that there is no practical distinction between an equitable mortgage and an equitable fixed charge so that, in reality, the choice available to a creditor is between:

- a legal mortgage; and
- an equitable mortgage or charge.

5.09 For the purpose of the creation of security which is effective in the insolvency of the debtor, there is no distinction between the two. They both create proprietary interests which are effective in the debtor's insolvency. The distinction is only of any material relevance in a priority dispute between the creditor and another person claiming a proprietary interest in the secured asset (which is considered in Chapter 7).

5.10 When deciding whether to create a legal mortgage or a charge, the parties have to weigh up the advantages and disadvantages of each. In some cases, the decision is straightforward. There are some types of asset (most intangibles and all future assets) which cannot be the subject of a legal mortgage. In the case of other types of asset, the priority advantages of a legal mortgage need to be weighed against the fact that it is generally quicker and easier to create a charge than a legal mortgage.

5.11 The security is often granted to the creditor itself, but this is not necessary. It is very common for the security to be held by a security trustee, particularly in the case of a syndicated facility. The reason for this is practical convenience. In the case of a syndicated loan, it is theoretically possible for the security to be created in favour of all of the lenders individually. But this would be difficult to operate in practice. It would also create material problems when a lender wanted to transfer its portion of the secured loan – which happens frequently in practice. For practical reasons, transfers of syndicated loans are

normally effected by novation, rather than by assignment.[1] If the security had been given to all the lenders individually, this would require new security to be taken by the new lender.

5.12 The advantage of the security being held by a security trustee is that the security trustee can hold the benefit of the security on behalf of all the lenders from time to time under the facility. The transfer of a portion of the loan from an existing lender to a new lender will not require the creation of new security. The security trustee will continue to hold the existing security on trust for the existing class of beneficiaries – the lenders under the facility from time to time. Anyone who has had experience of having to deal with the transfer of secured syndicated loans in jurisdictions that do not recognise trusts will be well aware of the difficulties that this causes, and the advantage of having a security trustee.

5.13 There are two other matters which concern a creditor taking security over an asset:

- What is the value of the asset, particularly on enforcement?
- Is the debtor bound by the transaction by which the security is created?

5.14 The first issue is, of course, of great practical importance. Much of the time taken by creditors and their lawyers in relation to secured transactions is spent evaluating the secured assets. In the case of land, for instance, the creditor would expect to obtain a certificate as to the title to the land. Similarly, a creditor obtaining security over a major piece of equipment will be concerned about its physical state and any contracts connected with it (such as leases or charterparties). Where the secured asset is a contract, the creditor will want to know what the debtor's rights are under the contract and the circumstances in which those rights can be lost.

5.15 These issues go to the value of the asset rather than to the way in which security is taken over it, and it is beyond the scope of this chapter to consider them. For the most part, they are not specific to the law of security, but are general matters of land law and personal property law. But their importance in practice should not be ignored.

5.16 Whether or not the debtor is bound by the transaction also depends on general legal considerations, in this case deriving from areas of law such as company law, equity, the law of contract and the law of agency. Although they are not peculiar to the law of security, they are of practical importance and, because they do go to the validity of the security, they are considered briefly in this chapter.

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[1] An assignment could only transfer the benefit of drawn loans, not the obligation to make further loans.

5.17 The remaining parts of this chapter therefore consider the following issues:

- Part 2 (5.19ff) – how can the creditor ensure that the debtor is bound by the secured transaction?
- Part 3 (5.49ff) – in the case of a mortgage, how is title to the secured assets transferred to the creditor?
- Part 4 (5.60ff) – in the case of a mortgage or charge, what documentation is required?

5.18 The other key requirement of the creation of effective security is that, in many cases, registration is required at a debtor registry, either under the Companies Act 2006 or under the Bills of Sale Acts 1878–1891. This topic deserves a chapter to itself, and is considered in Chapter 6.

PART 2: IS THE DEBTOR BOUND BY THE SECURED TRANSACTION?

5.19 Whether a debtor is bound by a transaction encompasses two main issues – whether he has validly entered into the transaction, and whether it can be set aside. Particularly where the debtor is a company, it is helpful to divide the first of these questions into two – does the debtor have the capacity to enter into the transaction, and do those persons who have purported to enter into it on behalf of the debtor have the authority to do so? This part will accordingly consider three separate issues:

- capacity;
- authority; and
- setting aside transactions (particularly for breach of fiduciary duty).

Capacity

5.20 Capacity is no longer an issue of much practical importance in English law. As far as individuals are concerned, there are now very few limitations on the capacity of an individual. The reduction in the age of contractual consent to 18 has reduced the number of problems concerning minors. As a result, the two main limitations on capacity of an individual are bankruptcy and mental incapacity.

5.21 As far as companies incorporated under the English Companies Acts are concerned, the old rule that a company only had the capacity to do that which was authorised by its memorandum of association has been abolished. By the middle of the twentieth century, the proliferation of objects in companies' memoranda of association and the introduction of provisions which turned every power in a memorandum into a main object meant that there were very few cases in practice of incapacity of companies. Since 1972, there have been various statutory attempts to limit, and then to abolish, restrictions on a company's capacity.

5.22 Despite some false starts, this has now been achieved. Memoranda of association have been abolished and section 31(1) of the Companies Act 2006 provides that: 'Unless a company's articles specifically restrict the objects of the company, its objects are unrestricted.' In addition, s 39(1) of the Companies Act 2006 provides that: 'The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's constitution.'

5.23 As a result, capacity is no longer an issue in relation to companies incorporated under the Companies Acts. It may, nevertheless, be a problem in relation to other types of debtor, including public bodies and foreign companies. Even in relation to English companies, it still continues to be the practice of lawyers advising lenders in financing transactions (particularly if they are secured) to check the debtor's articles of association and, if they do contain restrictions, to require them to be altered by special resolution before the transaction is effected.

Authority

5.24 Where the debtor is an English company, of more importance in practice is to ensure that those persons who have purported to enter into the transaction on its behalf have the authority to do so. In most cases, the body which will have the authority to do so is the company's board of directors. The company will only be bound if those acting on its behalf had the authority to do so. If they did not have the authority, the transaction does not bind the company, although it can be ratified by the company.

5.25 Even if the persons who are purporting to act on behalf of the debtor company do not have the actual authority to do so, the debtor will nevertheless be bound by their actions if it has conferred on them the apparent (or, as it is sometimes called, ostensible) authority to do so. This will be the case if the debtor has held out those who purport to enter into the transaction as having the authority to do so on its behalf. This general principle of the law of agency is reflected in company law by the rule in *Turquand's* case,[2] which establishes that persons dealing with a company are entitled to assume that the requirements of its internal corporate governance have been complied with.

5.26 There is now statutory recognition of this principle in s 40(1) of the Companies Act 2006:

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2 *Royal British Bank v Turquand* (1856) 6 E & B 327.

'In favour of a person dealing with a company in good faith, the power of the directors to bind the company, or authorise others to do so, is deemed to be free of any limitation under the company's constitution.'

5.27 The legislation makes it clear that the person dealing with the company is presumed to have acted in good faith unless the contrary is proved and that he will not be regarded as not acting in good faith 'by reason only of his knowing that an act is beyond the powers of the directors under the company's constitution'.[3] In most day-to-day transactions with companies, persons dealing with a company rely on these common law and statutory protections. In financing transactions, however, particularly when they are secured, it is the general practice of the lawyers acting on behalf of the lenders to check that the persons who have entered into the transaction on behalf of the company did, in fact, have the authority to do so. This is because there are limits on the common law and statutory protections (such as the requirement that the creditor acted in good faith), which might throw doubt on their application in any particular case.

5.28 The result is that the lawyers acting for the lenders will take steps to establish whether the transaction has, in fact, been authorised by the company. In doing so, a number of issues need to be considered, including the following:

- Who are the directors of the company?
- Does the board of directors have the authority to enter into the transaction? This is established by reference to the company's articles of association. It will normally give the board of directors wide powers to manage the company's business.[4] In some cases, there will be a specific provision concerning borrowing powers, which may contain limitations on the amount of borrowings.[5]
- Has the board of directors properly exercised its authority to enter into the transaction? This will require an appropriate board resolution passed by the requisite number of directors in accordance with the company's articles of association. It is often the case that some of the company's directors are interested in the transaction (for instance, because they are directors of other companies in the group which are guaranteeing the transaction), in which event it needs to be established whether (and, if so, on what terms) interested directors are entitled to be counted in a quorum and to vote on the resolution.

5.29 The other matter which can affect the authority of the board of directors is the commencement of insolvency proceedings. If the company goes into

3 Companies Act 2006, s 40(2)(b).
4 See, for instance, The Companies (Model Articles) Regulations 2008, SI 2008/3229, Sch 1, art 3; and also art 70 of Table A to the Companies Act 1985 and art 80 of Table A to the Companies Act 1948.
5 This is particularly likely in the case of companies listed on The Stock Exchange, but may also be the case with companies which have adopted Table A to the Companies Act 1948 – see art 79.

liquidation or administration, the authority of the board to bind the company is terminated and replaced by that of the insolvency officer concerned.[6] In addition, if a petition is presented for the compulsory winding up of a company, and a winding up order is ultimately made, the liquidation dates back to the date of the presentation of the petition (which is quite likely to have happened a month of two before the order is made), and any disposition of the company's property entered into in the meantime is void unless the court validates it.[7]

5.30 Where the debtor is incorporated outside England, advice will be required on these issues from lawyers in the appropriate jurisdiction.

Can the transaction be set aside?

5.31 There are various ways in which a security arrangement which has been duly entered into by the debtor is capable of being set aside. Such circumstances include mistake, misrepresentation, duress, fraud, undue influence and illegality. Most of these arise under general principles of the law of contract and will not be discussed here. In practice, the most likely circumstances in which a security transaction will be set aside is where the security has been created by a company and its directors have acted in breach of fiduciary duty when entering into the transaction.

Breach of fiduciary duty

5.32 The directors of an English company have a collective fiduciary duty, when deciding how to exercise their powers, to do so in the best interests of the company.[8] If the directors of the debtor company commit a breach of that duty and the person dealing with the company enters into the transaction with (actual or constructive) notice of that breach of duty, then:

- although the transaction is valid at common law, it is voidable in equity;
- if it still executory, it can be set aside at the instance of the company (normally by a liquidator or administrator), subject to the normal limitations on the right of rescission;
- the company can trace into the hands of the person dealing with the company any money paid or property transferred to him under the transaction, subject to the normal limitations on equitable tracing; and
- the person dealing with the company may also be personally liable to the company as a constructive trustee for the benefits he has received under the transaction.[9]

6 Insolvency Act 1986, ss 91(2) and 103 and Sch B1, para 64.
7 Insolvency Act 1986, s 127.
8 *Re Smith and Fawcett* [1942] Ch 304.
9 *Rolled Steel Products (Holdings) v British Steel Corporation* [1986] Ch 246.

8.13 Two different systems for the enforcement of security over land had therefore developed. One enabled the creditor to go into possession and to foreclose, but not, generally, to sell the land. The other allowed the creditor to apply to the court for the land to be sold or for the appointment of a receiver of the income of the land.

8.14 These powers of the creditor were capable of being increased by agreement and, during the nineteenth century, the practice became more common for security documents to include an express power of sale by the creditor. In the case of an equitable charge, the benefit of such a provision was to avoid the necessity to apply to the court for the sale to be effected. It was even more advantageous in relation to a legal mortgage because, in the absence of such an express provision, the court would not generally order the sale of the property concerned. This practice led to legislation (Lord Cranworth's Act of 1860) which implied powers of sale and receivership, subject to certain conditions, into mortgages and charges. These implied powers were extended by the Conveyancing Act 1881 and are now contained in the Law of Property Act 1925. In relation to any mortgage or charge over land which was created by deed, the creditor therefore had implied powers of sale and to appoint a receiver of income. These powers could be exercised without application to the court and, in the case of a legal mortgage, they avoided the necessity for relying on the rights of foreclosure and possession.

Enforcement powers over businesses

8.15 The other important development in the nineteenth century was, as a result of the creation of the floating charge in the 1860s, to enable a creditor to take security over all of the present and future assets of a corporate debtor. In the absence of specific powers of enforcement in the floating charge, the creditor's principal remedy was to apply to the court for the appointment of a receiver and manager of the charged assets. Such a receiver and manager served a very different purpose from a receiver of the income of land. His function was not simply to collect rent, but to sell the charged assets. And because these would often be realised more advantageously if they were sold as a going concern, he was also given the power to continue the company's business for the purpose of effecting a sale as a going concern. The ultimate remedy of the floating chargee was the same as the fixed chargee's – to have the charged property sold. The difference lay in the way in which this object was to be achieved. In the case of a fixed charge over land, it was effected simply by giving the creditor the ability to have the land sold. Where a business was concerned, however, this would be insufficient if the business was to be sold as a going concern. It was therefore necessary for the court to appoint a receiver and manager whose primary function was to sell the charged property but who was entitled to run the business in the meantime for the purpose of effecting the sale.

8.16 The advantages to the creditor of such an approach are manifest. He is likely to get a better price where the business is sold as a going concern than he would if it was sold on break-up basis. It therefore soon became the practice in floating charges for the creditor to be given an express power to appoint a receiver and manager, thus avoiding the necessity to apply to the court.

8.17 By these processes, the nature of the creditor's powers of enforcement has been totally reinvented. Foreclosure and possession are still available, at least in relation to legal (and some equitable) mortgages, but are rarely used in practice. It is still possible for a creditor to apply to the court for sale, for the appointment of a receiver of income or for the appointment of a receiver and manager, but the limitations on a number of these powers and the time and expense involved in an application to court mean that they are hardly ever used. Although (at least in relation to security over land) there are now implied statutory powers of sale and of the appointment of a receiver of income, these powers are only capable of being enforced subject to restrictive conditions and are not sufficiently wide to enable the creditor to appoint a receiver and manager to carry on the debtor's business and then to sell it.

8.18 For these reasons, it is invariably the practice for express powers of enforcement to be contained in the security document, or at least for the implied powers to be extended. A debenture over the present and future assets of a corporate debtor will contain express powers for the appointment of a receiver, and it has generally been the case that enforcement of such security has been effected by the appointment of a receiver. In the case of other types of security, other remedies (such as the power to enter into possession of, and sell, the assets) may be appropriate, but receivership is still the preferred method of enforcement in most cases, not least because it enables the enforcement to be carried out by professionals and without the necessity for the creditor to assume the liabilities which he might incur if he enforced the security himself.

8.19 Since the Enterprise Act 2002 came into force in September 2003, the power of a creditor to appoint a receiver over all or substantially all of the assets of a corporate debtor (such a person being referred to in the legislation as an 'administrative receiver'), has been severely curtailed. A creditor can now only appoint an administrative receiver in limited circumstances. In those cases where it cannot, the creditor has been given a statutory power to appoint an administrator of the debtor company under the Insolvency Act 1986. In practice, such an administrator will have broadly the same powers as a receiver, although these are contained in the statute, rather than in the security document itself. As a result of these legislative changes, administration has become the principal method of enforcing security over businesses, although receivership will continue to be of importance in some cases.

Enforcement powers over other assets

8.20 It cannot necessarily be assumed that the powers of a creditor in relation to security over land are replicated where goods or intangibles are involved. Pledges over goods are straightforward. As has been seen in part 6 of Chapter 2 (2.72ff), a pledgee has the power to sell the pledged goods if default is made in

paying the secured debt, and this can be done without the necessity for application to the court. Even in the case of pledges, however, it is normal to give the creditor express powers of enforcement, in order to ensure that it is clear both when and how the security can be enforced. A pledgee does not, however, have legal title to the goods concerned, and cannot, therefore, foreclose.

8.21 There is little authority in relation to the implied powers of a legal mortgagee of goods. In principle, they should be similar to those in relation to legal mortgages of land, although the mortgagee may, in addition, have an implied power of sale similar to that of a pledgee. Because of the uncertainty, it is invariably the case that the mortgage will contain express powers of enforcement.

8.22 As far as security over intangibles is concerned, the position becomes even less clear. Except in the case of those limited types of intangible which are transferable at common law (such as shares), it is not possible to obtain a legal mortgage over intangibles. The security will, therefore, normally consist of an equitable mortgage or charge. Where the security is taken over receivables, the basic remedy of the creditor is to give notice to the counterparty to pay them directly to the creditor. Alternatively, the creditor could apply to the court for the appointment of a receiver. But the creditor will, in practice, also want a power to sell the receivables and this needs to be expressed in the security document, which should also contain a power to appoint a receiver out of court.

8.23 It is important to tailor the enforcement powers in a security document to the nature of the property charged. In the case of a debenture over all of the debtor's assets, there should always be an express power to appoint a receiver and manager or an administrator. In other cases, it will nearly always be appropriate for there to be a power to appoint a receiver, but it may not always be appropriate to use that power. In relation to security over a receivable, for instance, the creditor may simply wish to require the counterparty to pay the creditor direct. Where the security is taken over a credit balance with the creditor himself, he will wish to enforce the security by applying that credit balance in discharge of an equivalent amount of the secured debt. What is important is to ensure that the security document gives the creditor all express powers which he needs in order to enforce the security in the most beneficial way. It is unwise to rely on the powers of a secured creditor under the general law.

The position of the debtor

8.24 There are two parties to a security document, and the position also needs to be seen from the point of view of the debtor. Until enforcement, what are his rights in relation to the property concerned? In the case of a legal mortgage, the creditor is, on the face of it, entitled to possession because he has title but, in practice, it is generally agreed that he will not enter into possession until

default. The security document will, however, normally restrict the powers of the mortgagor to deal with the property concerned without the approval of the mortgagee. The extent of those restrictions is a matter for agreement. But there are certain limitations on the powers of the mortgagor which result from the nature of a legal mortgage itself. Because the creditor becomes the legal owner of the property, any lease created by the debtor after the mortgage has been created will be ineffective to bind the mortgagee unless he has expressly or impliedly consented to it. The Law of Property Act 1925 gives the debtor certain implied powers to create leases, but these are normally contracted out of.

8.25 The position of the debtor before enforcement is, therefore, ultimately a question to be decided by agreement with the creditor. In many cases, in the absence of agreement, the debtor will be able to do things which might prejudice the creditor. In other cases, the nature of a legal mortgage, even after the 1925 property legislation, means that the debtor will, in the absence of any specific provision, be prevented from doing certain things merely as a result of having entered into the mortgage. It is therefore important, from the point of view of both parties, to ensure that the security document properly regulates the powers of the creditor and the debtor in relation to the charged property.

The structure of this chapter

8.26 The next part of this chapter considers when the creditor is entitled to exercise his powers of enforcement. The following parts consider the powers of the creditor under the general law. They are considered in ascending order of importance, starting with foreclosure, working through possession and sale and finishing with receivership and administration. It then considers the responsibilities of a creditor, receiver or administrator when exercising his powers and it concludes with a discussion of powers of enforcement in practice. This chapter is accordingly divided into the following parts:

- Part 2 (8.27ff) – when can the creditor exercise his powers?
- Part 3 (8.53ff) – foreclosure and appropriation.
- Part 4 (8.77ff) – possession.
- Part 5 (8.93ff) – sale.
- Part 6 (8.113ff) – receivership.
- Part 7 (8.158ff) – administration.
- Part 8 (8.183ff) – liabilities of the creditor, receiver and administrator.
- Part 9 (8.232ff) – enforcement in practice.

PART 2: WHEN CAN THE CREDITOR EXERCISE HIS POWERS?

8.27 Because the creditor's powers of enforcement are normally expressly provided for in the security document, the circumstances in which he is entitled to exercise those powers normally depends on the construction of that document and on the other documents which govern the relationship between the debtor and the creditor, such as the facility agreement. It is nevertheless necessary briefly to consider when the creditor can exercise his rights if he is relying on his implied powers of enforcement. This depends on the nature of the power concerned.

Implied enforcement powers

8.28 Generally, the creditor's implied powers of enforcement are only available once the secured debt has become payable to the creditor. The creditor can therefore apply to the court for a foreclosure order, for the sale of the property concerned or for the appointment of a receiver if the secured liability has become payable.[2] The creditor's implied power to sell the property or to appoint a receiver of its income under the Law of Property Act 1925 are also exercisable once the secured debt has become payable, subject to certain limitations.[3]

8.29 The right of a legal mortgagee to obtain possession of the mortgaged property is different. Because the creditor is the legal owner of the property, he has the right to possession unless it is expressly or impliedly excluded by the terms of the mortgage. Although a mortgagee will rarely rely on this implied right of possession, it can be useful where the mortgage document is defective as far as the creditor's powers are concerned. Its availability has been reaffirmed in *Western Bank v Schindler*.[4] In that case, the Court of Appeal confirmed that a legal mortgagee's right to possession of the mortgaged property arose as soon as the mortgage was entered into unless it was expressly or impliedly limited by the terms of the documentation, and that it therefore arises even before default in payment by the debtor. But, until the power of sale is exercisable, 'the right to possession can only be exercised to protect the security, not as a means of enforcing it'.[5]

8.30 Unless it is excluded, therefore (and it can be excluded impliedly, as well as expressly), the right to possession can be used to protect the security even before the secured debt becomes payable. It is also possible for the creditor to

2 *Burrowes v Molloy* (1845) 8 I Eq R 482. This assumes that the creditor has such an implied power. Whether he does is considered in the following parts of this chapter.
3 Law of Property Act 1925, s 101(1)(i) and (iii), although these are subject to s 103.
4 [1977] Ch 1.
5 [1977] Ch 1 at 10, per Buckley LJ.

apply to the court for the appointment of a receiver of income in circumstances where the value of the secured property is diminishing, even though the secured debt is not then payable.[6]

8.31 In summary, the creditor's power to apply to the court for foreclosure or sale, or to exercise the implied powers to sell or appoint a receiver under the Law of Property Act 1925, are only available once the secured liability has become payable. But, unless expressly or impliedly excluded, the power of a legal mortgagee to take possession is available before default, as is a creditor's power to apply to the court to appoint a receiver if it is necessary to preserve the value of the security.

Express enforcement powers

8.32 If, as is normally the case, the creditor's powers of enforcement are provided for expressly in the security document, it is a matter of construction of that document when they arise.[7] In practice, they are likely to be exercisable when the secured debt has become payable. In most cases, therefore, the creditor's first question will be whether the secured liability is payable. This will normally depend, not on the security documents, but on the document (such as a loan agreement) which evidences the terms of the underlying transaction by which the creditor has made credit available to the debtor.

8.33 One question which frequently arises is whether the secured liability is payable automatically, or whether it is necessary for the creditor to demand repayment before it becomes payable. This depends on the terms of the documentation concerned. It will sometimes provide that, on the happening of a certain event, the debtor is under a liability to pay the creditor. This is likely to be the case, for instance, on expiry of the term of the loan. More frequently, the documentation will provide that, on the happening of the event concerned, the creditor will have the option to require payment of the secured liability by serving a demand on the debtor. This is normally (but not always) the case if there is an event of default. In such a case, the secured debt will only become payable once the demand has been made.

8.34 In practice, a creditor who is about to enforce security will, in any event, want to make formal demand on the debtor for payment of the secured liability, not only to prevent any argument by the debtor that there was an express or implied obligation to do so, but also to make sure that the debtor is fully aware of what is happening.

8.35 A further question for the creditor is to establish if there are any other requirements in the security or facility documentation which need to be complied with before the security can be enforced. Security documents commonly provide that the security can be enforced once the secured debt has

6 *Burrowes v Molloy* (1845) 8 I Eq R 482.
7 *Twentieth Century Banking Corporation Limited v Wilkinson* [1977] Ch 99 at 105, per Templeman J.

become payable, without the requirement for any notice to the debtor or any other formality. In particular cases, however, the security document might provide that it cannot be enforced until notice has been given to the debtor, and it may also give a period of grace within which the security cannot be enforced.

8.36 Finally, the creditor will want to ensure that any relevant statutory provisions have been complied with. There are few statutory requirements, but the Insolvency Act 1986 does contain certain formal provisions which need to be complied with in relation to the appointment of receivers.[8]

Administration

8.37 One effect of the Enterprise Act 2002 has been to increase the importance of statutory provisions in the enforcement of security. The restriction on a secured creditor's ability to appoint an administrative receiver (ie a receiver over all or substantially all of the debtor's assets), and the consequent ability of the creditor to appoint an administrator in cases where he could previously have appointed an administrative receiver, has had the effect that the most common method of enforcing security over a business is to appoint an administrator. Unlike the appointment of a receiver, this is a statutory procedure, the requirements of which cannot be contracted out of. These requirements are considered in part 7 of this chapter (**8.158**ff).

Giving the debtor time to pay

8.38 In addition to complying with the terms of the relevant finance documents, the debtor must also be given sufficient time to enable him to effect the repayment before the creditor enforces his security.[9] The purpose of this requirement is to enable the debtor to get the money from a source already available to him (for example, a bank account in credit or an established line of credit on which he can draw). He will not be given time to raise finds from elsewhere, only to effect the mechanics of repayment.[10]

8.39 Whether or not he has been given sufficient time depends on the circumstances of the transaction.[11] There are five factors which have been particularly important in the cases in establishing whether or not the debtor has been given sufficient time to pay:

- What does the documentation say about the issue? A demand will clearly be invalid if the creditor does not comply with the terms of the documentation. But, even where the requirement is to pay 'immediately upon demand'[12] or 'instantly on demand, and without any delay on any

8 See, for instance, Insolvency Act 1986, s 33.
9 *Massey v Sladen* (1868) LR 4 Exch 13.
10 *Bank of Baroda v Panessar* [1987] Ch 335.
11 *ANZ v Gibson* [1981] 2 NZLR 513; [1986] 1 NZLR 556.
12 *Toms v Wilson* (1862) 4 B & S 442.

pretence whatsoever',[13] the courts will imply that the debtor must be given a reasonable time to effect the repayment.

- On whom was the demand served? If it is not served on an officer of the debtor who has the authority to obtain the funds and effect the repayment, the period required to effect repayment will be longer than it would have been if demand had been served on someone with that authority.[14]
- How specific and accurate was the demand? If a demand is made for 'all monies due' to the creditor, or for more than the amount owing to the creditor, the debtor will be given longer to effect the repayment than if the demand were precise.[15]
- What discussions have taken place between the parties beforehand? If the creditor has been negotiating for some time with the debtor to have the loan repaid, and the debtor is aware that it is only a matter of time before a formal demand is made, the period of that formal demand can be very short.[16]
- Most importantly, what is the financial position of the debtor? If the debtor is insolvent or in such a difficult financial position that it is unable to repay, very little time will be required between the making of the demand and the enforcement of the security because the debtor will not be able to pay in any event.[17]

8.40 Three examples illustrate how these principles operate in practice. In *Massey v Sladen*,[18] a security bill of sale provided by an individual debtor stated that the loan should be repaid 'instantly on demand, and without any delay on any pretence whatsoever'. It also provided that the demand could be made either personally on the debtor 'or by giving or leaving a verbal or written notice to or for him at his present or last-known place of business, ... so nevertheless that a demand be in fact made'. The creditor made demand for payment on the debtor but, earlier on the same day, the creditor's solicitor had already made a demand at the debtor's place of business on the debtor's son, who had been left in charge of the business, and the creditor had immediately taken possession of the debtor's chattels. The debtor sued the creditor in trespass for wrongful seizure of the goods and it was held that his claim succeeded.

8.41 The court held that, on a proper construction of the bill of sale, the words 'instantly on demand' and 'without any delay on any pretence whatsoever' must be construed to give the debtor a reasonable time to pay.

13 *Massey v Sladen* (1868) LR 4 Exch 13.
14 *Massey v Sladen* (1868) LR 4 Exch 13.
15 *Massey v Sladen* (1868) LR 4 Exch 13.
16 *Cripps v Wickenden* [1973] 1 WLR 944.
17 *Cripps v Wickenden* [1973] 1 WLR 944; *Bank of Baroda v Panessar* [1987] Ch 335.
18 (1868) LR 4 Exch 13.

Chevron's lien to their own property, DSNL could not divest Chevron of its beneficial interest in the equipment (if it was severable) or in the composite structure (if it was not severable).

10.115 This is a difficult conclusion to accept for two reasons:

- The ability of a person to obtain an injunction in relation to an asset does not necessarily lead to the conclusion that he has a proprietary interest in it. And there is considerable doubt whether equitable liens should be extended beyond contracts for the sale of land – particularly to contracts relating to goods.
- Equally surprisingly, the lien continued even though the title to the equipment was lost by being fixed to another asset. If legal title under a reservation of title clause falls away in such a case, how can an equitable lien continue?

Conclusion

10.116 The liens of unpaid vendors and purchasers can best be seen as default rules which, in the absence of contrary intention, establish the respective proprietary interests of vendors and purchasers in relation to contracts for the sale of land and of certain other types of asset.

10.117 In the case of a contract for the sale of land:

- beneficial title passes to the purchaser on exchange of contracts and, accordingly, if the contract is rescinded otherwise than as a result of the fault of the purchaser, the purchaser's proprietary interest secures the repayment of the deposit; and
- the vendor retains an equitable proprietary interest in the land by way of security until the purchase price has been paid in full.

10.118 These principles only apply in the absence of contrary intention. They do not apply to contracts for the sale of goods, but the extent to which they apply to contracts for the sale of other types of asset is by no means clear.

10.119 The effect of land registration is that such liens are of much less importance in practice in relation to contracts for the sale of land than they used to be. When this is added to the doubt that exists as to whether such liens apply to contracts for the sale of intangibles, the moral is clear – express provision should be made either for the retention of title by the vendor or for the creation of security.

Subrogation

10.120 In commercial transactions, the law of subrogation has been of particular importance in relation to contracts of guarantee and contracts of

insurance. The precise limits of the doctrine of subrogation are not clear. The decision of the House of Lords in *Banque Financière de la Cité v Parc (Battersea)*[84] has opened up the possibility of the considerable extension of the doctrine, although the conceptual basis of that decision is difficult to discern and the extent of its application in other cases is uncertain. This part of this chapter will concentrate on subrogation in the context of guarantees and insurance, in part because of the importance of these types of contract in commercial transactions but also because they illustrate the two different ways in which rights of subrogation are used to create security interests which arise by operation of law.

10.121 The application of the doctrine of subrogation to contracts of guarantee is discussed in part 5 of Chapter 11 (**11.146**ff). If the guarantor pays the creditor in full, the effect of subrogation is to transfer the personal and proprietary rights previously owned by the creditor to the guarantor.[85] If, therefore, the creditor had taken security from the debtor, payment by the guarantor in discharge of the debtor's obligation to the creditor results in the transfer by operation of law of the benefit of the security from the creditor to the guarantor. The debtor is in no worse position than it was before. The effect of the subrogation is to transfer, rather than create, a proprietary interest.

10.122 The effect of the doctrine of subrogation in relation to contracts of insurance is very different. It is best illustrated by the decision of the House of Lords in *Lord Napier & Ettrick v Hunter*.[86] In that case, the insurers had paid the insureds, and the insureds' solicitors then received money from third parties in reduction of their clients' insured loss. As a result, the insurers were entitled to repayment by the insureds to the extent that they had been overpaid. But the House of Lords went further. It imposed an equitable lien in favour of the insurers over the moneys held by the insureds' solicitors to secure the insureds' obligation to repay the insurers, even though it was not provided for in the contract of insurance. The House of Lords left open the question whether such a lien would also have existed over the insureds' right to payment from the third parties before it had been collected by them.

10.123 Lord Browne-Wilkinson justified the decision on the basis of the maxim that equity treats as done that which ought to be done. He decided that the insureds must repay the insurer 'out of the moneys received in reduction of the loss'.[87] It is a surprising decision. Equity treats as done that which ought to be done, but what ought to have been done in this case? It was clearly necessary to require the insureds to repay the insurer because the insureds would otherwise have recovered more than their loss. But there was no reason to require them to do so out of the very money received from the third parties. This case is nevertheless authority for the proposition that an equitable lien will

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84 [1999] 1 AC 221.
85 For an example of its application see *Duncan, Fox, & Co v The North and South Wales Bank* (1880) 6 App Cas 1.
86 [1993] AC 713.
87 [1993] AC 713 at 752.

be imposed in favour of insurers in these circumstances, even though the contract of insurance makes no reference to it.

10.124 The effect of the doctrine of subrogation therefore depends on the circumstances in which it is used. In the case of a contract of guarantee, it does not create a proprietary interest by operation of law – what it does is to transfer it from the creditor to the guarantor. The effect of the doctrine in relation to contracts of insurance is to create a new proprietary interest by operation of law.

Salvage

10.125 Liens have always played an important part in maritime law, although it is beyond the scope of this chapter to consider them in any detail. In practice, their importance in the law of security is that the rights of mortgagees and chargees of vessels rank behind many maritime liens. Maritime liens arise in various circumstances – for instance, to secure liability for damage done by a ship, to secure the wages of the master and seamen of the ship and to secure the cost of salvage services rendered in respect of a ship. There are also various statutory liens imposed in relation to ships and aircraft, which are particularly important in practice in relation to aircraft.

10.126 Most maritime liens arise in circumstances which are particular to maritime law, and which are not duplicated in other areas of the law. The main exception to this principle is the law of salvage, where there are some similarities between maritime law and other areas of the law, although even here, the link is tenuous. The maritime lien for salvage attaches to a ship in respect of the rendering of salvage services or, in certain circumstances, the saving of life from a ship. A lien is imposed in such a case because the vessel is in danger and there is accordingly a need to take immediate action, without there being sufficient time to reach an agreement with the ship's owners as to the terms on which the salvage will be effected.

10.127 Cases of salvage are rare in non-maritime circumstances but they have arisen in relation to cases involving the management of insolvent estates. The courts have a variety of statutory and inherent powers to appoint persons to manage insolvent estates. These include statutory powers to appoint liquidators or provisional liquidators of companies and an inherent power to appoint a receiver.[88] When these powers are exercised, the proper remuneration and expenses of the officers appointed are payable out of the assets which they are managing, and they have an equitable proprietary interest in the assets by way of security.[89]

[88] Insolvency Act 1986, ss 125 and 135; *Hopkins v Worcester and Birmingham Canal* (1868) LR 6 Eq 437.

[89] *Bertrand v Davies* (1862) 31 Beav 429 at 436; *Re Exchange Securities & Commodities (No 2)* [1985] BCLC 392.

10.128 Such cases do not lay down any general principle because they can be seen simply as examples of the courts' general power to regulate the affairs of estates within their control. But the creation of such a proprietary interest is not limited to cases where the person concerned was appointed by the court. In *Re Berkeley Applegate*,[90] a liquidator of a company in creditors' voluntary liquidation (ie one in which there was no court involvement) was faced with a situation where the bulk of the assets under his control were held on trust, and he had insufficient funds to pay his remuneration and expenses out of the company's free assets. The court decided that the work had to be done, and that the liquidator was entitled to have his reasonable remuneration and expenses paid out of the trust fund to the extent that they were incurred in relation to the administration of the fund.

10.129 Outside the area of maritime law, salvage cases rarely arise in practice, and their application is subject to two limitations. In the first place, before there can be any question of his claim being proprietary, the claimant must establish that he is entitled to recover the expenditure incurred by him under general restitutionary principles. In most cases, expenditure incurred by one person in relation to another's asset without that person's consent will not be recoverable, even by means of a personal claim. He can only recover if his actions are not officious and the owner has benefited as a result.[91] The types of circumstance in which this will be the case are where there is an imminent danger to the asset (as in the case of maritime salvage) or it is impracticable for the claimant to get the consent of all the owners of the asset (as in the *Berkeley Applegate* case).

10.130 Secondly, the expenditure must have been incurred in relation to the defendant's asset, and there must be a good reason why the claimant should have a proprietary right rather than a mere personal one.[92] In the *Berkeley Applegate* case, for instance, a personal claim would have been impracticable because of the large number of beneficiaries involved and, in any event, recourse needed to be limited to the value of the fund. A proprietary, rather than a person, right was therefore the only practicable solution.

False cases

10.131 Equitable liens are created in other types of case, but they are of less importance in practice and they arise in circumstances which, when properly examined, do not involve the imposition of a security interest over a person's assets. This can be illustrated by three examples.

Trustee's lien

10.132 As Lindley LJ said in *Re Beddoe*:[93] '[A] trustee is entitled as of right to full indemnity out of his trust estate against all his costs, charges, and expenses

[90] [1989] Ch 32.

[91] *Falcke v Scottish Imperial Insurance Co* (1886) 34 Ch D 234.

[92] *Falcke v Scottish Imperial Insurance Co* (1886) 34 Ch D 234.

[93] [1893] 1 Ch 547 at 558.

properly incurred.' He also has a lien on the trust assets to secure that indemnity.[94] Although the trustee's right is described as a lien, it is not an example of a case where the law imposes a proprietary interest by way of security over the assets of another person. The trustee is already the legal owner of the assets concerned. Although he has a duty to hold them on behalf of the beneficiaries of the trust, it does not follow that he has no interest whatsoever in the assets. He is entitled to recover his proper expenses in acting as trustee and, in order to do so, he can exercise his legal rights as owner of the assets. The effect of the trustee's lien is not to create a proprietary interest which did not previously exist, but to regulate the existing proprietary rights of the trustee and the beneficiaries in those assets.

Partner's lien

10.133 The same can be said of a partner's lien. On dissolution of a partnership, each partner has a lien on the firm's surplus assets. In *Re Bourne*,[95] Fletcher Moulton LJ said[96] 'I doubt whether "lien" is the word which best describes his right', but the expression is frequently used and it is clear that a partner's lien is a proprietary interest which binds third parties with notice of it.[97] Nevertheless, like a trustee's lien, a partner's lien does not involve the imposition of a proprietary interest over someone else's assets. The partners are the owners of the partnership assets, and the lien simply establishes the extent of their respective interests in the surplus assets of the partnership once creditors have been paid.

Consensual arrangements

10.134 A third example of the use of the expression 'lien' to mean something other than the imposition of a proprietary interest by way of security relates to the creation of consensual interests. In some cases, the expression 'equitable lien' is used to describe a consensual security interest, such as a charge.[98] In *Legard v Hodges*,[99] for instance, a contract to charge future property was expressed to create a lien over that property. In this context, the expression 'lien' was used to describe a consensual security interest. This is often the case in the United States, where the expression 'lien' is given a wider meaning than it has in England. For the sake of clarity, however, as Slade J indicated in *Re Bond Worth*,[100] it is better to restrict the use of the word 'lien' to non-consensual security interests.

94 *Re Leslie* (1883) LR 23 Ch D 552.
95 [1906] 2 Ch 427.
96 [1906] 2 Ch 427 at 434.
97 *Cavander v Bulteel* (1873) LR 9 Ch App 79.
98 *Re Crossman* [1939] 2 All ER 530.
99 (1792) 1 Ves Jun 477.
100 [1980] Ch 228 at 250–251.

Losing the lien

10.135 It has been seen that a legal lien is lost if the creditor loses possession of the asset concerned. Since possession is not a requirement of an equitable lien, no such principle applies in relation to equitable liens.

10.136 Like any other equitable interest, an equitable lien may rank behind another proprietary interest in the asset concerned in accordance with the normal priority rules which are discussed in Chapter 7. In such a case, the lien is not lost although, in practice, the result may be little different.

10.137 The main circumstance in which an equitable lien is lost is where the express or implied intention of the parties is that the creditor should not have a lien. This principle applies to all liens – although they are created by operation of law, they give way to contrary intention. In the case of equitable liens, the most difficult question is whether they are lost if the creditor takes other security. In the leading case of *Mackreth v Symmons*, Lord Eldon LC said:[101]

> 'It does not however appear to me a violent conclusion, as between vendor and vendee, that notwithstanding a mortgage the lien should subsist. The principle has been carried this length; that the lien exists; unless an intention, and a manifest intention, that it shall not exist, appears.'

10.138 In spite of this statement, and a number of similar statements in early cases, the more recent cases on equitable liens suggest that it is difficult for a creditor to deny that the lien has been lost if he has purported to take consensual security over the asset concerned. This was the case in *Capital Finance v Stokes*[102] even though the security purported to be taken by the creditor was in fact void for non-registration – a puzzling decision.

10.139 Nevertheless, the principle is clear that the lien will only be lost if the taking of the other security evinces an intention to release the lien. Most modern security documents contain provisions which provide that the security is in addition to, and without prejudice to, any other security to which the creditor is entitled. In practice, the question of whether or not the taking of other security does evince an intention that there should be no lien can be difficult to resolve, depending as it does on the precise facts of the case. If a creditor is to avoid losing the benefit of an equitable lien, the security document ought to contain such a provision.

Remedies

10.140 In *Rose v Watson*,[103] Lord Cranworth said,[104] in relation to a purchaser's lien, that the purchaser 'acquires a lien, exactly in the same way as

101 (1808) 15 Ves Jun 329 at 341.
102 [1969] 1 Ch 261.
103 (1864) 10 HLC 672.
104 (1864) 10 HLC 672 at 684.

12.12 This part is concerned with the circumstances in which A is entitled to say that he is not liable to B because of a claim he has against B. There are two types of case:

- *Conditional payment obligation*: In this case, A is not liable to make a payment to B until such time as B has performed his obligation to A. A's obligation to B is conditional on the performance of B's obligation to A.
- *Netting*: In this case, A is only liable to pay B a net amount which takes account of the amount of B's liability to A.

12.13 Each of these rights can be available to A either under the general law or as a result of specific contractual arrangements between A and B. This part will consider five examples of the application of these principles which are particularly important in practice. They are:

- contractual conditions precedent;
- abatement;
- the banker's right to combine accounts;
- flawed assets; and
- netting agreements.

The first can arise by operation of law or by agreement. The next two arise by operation of law, the remaining two by agreement. Contractual conditions precedent and flawed assets are examples of conditional payment obligations. The other three are examples of netting.

Contractual conditions precedent

12.14 When considering the extent of a contractual obligation by A to make a payment to B, the first question to ask is whether A is under an obligation to make the payment at all. This depends on general contractual principles. A's obligation to make the payment may be subject to an express or an implied condition precedent.[2] Alternatively, A's obligation to pay may initially have arisen but have been discharged, for instance, by a repudiatory breach of contract by B which has been accepted by A.[3] These underlying principles are, of course, subject to the express provisions of the particular contract, which may require complete performance by B before A is under any obligation to pay or may provide for payments in stages following particular partial performance. But, whatever the contract provides, the first question is always whether A does, in fact, have an obligation to make a payment to B. It is only if he does that any further question arises.

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2 Express conditions precedent are ubiquitous. For an example of an implied condition precedent see *Associated Japanese Bank (International) v Credit du Nord* [1989] 1 WLR 255.

3 For instance, if it has deprived A of substantially the whole benefit of the contract: *Hong Kong Fir Shipping Co v Kawasaki Kisen Kaisha* [1962] 2 QB 26.

Abatement

12.15 If A does have an obligation to make payment to B, the next question is whether his obligation is to pay the full amount provided for in the contract, or whether the amount of the payment is reduced by the amount of any cross-claim which A may have against B as a result of a breach of contract by B.

12.16 The general position at common law is that, once A is under an obligation to make the payment to B, B is entitled to recover that payment from A. Even if A has a cross-claim against B for breach of the contract, A has no right to reduce the amount of the payment to take account of B's breach. A must pay the full amount to B and bring a separate claim against B for damages for breach of contract. In the words of Parke B in *Mondel v Steel*:[4]

> 'Formerly, it was the practice, where an action was brought for an agreed price of a specific chattel, sold with a warranty, or of work which was to be performed according to contract, to allow the plaintiff to recover the stipulated sum, leaving the defendant to a cross action for breach of the warranty or contract.'

12.17 Although this continues to be the underlying position at common law, as Baron Parke's comment suggests, there is an exception in relation to contracts for the sale of goods or for work and labour. During the nineteenth century, it became established that, in such cases, A was entitled to reduce the contractual payment required of him by an amount equal to the claim he had against B for damages for breach of contract if he could establish that the value of what he had obtained under the contract was reduced as a result of the breach of contract. As Baron Parke said in *Mondel v Steel*:[5]

> '[I]n all these cases of goods sold and delivered with a warranty, and work and labour, as well as the case of goods agreed to be supplied according to a contract, the rule which has been found so convenient is established; and that it is competent for the defendant, in all of those, not to set-off, by a proceeding in the nature of a cross action, the amount of damages which he has sustained by breach of the contract, but simply to defend himself by shewing how much less the subject-matter of the action was worth, by reason of the breach of contract; and to the extent that he obtains, or is capable of obtaining, an abatement of price on that account, he must be considered as having received satisfaction for the breach of contract, and is precluded from recovering in another action to that extent; but no more.'

12.18 This principle, that A can deduct the amount of his damages claim against B from the amount of his liability to B, only applies to two types of contract:

- contracts for the sale of goods (where the position is now regulated by statute);[6] and

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4 (1841) 8 M & W 858 at 870.

5 (1841) 8 M & W 858 at 871 and 872.

6 Sale of Goods Act 1979, s 53(1).

- contracts for work and labour.[7]

12.19 In *Aries Tanker Corporation v Total Transport*,[8] the House of Lords confirmed that this principle does not apply to any other type of contract. In particular, that case decided that it does not apply to contracts for the carriage of goods by sea and, as a result, that it is not open to the charterer to deduct from freight owing to a shipowner the amount of damage suffered by it in respect of cargo. In the words of Lord Simon of Glaisdale:[9] 'Freight, representing the original rule, stands uneroded, like an outcrop of pre-Cambrian amid the detritus of sedimentary deposits.'

12.20 This principle has also had a limiting effect on equitable set-offs (which is discussed in part 4 of this chapter (**12.74**ff)). But, for this purpose, suffice it to say that the doctrine of abatement is not a general principle of contract law. It only applies to the two types of contract described above, and then only to the extent that the damages claim reduces the value of the subject matter of the contract. To the extent that A may have a further damages claim against B for consequential loss, he must bring a separate claim against B to recover it.[10]

The banker's right to combine accounts

12.21 The right of a bank to combine (or, as it is sometimes called, consolidate) its accounts is, like abatement, also an example of a default rule (ie one which arises by operation of law). It establishes the circumstances in which a bank is only liable for the net amount owing by it to its customer after debit and credit balances on the customer's accounts with the bank have been applied against each other.

12.22 Two examples illustrate its application in practice. In *Garnett v M'Kewan*,[11] a customer held accounts with two different branches of the same bank, one of which was in credit, and the other in debit, each of an approximately equal amount. The customer drew a cheque on the bank, which it refused to honour. The Court of Exchequer held that the bank was only indebted to the customer for the net amount which was established after applying the credit balance on one account against the debit balance on the other. As a result, the bank had no obligation to honour the cheque.

12.23 The conceptual basis of a bank's right to combine accounts was considered in *Re K*.[12] In that case, the customer had three accounts with the bank – two deposit accounts, which were in credit, and one overdraft account, which was in debit. The customer was arrested for drug-related offences, and a restraint order was made prohibiting the customer from dealing with the three

7 *Mondel v Steel* (1841) 8 M & W 858.
8 [1977] 1 WLR 185.
9 [1977] 1 WLR 185 at 193.
10 *Mondel v Steel* (1841) 8 M & W 858 at 872.
11 (1872–73) LR 8 Exch 10.
12 [1990] 2 QB 298.

bank accounts. The bank applied to court to vary the order to enable it to combine the accounts. The court held that it was able to do so for two reasons. In the first place, it was held that the bank had a common law right to combine the three accounts, with the effect that it was only liable to the customer for the net balance. In the words of Otton J:[13]

> 'In my judgment, the right of a bank to combine is well established and is fundamental to the bank/customer relationship. It is a means of establishing the indebtedness of the customer to the bank and the bank to the customer. In exercising this right a bank is not asserting a claim over the moneys ... It is merely carrying out an accounting procedure so as to ascertain the existence and amount of one party's liability to the other. This can only be ascertained by discovering the ultimate balance of their mutual dealing.'

12.24 The bank had also obtained a contractual right of set-off from the customer, which it was held would have enabled the bank to exercise a contractual right of set-off. In fact, it was not necessary for the bank to rely on this, because it was only liable to the customer for the net balance.

12.25 The bank's right to combine accounts does not extend to all accounts which a customer holds with it. Where the bank is aware that an account in the name of a customer is in fact held on behalf of someone else, it is not able to combine the accounts for the same reason that it is unable to set off (as to which see part 3 of this chapter (**12.38**ff)). The types of account which can be combined are also limited. It would appear that there is no right to combine a loan account with a current account.[14] Nor does the right apply where arrangements between the bank and the customer expressly or impliedly contract out of it.

12.26 Because the right to combine accounts does not extend to all accounts and it is relatively easy for the customer to allege that the bank has contracted out of it, it is rare for banks to rely on the right of combination. In practice, as was seen in *Re K*, banks require contractual rights of set-off from their customers which are expressed to extend to all accounts and negative any implication that the right of combination is being waived by the bank. Contractual rights of set-off are considered further in part 4 of this chapter (**12.74**ff).

Flawed assets

12.27 The three examples described above all arise by operation of law without the necessity for any provision in the contract, although they are all subject to contrary agreement. The last two are examples of ways in which creditors can enhance by contract their rights against the debtor.

13 [1990] 2 QB 298 at 304.
14 *Re EJ Morel* [1962] Ch 21 at 31–32; *Bradford Old Bank v Sutcliffe* [1918] 2 KB 833 at 847.

12.28 One concerns the use of what is sometimes known as a 'flawed asset'. The purpose of a flawed asset arrangement is to establish that A has no obligation to pay B until such time as B has fully performed its obligation to A. It is, in effect, an express condition precedent.

12.29 It is best explained by means of an example. A bank may agree to issue a letter of credit for a customer in consideration of the customer depositing cash with the bank, to be held as security for the obligation of the customer to indemnify the bank if it is called upon to make payment under the letter of credit. The parties may agree that the deposit is only to be repayable to the customer once the customer has fully indemnified the bank in respect of any payments it may make under the letter of credit. Such an arrangement is frequently described as creating a 'flawed asset' – in the sense that the customer's right to recover its asset (the deposit) is flawed – ie it is subject to the complete performance by the customer of its obligation to indemnify the bank.

12.30 These arrangements used to be common because of certain perceived deficiencies in the law of insolvency set-off (which have now been resolved, and are discussed in part 5 of this chapter (**12.116**ff)) and because of a perceived doubt about the ability of a bank to take a charge over its own deposit (which has also now been resolved, and is discussed in part 6 of this chapter (**12.171**ff)). Such arrangements are now of less importance than they were when those uncertainties still existed, but there is no reason why they cannot continue to be used in an appropriate case. If the customer made demand on the bank for repayment of the deposit, the bank would be able to deny liability until such time as the customer had performed its obligations to the bank.

12.31 Nevertheless, although such arrangements work in theory, in practice they are likely to be more difficult to enforce. Unless the wording of the arrangements is so clear that there can be no doubt about its effect, it might not take a great deal of evidence to persuade a court that the real intention of the parties was not that the bank should have no liability until the customer had paid in full, but that the bank's liability should be limited to the net amount of the deposit, once the customer's obligations had been taken into account. Ultimately, this will be a matter of construction of the contractual arrangements between the parties in the light of the surrounding matrix of facts at the time they were entered into.

Netting agreements

12.32 This leads on to the other way in which A can protect itself against B by contract. The arrangements between the parties can provide that neither A nor B is liable for the gross value of the consideration provided by the other under the contract, but that the only liability of either party is for the net amount of the consideration provided by both parties from time to time. Although such arrangements can be used in commercial contracts, they are also frequently used in financial arrangements, such as in swap contracts.

12.33 The effect of such a netting arrangement is that each party is only liable for the net balance of advantage from time to time. As with flawed asset arrangements, there is no conceptual reason why such a provision should not be effective, but it is important that the contractual arrangements should be clearly drafted to this effect and that the subsequent actions of the parties do not suggest that they are varying the arrangements. If, on their true construction, the arrangements involve the creation of cross-debts owing by both parties, it will not be a netting arrangement, but a set-off arrangement.

12.34 Whilst the debtor remains outside insolvency proceedings, this is unlikely to have many adverse consequences but, in the liquidation, administration or bankruptcy of the debtor, a contractual set-off arrangement will be ineffective, and the effectiveness of the netting arrangement may therefore be crucial. In principle, a netting arrangement ought to be effective in the debtor's insolvency, but the authorities (discussed in part 5 of the chapter) indicate it will not be if it gives the creditor more than he would have been entitled to by way of insolvency set-off. Where the netting agreement is part of a financial collateral arrangement, the Financial Collateral Arrangements (No 2) Regulations 2003[15] make it clear that it will be enforceable even in an insolvency if it contains a 'close-out netting provision'. Financial Collateral is discussed in part 5 of chapter 3 (**3.177**ff).

Conclusion

12.35 Before considering whether A is able to exercise a right of set-off against B, it is first necessary to establish whether A is, in fact, indebted to B. In some cases, A may not be indebted to B as a result of the operation of general principles of law. Alternatively, A may be able to rely on express contractual provisions in order to create the same effect. Examples of such arrangements which arise by operation of law include the common law rule of abatement and the bank's right to consolidate accounts. Contractual extensions of such arrangements include flawed asset and netting arrangements.

12.36 An alternative way of analysing these arrangements is by reference to their effect, rather than by reference to the way they were created. In some cases, the effect of these arrangements is that A is not liable to B at all until certain conditions have been fulfilled. A flawed asset arrangement is an example of such a case. Alternatively, A may only be liable to B for the net amount of the consideration provided by both parties. The common law rule of abatement, the bank's right to consolidate accounts and contractual netting arrangements are examples of this type of case.

12.37 Finally, it should be emphasised that contractual extensions of these arrangements (whether by means of flawed assets or netting arrangements) require not only careful drafting but also the likelihood that the parties will carry them out as the contractual arrangements require. If the effect of the

[15] SI 2003/3226.

contract in the light of its surrounding matrix of facts establishes that the arrangements between the parties do not actually result in a net amount owing by one to the other but that the parties intend there to be cross-claims which are set off, the arrangements cease to be effective as flawed assets or netting arrangements and will only be effective to the extent that a set-off agreement is effective.

PART 3: MUTUALITY

12.38 With one exception, mutuality of cross-claims is a prerequisite of all types of set-off, although the cases tend to be concerned with insolvency set-off. Before considering the various types of set-off available to a creditor, this part will accordingly analyse what is meant by 'mutuality'. Cross-claims are mutual if they satisfy four criteria:

- they are money claims;
- they are personal, not proprietary, claims;
- they are owing between the same persons; and
- they are owing in the same right.

Money claims

12.39 It is in the very nature of rights of set-off that they can only apply to cross-claims for money. There is no requirement that the cross-claims will result in debts – a claim for damages is equally capable of being set off – but each claim must result in an obligation to pay money to the other party. This was made clear by Lord Russell of Killowen CJ in *Palmer v Day*,[16] who said that the dealings between the parties must end in money claims owing between the parties 'otherwise the claims are incommensurable' (ie are incapable of being measured by the same standard).

12.40 This may seem self-evident, and it has always been the case that set-off outside insolvency proceedings is limited to monetary cross-claims. But, in the case of insolvency set-off, the courts have flirted with the idea of extending its scope to non-monetary claims. The issue has arisen in cases where the debtor has entered into insolvency proceedings at a time when the creditor is holding goods belonging to the debtor. On the face of it, no set-off is available in such a case. The creditor may have a lien on the goods (as to which, see Chapter 10) but will generally have no right of set-off. This is because, although the creditor may have a money claim against the debtor, the debtor's claim against the creditor is for the return of his goods.[17] In practice, though, the position is more complicated. There is a lot of case-law, and the cases divide themselves into two

16 [1895] 2 QB 618 at 622.

17 Under s 3 of the Torts (Interference with Goods) Act 1977, the remedy is discretionary, but it would be awarded in the debtor's insolvency if the creditor is the owner of the goods.

categories – those cases where the creditor has a power of sale over the goods held by him, and those where he does not.

12.41 Where the creditor does not have a power of sale over the goods in his possession, there were some suggestions in eighteenth-century cases that the creditor would have a right of set-off in respect of the value of the goods.[18] But, in *Rose v Hart*,[19] the Court of Common Pleas declined to follow the earlier authorities and decided that set-off was only possible where the arrangements between the parties would eventually terminate in money claims.

12.42 Where the creditor does have a power of sale, the position is more complicated. The authorities distinguish between two types of case:

- those where the creditor's authority to sell the goods continues even though the debtor goes into insolvency proceedings, and the goods are then sold; and
- those where the creditor's authority to sell the goods is revoked by the debtor's insolvency proceedings, and the goods accordingly remain unsold.

12.43 An example of the first type of case is *Palmer v Day*.[20] D had deposited certain pictures with C, a firm of auctioneers, for sale, but became bankrupt whilst the pictures were still unsold. C subsequently sold the pictures, acting upon the instructions of D's trustee in bankruptcy. A Divisional Court of the Queen's Bench Division held that C had the right to set off the proceeds of sale against a debt owed from D which pre-dated the bankruptcy.

12.44 In contrast, in *Eberle's Hotels Co v Jonas*,[21] D deposited cigars with C as security for a particular debt, giving C authority to sell the cigars and credit D with the proceeds. D went into liquidation at a time when C still had cigars in his possession. The secured debt had been repaid, but C claimed to set off the value of the cigars against another debt owing by D. The Court of Appeal held that C was not entitled to a set-off. In the words of Lord Esher MR:[22]

> 'Although there may be mutual dealings, and the parties are such as come within the terms of [the statutory provision concerning set-off in insolvency], it is obvious that its provisions cannot apply unless the dealings are such that in the result the account contemplated by the section can be taken in the way described. If the claim on one side in the action and the counter-claim on the other were such as would both result in a money claim, so that for the purposes of the action there would be merely a pecuniary liability on each side, the case would, I think, come within the section.'

18 *Ex parte Deeze* (1748) 1 Atk 228; *Olive v Smith* (1813) 5 Taunt 56.

19 (1818) 8 Taunt 499.

20 [1895] 2 QB 618. It is a curious case, and is considered further in part 5 of this chapter (**12.116**ff).

21 (1887) LR 18 QBD 459.

22 (1887) LR 18 QBD 459 at 465.