Chapter 2

MINUTES

2.1 Some banks choose not to involve themselves with the formalities of the meetings at which their security is created, preferring instead to rely on the rule in *Royal British Bank v Turquand*[1] and on the Companies Act 2006, ss 39 and 40. Others call for certified extracts from the minutes with a view to ensuring that appropriate resolutions have been passed.

The writer's view is that it remains good practice to call for certified extracts from the minutes in some such form as is set out at the end of this chapter because in extreme cases no board meetings are in fact convened, the security documents simply being executed. If they are under seal or executed by two directors or a director and the secretary or a joint secretary of a company (or, in relation to documents executed on or after 6 April 2008, by a director of a company in the presence of a witness who attests the signature) the bank may be saved by ss 74 and 74A of the Law of Property Act 1925 or ss 44 and 46 of the Companies Act 2006 (see para **2.5** et seq).

However, if the bank has received certified minutes of a purported board meeting, the company may be estopped from denying a board meeting was held (*TCB Ltd v Gray*[2]). Browne-Wilkinson V-C said:

> In my judgment L, having put forward the minutes of the meeting as one of the completion documents on the basis of which TCB made the loan, could not be heard to challenge the validity of that minute by denying that such meeting ever took place. Therefore the minute stands as irrefutable evidence against L that the grant of the debenture was a 'transaction decided on by the directors'. Accordingly the necessary basis for section 9(1) of the Act of 1972 to apply, as between L and TCB, exists. It follows that the debenture was valid.

It is questionable whether such estoppel will necessarily bind a liquidator of the company (*Re Exchange Securities and Commodities Ltd*[3]).

Occasionally, company secretaries produce minutes which show that they (and possibly the board) have misunderstood the nature of the security created. Badly-drawn minutes or the absence of minutes naturally excite the attention of liquidators when in the course of their duties they call for and examine the minute book of the company. The importance of observing correct procedures in taking security is illustrated by *Rolled Steel Products (Holdings) Ltd v British Steel Corpn*[4] (see para **4.6**).

Bankers often have detailed actual knowledge of the affairs of their customers, and it is well established that notice of irregularities removes any protection given by the rule in *Turquand's* case[1] and may even take a bank outside the protection conferred by s 40 of the Companies Act 2006. The problem for

large organisations such as banks is that those responsible for taking the security may be unaware of the irregularities and their colleagues who are aware may not appreciate the significance of what they learn. Although the existence of 'good faith' was assumed by the Court of Appeal in *Smith v Henniker-Major & Co*[5] (and the case concerned a director of the very company in question seeking protection under the provisions of s 35A of the Companies Act 1985), it is clear that the courts will give little assistance to a third party who is directly concerned with overstepping the limitations upon the authority of directors and others contained in the company's constitution.

1 (1856) 6 E & B 327.
2 [1986] Ch 621 at 637, CA.
3 [1988] Ch 46, [1987] 2 All ER 272 and see also the observations of Neuberger J in *Re Harvard Securities Ltd* [1997] 2 BCLC 369 at 386.
4 [1986] Ch 246, [1985] 3 All ER 52, CA.
5 [2002] EWCA Civ 762, [2003] Ch 182.

ROYAL BRITISH BANK V TURQUAND

2.2 Under the rule in *Royal British Bank v Turquand*[1], third parties dealing with the company were deemed to have notice of the public documents of the company filed at the Companies Registry but this assumption was materially modified by the Companies Act 1985, new ss 35 to 35B, now contained in a modified form in the Companies Act 2006, ss 39 and 40 (para **2.7** et seq). Third parties acting in good faith are absolved from enquiring into internal irregularities unless they have notice of the irregularity or are put upon enquiry and would have discovered the irregularity had due enquiries been made (see *Morris v Kanssen* per Lord Simonds[2]).

In *Rolled Steel Products (Holdings) Ltd v British Steel Corpn*[3] at 283 and 284, Slade LJ explained the qualification in *Turquand's* case about notice of irregularities in these terms:

> However, [ss 39 and 40 of the Companies Act 2006] apart, persons dealing with a company registered under the Companies Acts must be taken not only to have read both the memorandum and articles of a company but to have understood them according to their proper meaning . . .
> It is a rule which only applies in favour of persons dealing with the company in good faith. If such persons have notice of the relevant irregularity, they cannot rely on the rule.

He added at 292:

> Nevertheless, as a general rule, a company incorporated under the Companies Acts holds out its directors as having ostensible authority to do on its behalf anything which its memorandum of association expressly or by implication gives the company the capacity to do . . . . In the absence of notice to the contrary, the lenders would thus have been entitled to assume, on the authority of the principle in *Turquand's* case[1], and on more general principles of the law of agency, that the directors of the borrowing company were acting properly and regularly in the internal management of its affairs . . . . However, a party dealing with a company cannot rely on the ostensible authority of its directors to enter into a particular transaction if it knows they in fact have no such authority because it is being entered into for improper purposes. Neither the rule in *Turquand's* case nor more general principles of the law of agency will avail him in such circumstances.

In *Gloucester County Bank v Rudry Merthyr Steam and House Coal Colliery Co*[4], a person dealing with the company obtained a mortgage under seal signed by two directors and the secretary. In fact, there was no quorum present at the board meeting at which the mortgage was executed but it was held that the mortgage was valid. Lord Halsbury[5] said:

> The only external fact with respect to the management of the company of which an outside person would be cognisant would be that they had power to make any quorum they pleased, and I think he would be entitled to assume that the proper quorum had been properly summoned and had attended . . .

A third party may be put upon enquiry by reason of the unusual nature of the transaction, and in particular if the transaction is outside the ostensible authority of the officer carrying it out.

In *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd*[6], Willmer LJ summarised the effect of earlier authorities by quoting the following from an earlier report[7]:

> If the articles merely empower the directors to delegate to an officer authority to do the act, and the officer purports to do the act, then, if the act is one which would ordinarily be beyond the powers of such an officer, the plaintiff cannot assume that the directors have delegated to the officer power to do the act; and if they have not done so, the plaintiff cannot recover.

It is crucial to know when a bank is and when it is not on enquiry. Anything out of the ordinary may suffice to defeat the protection of the rule in *Turquand's* case[1]. For example, if a charge is taken over documents from time to time deposited within a bank, the bank will be put on enquiry if documents are lodged by some junior official acting outside his ostensible authority. In *Rolled Steel Products (Holdings) Ltd v British Steel Corpn*[3] Slade LJ said that the very nature of a proposed transaction may put a person upon enquiry as to the authority of the directors of a company to effect it, the issue depending on all the particular circumstances.

1 (1856) 6 E&B 327.
2 [1946] AC 459 at 475, HL.
3 [1986] Ch 246, [1985] 3 All ER 52, CA.
4 [1895] 1 Ch 629.
5 [1895] 1 Ch 629 and 633, CA.
6 [1964] 2 QB 480 at 496, CA.
7 *British Thomson-Houston Co Ltd v Federated European Bank Ltd* [1932] 2 KB 176 at 184.

STATUTORY PROTECTION

2.3 The old cases must now be read in the light of s 74 of the Law of Property Act 1925 as amended and ss 39 and 40 of the Companies Act 2006 (which have in some respects altered the impact of ss 35 to 35B of the Companies Act 1985 discussed in previous editions of this work). Section 74(1), (1A) and (1B) of the Law of Property Act 1925 enact:

> (1) In favour of a purchaser an instrument shall be deemed to have been duly executed by a corporation aggregate if a seal purporting to be the corporation's seal purports to be affixed to the instrument in the presence of and attested by:

(a) two members of the board of directors, council or other governing body of the corporation, or

(b) one such member and the clerk, secretary or other permanent officer of the corporation or his deputy.

(1A) Subsection (1) of this section applies in the case of an instrument purporting to have been executed by a corporation aggregate in the name or on behalf of another person whether or not that person is also a corporation aggregate.

(1B) For the purposes of subsection (1) of this section, a seal purports to be affixed in the presence of and attested by an officer of the corporation, in the case of an officer which is not an individual, if it is affixed in the presence of and attested by an individual authorised by the officer to attest on its behalf.

The Law of Property Act 1925, s 205, defines 'purchaser' in the following terms:

> 'Purchaser' means a purchaser in good faith for valuable consideration and includes a lessee, mortgagee or other person who for valuable consideration acquires an interest in property . . . and in reference to a legal estate includes a chargee by way of legal mortgage; and where the context so requires 'purchaser' includes an intending purchaser . . . and 'valuable consideration' includes marriage, and formation of a civil partnership, but does not include a nominal consideration in money.

It will be seen that s 74 extends to bank security documents under seal but only to documents under seal. It confers protection if the seal is attested by persons purporting to hold the office of secretary and director or two directors even if they do not in fact hold such office. It should be noted that notwithstanding the amendment of s 74 by the Regulatory Reform (Execution of Deeds and Documents) Order 2005[1], in relation to documents under seal executed before 15 September 2005, the previous form of s 74 whereby attestation by a permanent officer such as the secretary is required and attestation by two directors is *not* sufficient still applies (see however para **2.4** below).

[1] SI 2005/1906.

2.4 The abolition of the need for a seal by s 36A(3) of the Companies Act 1985 (now s 45(1) of the Companies Act 2006) made it necessary to supplement the protection conferred by s 74. The former s 36A(6) (as amended in 2005) enacted:

> (6) In favour of a purchaser a document shall be deemed to have been duly executed by a company if it purports to be signed by a director and the secretary of the company, or by two directors of the company.
>
> A 'purchaser' means a purchaser in good faith for valuable consideration and includes a lessee, mortgagee or other person who for valuable consideration acquires an interest in property.

Section 36A(6) conferred similar protection to the Law of Property Act 1925, s 74 not only to deeds executed without a seal but to any document which purported to be signed by a director and the secretary or by two directors of the company. Signature by persons purporting to be two directors of the company sufficed, whereas under s 74, in relation to instruments under seal executed prior to 15 September 2005, one of the signatories had to purport to

hold the office of a permanent officer such as the secretary. However, s 36A(6) unlike s 74 did not extend to signature by a deputy secretary. The definition of 'purchaser' remained unchanged.

2.5 In relation to documents[1] executed on or after 6 April 2008, it is now necessary to consider due execution in the light of the Companies Act 2006, s 44. That section relevantly provides as follows:

> **44**
>
> . . .
>
> (2) A document is validly executed by a company if it is signed on behalf of the company—
>
> (a) by two authorised signatories, or
>
> (b) by a director of the company in the presence of a witness who attests the signature.
>
> (3) The following are 'authorised signatories' for the purposes of subsection (2)—
>
> (a) every director of the company; and
>
> (b) in the case of a private company with a secretary or a public company, the secretary (or any joint secretary) of the company.
>
> . . .
>
> (5) In favour of a purchaser a document is deemed to have been duly executed by a company if it purports to be signed in accordance with subsection (2). A 'purchaser' means a purchaser in good faith for valuable consideration and includes a lessee, mortgagee or other person who for valuable consideration acquires an interest in property.
>
> . . .

The definition of 'purchaser' still remains unchanged. A comparison with the previous provision set out in para **2.4** readily shows that the protection formerly afforded by s 36A(6) of the 1985 Act has been extended to encompass documents signed on behalf of a company by a single director in a presence of a witness who attests the signature.

[1] A 'document' in this context includes all documents including informal ones such as notices: see *Hilmi & Associates Ltd v 20 Pembridge Villas Freehold Ltd* [2010] 3 All ER 391, [2010] 1 WLR 2750, CA.

2.6 Like ss 40 and 44 of the Companies Act 2006, protection under s 74 of the Law of Property Act 1925 only exists if the purchaser is in good faith. Any third party who has actual notice of irregularities will fail this test. The meaning of 'good faith' in the context of the older law regarding corporate capacity was considered in *International Sales and Agencies Ltd v Marcus*, in which Lawson J held[1]:

> . . . the test of the lack of . . . good faith in somebody entering into obligations with a company will be found either in proof of his actual knowledge that the transaction was ultra vires the company or where it can be shown that such a person could not in view of all the circumstances, have been unaware that he was a party to a transaction ultra vires.

Further assistance can be derived from the remarks of Lord Herschell in *London Joint Stock Bank v Simmons*[2] where he considered the meaning of 'good faith' in relation to negotiable instruments:

> I should be very sorry to see the doctrine of constructive notice introduced into the law of negotiable instruments. But regard to the facts of which the taker of such

> instruments had notice is most material in considering whether he took in good faith. If there be anything which excites the suspicion that there is something wrong in the transaction, a taker of the instrument is not acting in good faith if he shuts his eyes to the facts presented to him and puts the suspicions aside without further inquiry.

The question of good faith has more recently been considered in the unreported case of *Re Rapierway Ltd*[3]. Peter Gibson J held that failure to make a company search before making a loan might be regarded as somewhat careless but certainly did not constitute lack of good faith. He cited *Midland Bank Trust Co Ltd v Green* where Lord Wilberforce said[4]:

> I think that it would generally be true to say that the words 'in good faith' related to the existence of notice. Equity, in other words, required not only absence of notice, but genuine and honest absence of notice.

Peter Gibson J commented that:

> Genuine and honest absence of notice must, I think, also comprehend that the purchaser is not a person who shuts his eyes to the truth. Thus if the purchaser were put on enquiry but avoided making such enquiries, it may well be that he could not be said to be a purchaser in good faith.

However, the courts will be reluctant to import constructive notice into the test of good faith particularly if the Companies Act 2006, ss 39 and 40 apply (*TCB Ltd v Gray*[5]).

1 [1982] 3 All ER 551 at 559.
2 [1892] AC 201 at 221, HL.
3 Unreported, 17 May 1989, Ch D.
4 [1981] AC 513 at 528, HL.
5 [1986] Ch 621, [1986] 1 All ER 587; affirmed on appeal [1987] Ch 458, [1988] 1 All ER 108, CA.

2.7 The Companies Act 2006, by ss 39 and 40 (replacing with some modification ss 35 to 35B of the 1985 Act) provides:

39

(1) 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.

(2) This section has effect subject to section 42 (companies that are charities).

40

(1) 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.

(2) For this purpose—

(a) a person 'deals with' a company if he is a party to any transaction or other act to which the company is a party,

(b) a person dealing with a company—

(i) is not bound to enquire as to any limitation on the powers of the directors to bind the company or authorise others to do so.

(ii) is presumed to have acted in good faith unless the contrary is proved, and

(iii) is not to be regarded as acting in bad faith by reason only of his knowing that an act is beyond the powers of the directors under the company's constitution.

(3) The references above to limitations on the directors' powers under the company's constitution include limitations deriving—

(a) from a resolution of the company or of any class of shareholders, or

(b) from any agreement between the members of the company or of any class of shareholders.

(4) This section does not affect any right of a member of the company to bring proceedings to restrain the doing of an action that is beyond the powers of the directors.

But no such proceedings lie in respect of an act to be done in fulfilment of a legal obligation arising from a previous act of the company.

(5) This section does not affect any liability incurred by the directors, or any other person, by reason of the directors' exceeding their powers.

(6) This section has effect subject to—

section 41 (transactions with directors or their associates), and

section 42 (companies that are charities).

The approach of the courts to these sections and their predecessors has to some extent followed that of Browne-Wilkinson V-C in *TCB Ltd v Gray*[1] when he was considering the European Communities Act 1972, s 9 which contained the original form of the present provisions. He said:

> In approaching the construction of the section, it is in my judgment relevant to note that the manifest purpose of . . . the section is to enable people to deal with a company in good faith without being adversely affected by any limits on the company's capacity or its rules for internal management. Given good faith, a third party is able to deal with a company through its . . . directors . . . . I approach the construction of the subsection with a great reluctance to construe it in such a way as to reintroduce . . . any requirement that a third party acting in good faith must still investigate the regulating documents of a company.
>
> [Section 40(2)(b)(ii)] expressly provide(s) that good faith is to be presumed: [section 40(2)(b)(i)] further provides that the person dealing with the company is not bound to inquire as to limitations on the powers of the directors. In my judgment, it is impossible to establish lack of 'good faith' within the meaning of the subsection solely by alleging that inquiries ought to have been made which [s 40(2)(b)(i)] says need not be made.
>
> . . . Any provision in the articles as to the manner in which the directors can act as agents for the company is a limitation on their power to bind the company and as such falls within [s 40(2)(b)(i)].

The quotation is out of context but nevertheless shows that the courts will be reluctant to defeat the object of the legislation by reintroducing any need to investigate the regulating documents of a company. Reference, however, to the discussions of the somewhat circular nature of attempting to define a threshold of procedural or substantive irregularity for attracting the protection of s 40 contained in the judgments of the members of the Court of Appeal in *Smith v Henniker-Major & Co*[2] illustrates the difficulty this problem presents.

Section 39(1) expressly enacts 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. The previous reference to 'memorandum' required of course to be changed since any remaining provisions dealing with a company's objects are now deemed to form part of its articles of association.

Section 40(1) enacts that in favour of a person dealing with a company in good faith, the power of the directors to bind the company shall be deemed to be free of any limitation under the company's constitution. An important change has occurred here: whereas s 35(A)(1) of the 1985 Act referred to the 'board of

Chapter 5

FACILITY LETTERS

5.1 It is outside the scope of this book to discuss facility letters in detail[1], but it is necessary to consider the correlation of facility letters and security documents. The style of facility letters varies widely from bank to bank and is often dictated by marketing considerations.

[1] For such a discussion see *Commercial Loan Agreements* (Tolley, 1990) written by the original author.

5.2 Covenants and default clauses can appear either in a facility letter or in the security documents. It is, of course, quite unnecessary for the same clause to be repeated in both documents – a sign of weak drafting that is seen all too frequently!

It is recommended that covenants designed to protect the security should be in the security documents, but financial covenants are best set out in the facility letter. Some models of financial covenants are included at the end of this chapter. Breach of such covenants enables a bank to apply pressure to an unsuccessful management before it is too late.

In the context of a simple facility letter, there is much merit in putting default clauses in the security documents. Each facility letter must incorporate the default clause by reference, but well-drawn default clauses tend to be lengthy and are out of place in a short facility letter. From a marketing standpoint, it is undesirable to highlight the default clause and to repeat it each time a facility is granted. There is also some advantage in making the security document self-contained, should it have to be enforced.

The position will, however, be different in the context of a more formal and complex facility agreement, particularly a syndicated facility agreement under which a number of banks provide funds to the borrower. In such a case it is to be expected that detailed default provisions will be contained solely within the facility agreement itself.

5.3 Security documents preferably will secure all moneys and liabilities from time to time owing to the bank. Restriction to a particular facility is only desirable if the facility is provided by a syndicate of banks or as an interim measure whilst a rescue package is negotiated. If security is restricted to a particular loan as from time to time varied or extended, further security will have to be taken before the bank grants other facilities. Anything which weakens flexibility or causes delay and expense is to be deplored.

Security documents in all moneys form should be drawn sufficiently widely to cover all possible types of facilities including acceptance credits, bank guarantees and all types of bonds and indemnities.

5.4 It is sometimes questioned whether effective security can be taken for an acceptance credit facility in that the bank as acceptor is primarily liable on the bill and if a second chargee gives notice, subsequent debits to the borrower's account will be postponed to such chargee. However, any well- drawn acceptance credit-facility letter will contain an express term obliging the customer to put the bank in funds to meet maturing bills. This liability predates the subsequent charge and will retain its priority, provided the bank does not mislead the subsequent chargee by overlooking outstanding bills in answering enquiries about the extent to which it ranks in priority.

SECURITY

5.5 Two old maxims of banking are: 'Never lend against security' and 'The best lending is unsecured'. Neither should be taken literally! Both, of course, contain an inherent truth. Bankers will always enquire of a borrower how he proposes to generate the funds to repay however solid the security may be.

Prior to the Enterprise Act 2002

5.6 For many years, the ideal form of security (assuming the customer does not have adequate deposits to charge or negotiable instruments to pledge) has been considered to be a full debenture containing fixed and floating charges over all the assets of the company. Should the company later have collapsed, such security enabled the bank to appoint an administrative receiver who took control of the whole business and who had some prospects of selling any viable portions as a going concern. It was this ability which put UK enforcement procedures far ahead of other European countries where, on insolvency, businesses tend to be closed down. The appointment of an administrative receiver would preclude the court making an administration order unless the debenture-holder consents or the security was 'liable to be released or discharged'[1]. If security was only taken over certain specific assets, the security documents would confer a power of sale over the asset charged but would be unlikely to enable the business to be saved and would be vulnerable to being overridden by an administrator[2].

1 Insolvency Act 1986, 'old' s 9(3).
2 Insolvency Act 1986, 'old' ss 10(1)(b), 11(3)(c) and 15.

From 15 September 2003

5.7 For a variety of reasons, the security afforded by a debenture is less today than was the case several years ago (and, since *Re Spectrum Plus Ltd*[1], significantly less than many bankers thought – or at least hoped!). It has become more common to factor debts, and as factors tend to give notice to debtors of their rights – whereas bankers do not do so until they enforce their security – factors often gain priority. Again, floating charges over stock suffer from retention of title claims and from the inroads made by preferential

creditors who rank in priority to a floating charge[2]. More recently, legislation has also reinstated the general priority of liquidation expenses over the claims of a floating charge holder, subject in the case of certain litigation expenses to the approval of the floating charge holder and preferential creditors or of the court[3].

While the abolition of preferential status for Crown debts[4] has lessened the impact of preferential creditors, the simultaneous introduction of the requirement to set aside a pool of funds for unsecured creditors has had a significant effect.[5] In addition, the consequence of the final decisions in *Agnew v Commissioner of Inland Revenue*[6] and *Re Spectrum Plus Ltd*[1] is that in most situations involving 'traditional' forms of debenture, the bank will find it has only a floating charge in respect of the book debts of its borrower.

Most significantly, while the discussion contained in para **5.6** above is still applicable in relation to debenture security created before 15 September 2003[7], such security created since that date will no longer confer on the holder the ability to appoint an administrative receiver nor prevent the making of an administration order in relation to the charging company unless the security is granted in the context of the exceptions detailed in the Insolvency Act 1986, ss 72A–72H (relating to substantial capital market arrangements, public–private partnerships, certain utility project companies, urban regeneration project companies, large project companies, certain financial market charges, registered social landlords and certain water industry and railway companies). The reference to large project companies derives from s 72E which requires there to be a 'financial project' and 'step-in rights'. The mere right to appoint a receiver under a debenture will not constitute 'step-in rights' as defined by the Insolvency Act 1986, Sch 2A, para 6 (*Cabvision Ltd v Feetum*[8]).

The best now on offer to a debenture holder in the context of a general commercial transaction is the ability itself to appoint an administrator of the debenture holder's choosing where the debenture includes a 'qualifying floating charge'. The characteristics of a 'qualifying floating charge' are set out in the Insolvency Act 1986, Sch B1[9]. A floating charge will usually include wording expressly stating that it is a 'qualifying floating charge' for the purposes of these provisions. Provided the floating charge includes such language and relates to the whole or substantially the whole of the company's property (alone or with other such floating charges), the debenture holder will have the right to appoint an administrator.

1 [2005] UKHL 41, [2005] 2 AC 680.
2 Insolvency Act 1986, ss 40(2) and 175(2)(b).
3 Insolvency Act 1986, s 176ZA and see para **9.49** below.
4 Enterprise Act 2002, s 251 and Insolvency Act 1986, Sch 6.
5 Insolvency Act 1986, s 176A and Insolvency Act 1986 (Prescribed Part) Order 2003 (SI 2003/2007) and see para **1.17** above.
6 [2001] UKPC 28, [2001] 2 AC 710.
7 Also in respect of security created since that date and falling within the limited categories described in the Enterprise Act 2002, s 249.
8 Reported as *Feetum v Levy* [2005] EWCA Civ 1601, [2006] Ch 585 (affirming *Feetum v Levy* [2005] EWHC 349 (Ch), [2005] 1 WLR 2576, [2006] 2 BCLC 102), an interesting attempt to drive a '(hackney) carriage and horses' through the limitations in the definition!
9 Para 14.

5.8 It is, nevertheless, still advisable to take fixed charges over as many assets as possible and a 'qualifying' floating charge over the remainder. Unfortunately, the law will not recognise a fixed charge over all the undertaking, property and assets of a company, it being held that as the parties intend the business to continue as a going concern, such a charge is in law a floating charge. Lindley LJ said in *Biggerstaff v Rowatt's Wharf Ltd*[1]: 'It would be impossible for companies to get credit to carry on business at all if arrangements between them and their creditors could not be made without the assent of the debenture-holders.' Sargant J put it this way in *Re Benjamin Cope & Sons Ltd, Marshall v Benjamin Cope & Sons Ltd*[2]:

> Floating charges appear to have originated through the Courts having recognised that companies may validly charge the whole of their undertaking and assets, and having given practical effect to such a charge. To treat such a security as constituting a specific charge on the property of the company at the date of the charge itself would paralyse the business of the company, since the assent of the chargee, or of the whole body of chargees, would then be necessary to any sale or other disposition of any part of the property of the company in the course of carrying on its business. And accordingly the Courts solved the problem by treating such a charge, not as being specific or fixed, but as being ambulatory and attaching to the property for the time being of the company at the time when the charge came to be enforced.

Any device which defeated the above rule would prejudice preferential creditors and might well be set aside as contrary to public policy. The temptation to draft an all-embracing fixed charge should be avoided! An automatic crystallisation clause will not assist as the Insolvency Act 1986, s 251 defines floating charge as 'a charge which, *as created*, was a floating charge'. Such a charge ranks behind preferential creditors[3].

1 [1896] 2 Ch 93 at 101, CA.
2 [1914] 1 Ch 800 at 805.
3 Insolvency Act 1986, ss 40(2) and 175(2)(b).

5.9 Customers will not always concede a full debenture to their bankers. Some companies require each project they undertake to be self-financing, and will limit the assets they charge to those acquired with the aid of the facility. The important thing is to identify precisely what is charged, and to assess whether it is independently viable should the security be enforced.

5.10 It was important to banks to be able to appoint an administrative receiver and thereby prevent the appointment of an administrator in order to retain control over the timing and realisation of their security. Administrators are answerable to the court and to creditors generally and will not be concerned to protect the debenture-holder unlike receivers whose purpose, although agent for the company, is to realise the security of their appointor to his best advantage (*Gomba Holdings UK Ltd v Homan*)[1]. As Evershed MR said in *Re B Johnson & Co (Builders) Ltd*[2]:

> . . . it is quite plain that a person appointed as receiver and manager is concerned, not for the benefit of the company but for the benefit of the mortgagee bank, to realise the security; that is the whole purpose of his appointment; and the powers which are conferred upon him . . . are . . . really ancillary to the main purpose

> of the appointment, which is the realisation by the mortgagee of the security . . . by the sale of the assets.

1 [1986] 3 All ER 94, [1986] 1 WLR 1301.
2 [1955] Ch 634 at 644, CA.

5.11 If a bank did not have a floating charge over substantially the whole of the company's assets and therefore could not appoint an administrative receiver, it may not have been able to prevent an administration order being made. Occasionally, however, it was in the interest of banks to acquiesce in an administration petition even if they could have appointed an administrative receiver. Such receivers have no power to challenge transactions at an undervalue or voidable preferences or to prevent enforcement of a prior security, equipment leases or retention of title and may not be recognised by foreign jurisdictions in which the company has assets.

5.12 Apart from charges, security may take the form of guarantees from other group companies (assuming they can properly give guarantees for the facility) or from the directors or controlling shareholders of the company. Guarantees from directors are often taken as a means of pressing them to co-operate should other security be enforced, but such guarantees do have the disadvantage that if the bank is paid out or given further security by the company within two years of the commencement of its winding up, such payment or security is presumed to be a voidable preference of the director guarantors. By the Insolvency Act 1986, ss 239 and 240, for persons 'connected' with the company the voidable preference period is extended from six months to two years and preference is presumed unless the contrary is shown.

5.13 Sometimes, the best the banker can negotiate is some form of negative pledge, agreement for postponement of debt or comfort letter. These have relatively little value. Negative pledges are not registered (unless they are themselves contained within a registrable security instrument) and it would be difficult to prove that a subsequent debenture-holder was aware of their existence. Agreements for postponement of debt have some significance (discussed further in **CH 19**), but there are many ways open to a parent company of 'milking' its subsidiaries. Comfort letters vary in strength, from a mere acknowledgement of awareness of the subsidiary having borrowed, to a representation that it will repay the indebtedness. Such letters are discussed at the end of **CH 13** and should in all cases be treated with the utmost caution.

5.14 Primarily for the reasons discussed in para **5.7** above, however, it is still good practice to obtain a 'qualifying floating charge' where possible.

THE FACILITY LETTER: SPECIMEN

5.15 The following is a specimen facility letter for overdraft and loan facilities granted to a parent company against a debenture over all its assets, and a guarantee from one of its subsidiaries supported by a legal charge over a specified property, and a charge over shares from time to time deposited with the bank. It is not in particularly short form as brevity is not really appropriate where security is taken. Clearly, endless variations are possible depending on the terms agreed.

For the Attention of Mr . . . . . .

. . . . . p.l.c.,

[address]

. . . . . 20 . . .

Dear Sirs,

£500,000 Overdraft and £1.5m Loan Facilities

We, ... Bank Plc, are pleased to offer you an overdraft facility up to a maximum of Five Hundred Thousand Pounds Sterling (£500,000) at any one time outstanding ('the Overdraft Facility') and a loan facility of One Million Five Hundred Thousand Pounds Sterling (£1.5m.) ('the Loan Facility') on the terms and conditions set out below.

Amounts borrowed under the Overdraft Facility are repayable on demand. This facility will be reviewed on . . . . . .

1. *Definitions*

In this letter:

1.01 'Banking Day' means a day on which banks in London are open for banking business generally.

1.02 'Borrowings' means all moneys borrowed raised or secured by you or any of your subsidiaries or subsidiary undertakings (except to the extent already brought into account as Borrowings and excluding obligations owing to you or your wholly owned subsidiaries) including but not limited to all liabilities under any bond note debenture commercial paper or similar instrument or in respect of acceptance credits, bills, discounted instruments documentary or other credits guarantees or indemnities or liabilities otherwise incurred to discharge the obligations of any third party or for the payment of money under any time purchase credit sale conditional sale leasing debt purchase factoring and like agreement.

1.03 'Consolidated Current Assets' and 'Consolidated Current Liabilities' mean the aggregate current assets and the aggregate current liabilities respectively on a consolidated basis as shown in your latest available audited consolidated balance sheet from time to time adjusted if we shall so require to reflect any changes in accounting policy subsequent to the Facility Letter or material adverse changes in assets or liabilities on a consolidated basis provided always that the expression 'Consolidated Current Liabilities' shall be deemed to include all Borrowings of you and your subsidiaries and subsidiary undertakings payable on demand or due and payable within one year of the date of calculation.

1.04 'the Debenture' means the Debenture referred to in paragraph 8.01(a).

1.05 'the Facilities' means the Overdraft Facility and the Loan Facility.

1.06 'the Guarantee' means the guarantee referred to in paragraph 8.01.

1.07 the 'Guarantor' means . . . . . .

1.08 'Loan' means the aggregate principal amount borrowed and from time to time outstanding under the Loan Facility.

1.09 'the Security' means the Debenture the Guarantee and all other security referred to in paragraph 8.01.

1.10 'subsidiaries' and 'subsidiary undertakings' shall have the meaning ascribed to them by the Companies Act 2006, ss 1159 and 1162 and Schedules 6 and 7 respectively.

The Overdraft Facility

2. *Interest*

2.01 Interest will be payable on the cleared daily balance up to actual payment (as well after as before judgment) at a rate of . . . per cent per annum over . . . . Base Rate from time to time with a minimum of . . . 4 per cent per annum. Such interest will accrue from day to day and be calculated on the basis of the actual number of days elapsed and a 365 day year. Interest will be debited to your Current Account quarterly in arrears on . . . . . in each year and on final repayment. At present our Base Rate is . . . per cent per annum and any changes will be announced.

The Loan Facility

3. *Drawdown*

3.01 You may draw the Loan in not more than . . . tranches on or before . . . . . 20 . . . when any undrawn portion shall lapse. You must give us notice in writing or by telex on the previous Banking Day of the amount you require and the interest period selected in accordance with paragraph 4.01. Each tranche must be a whole multiple of £. . . . . with a minimum of £ . . . . . and must be drawn down on a Banking Day. Each drawing is subject to prior fulfilment of all terms and conditions in this Facility Letter.

3.02 No later than one Banking Day prior to the end of each interest period you will notify us in writing or by telex of the next interest period you select failing which such period shall be three months.

3.03 Every notice under this paragraph is irrevocable and shall be signed by duly authorised signatories in accordance with the Bank Mandate you have given to us.

4. *Interest Periods*

4.01 An interest period in relation to any tranche must be a period of one, three or six months (as selected by you) or such other period as may be agreed between us save that:

(a) The first interest period for any tranche shall commence on the date of drawing such tranche and each subsequent interest period relating to that tranche shall commence forthwith upon expiry of the previous interest period;

(b) Not less than one month prior to each date for repayment an interest period shall be selected to end on such date for tranches at least equal to the repayment then falling due; and

(c) If any interest period would otherwise end on a day which is not a Banking Day that interest period shall be extended to end on the next

liability until the bank receives payment in full in the currency in which such liability was incurred, and that if there is a deficiency, the bank shall have a further right to recover the shortfall.

If the liability is in a strong currency and sterling is collapsing against it, the bank will wish to have the right following an event of default to purchase currency to cover the liability at the spot rate of exchange then prevailing notwithstanding that the security might not then have been realised. Unless express power is given to do this, the customer could contend that conversion should have been delayed until a more favourable rate of exchange was available notwithstanding that so to delay was a gamble no prudent banker would willingly take.

[1] [1976] AC 443, [1975] 3 All ER 801, HL.

10.28 The specimen documents in Part IV contain a number of miscellaneous clauses, most of which are self-explanatory. The certificate that the execution of the debenture does not contravene the provisions of the memorandum and articles of association of the company is inserted so that the debenture can be registered at the Land Registry in respect of registered land owned by the company.

10.29 In the absence of a notice clause, the service of notices is governed by the Law of Property Act 1925, s 196. Section 196(5) does envisage that a contrary intention may appear from the instrument. In the absence of a contrary intention, the notice is sufficiently served if left at the last known place of abode or business in the United Kingdom of the person to be served, or if sent by registered letter addressed to the person to be served at such place of abode or business provided the letter is not returned undelivered through the post office. Service by post is deemed to be made at the time at which the registered letter would in the ordinary course be delivered.

10.30 The debentures in Part IV are recommended to be executed as deeds. Only if they are deeds do the statutory powers contained in the Law of Property Act 1925, s 101, arise or will an effective legal charge be created. Security documents which are signed but not deeds create equitable charges, but the assistance of the courts may be required to enforce them (*Re Fireproof Doors Ltd*[1]).

[1] [1916] 2 Ch 142.

10.31 It is usual expressly to exclude the operation of the Law of Property Act 1925, s 93 which would otherwise restrict the bank's right to consolidate mortgages and allow the mortgagor to redeem one mortgage without paying sums due under another mortgage thereby leaving the bank exposed to the risk of a shortfall under that other mortgage. In addition, the restrictions arising pursuant to the Law of Property Act 1925, s 103 on the exercise of mortgagee's statutory power of sale should be excluded.

Chapter 11

ENFORCEMENT

11.1 Security documents under deed confer four principal remedies, namely:

(a) a power of sale,
(b) a power to appoint a receiver of the assets charged,
(c) a right to take possession[1] of such assets (save that under the Administration of Justice Act 1970, s 36, the court may suspend a possession order in respect of a dwelling house if 'the mortgagor is likely to be able within a reasonable period to pay any sums due under the mortgage or to remedy a default consisting of a breach of any other obligation arising under or by virtue of the mortgage'), and
(d) a right of foreclosure (or in other words, to forfeit the asset charged) with the leave of the court.

There are, in addition, sundry ancillary powers referred to below which should be supplemented by express powers conferred by the charge. A lender who holds a 'qualifying floating charge' will have the right to appoint an administrator in respect of the company that created the charge (see paras **6.45** and **11.56** et seq).

[1] *National Westminster Bank plc v Skelton* [1993] 1 All ER 242, [1993] 1 WLR 72, CA.

11.2 In practice, banks normally only resort to the first two remedies and only obtain a possession order so that they can sell the asset. If a mortgagee takes possession, he becomes accountable for what he might have received but for his negligence or wilful default (*White v City of London Brewery Co*[1]) and for loss due to alterations which reduce the value of the property. Moreover, the mortgagee in possession must take reasonable steps to protect the premises from vandalism and damage. He is liable to account strictly upon the basis of managing the property with due diligence (*Noyes v Pollock*[2]).

The duty to account was summarised by Lord Esher MR in *White v City of London Brewery Co* as follows[3]:

> Now they are bound to account to him over the sale – for the proceeds of the sale – for any rents which they have received, or but for their wilful neglect or default might have received, from the property while they were in possession – and for any profits, during that period, they made out of and by managing the property. They have not to account for anything more, and as against that they are entitled to set the expenses which they have fairly incurred in consequence of having been obliged to take possession, and keep possession, and to sell. They have a right to set off against the rents and profits they have received, any rents they have been obliged to pay (in as much as this was leasehold property), and any insurance they were obliged

> to pay, and anything else which was an expense put upon them by reason of their being obliged to take and keep possession – expenses which they were obliged to incur in order to receive the rents and profits which they are to account for.

If a mortgagee in possession allows a property to remain vacant which might have been let, he is personally liable to pay the occupation rent. Moreover, a mortgagee in possession must get no advantage out of the mortgage beyond payment of the principal interest and costs secured by it, though the suggestion that the brewery should account for profit on its beer sold through the premises was dismissed contemptuously in the above case[1]. Possession of land may also run the risk of rendering the mortgagee liable for environmental damage and clean-up costs, this being a concern that has increased in recent years. These responsibilities are avoided if the bank appoints a receiver who is the agent of the company until the company is ordered to be wound up or goes into voluntary liquidation. Thereafter the receiver remains independent of the bank though accountable to it (*Gosling v Gaskell*[4]) unless the bank constitutes him its agent (*American Express International Banking Corpn v Hurley*[5]). Banks should avoid taking possession themselves or liaising with the receiver so constantly as to constitute him their agent.

A further disincentive to a mortgagee taking possession of mortgaged property now exists in the case of shares. By virtue of the Pensions Act 2004, a bank or other mortgagee who controls the exercise of voting rights in relation to shares in a company may render itself liable to contribute to any deficit in a pension scheme operated by a member of the group of which that company is a part.

1 (1889) 42 Ch D 237, CA.
2 (1885) 30 Ch D 336, CA.
3 (1889) 42 Ch D 237 at 243, CA.
4 [1897] AC 575.
5 [1985] 3 All ER 564.

11.3 The remedy of foreclosure is discretionary and will only be ordered by the court if the loan outstanding exceeds the value of the security. The borrower is usually given six months to redeem the loan before an order nisi is made absolute and the foreclosure becomes effective. Once a foreclosure order absolute has been made, the bank can no longer sue the borrower on the personal covenant save upon terms that the foreclosure is reopened. Similarly, the foreclosure will bar any remedies against a guarantor because if the guarantor had discharged the debt, he would have had rights barred by the foreclosure.

Only rarely have banks instituted foreclosure proceedings in recent times, largely no doubt because they have no ambition to own the assets charged to them. The remedy can be of value if the assets may subsequently increase in value, but it is not favoured by most banks which look upon it as confiscatory. The court has an inherent jurisdiction to reopen a foreclosure if in special circumstances relief appears to be due to the mortgagor (*Campbell v Holyland*[1]).

1 (1877) 7 Ch D 166 at 172-174.

DEMANDS

11.4 It has been said that a power to sell without notice is oppressive. Demand should always be made and notice given before a power of sale is exercised or a receiver appointed. Notice should be given not only to the borrower but to any subsequent mortgagee known to the bank.

In *Miller v Cook* Sir John Stuart V-C said[1]:

> In the present case, besides the other objections to the contract, the terms of the power of sale are oppressive, and put the plaintiff completely at the mercy of the defendant. The power to sell without any notice to the plaintiff enabled the defendant at any moment to extinguish the right of redemption.

1 (1870) LR 10 Eq 641 at 647.

11.5 There is authority that a demand can be still effective even if it overstates the amount due but the Court of Appeal rejected the demand in *Cryne v Barclays Bank plc*[1] even though the excess over the facility limit was payable on demand. A notice demanding payment of an excessive amount was also held to be bad in *Pigot v Cubley*[2].

A minor error in the amount due will *not* invalidate a demand. Cozens-Hardy MR in *Stubbs v Slater*[3] quoted from his earlier judgment in *Deverges v Sandeman, Clark & Co* where he had said[4]:

> Although a mistake as to the amount due may destroy the effect of the notice, as between pledgor and pledgee – *Pigot v Cubley*[2] – I think that is not the law as between mortgagor and mortgagee. In order to restrain a mortgagee from selling, in the absence of fraud, it is not sufficient to contest the amount due on the mortgage. The mortgagor must pay into Court, or tender to the mortgagee, the amount claimed to be due.

Buckley LJ in *Stubbs v Slater* put it this way[3]:

> If a mortgagee is going to exercise his power of sale he may say to the mortgagor 'pay me what you owe me; if not I will sell'. *It is not for him to name the amount due.* If the mortgagor asks what the amount is and the mortgagee states it, the mortgagor must come with that amount, otherwise the mortgagee may sell . . . . Suppose a mistake has been made as to the amount, the power of sale is nonetheless exercisable.

The position was reviewed in *Bank of Baroda v Panessar*[5] where the demand was served for 'all monies due to us' without specifying the amount demanded. Walton J held this to be a valid demand and said:

> I cannot see any reason why the creditor should not do precisely what he is, by the terms of his security, entitled to do, that is to say to demand repayment of all moneys secured by the debenture. . . . it would seem stupid that the creditor could put in, without imperilling the validity of the notice, an entirely wrong sum, and that is much more likely to give rise to confusion and difficulty than is the form of the notice adopted in . . . the present case. Indeed, it is quite clear that knowledge of the precise amount of the sums outstanding is only required in the exceptional case, because in most cases (as in the present case) the debtor has no real means whatsoever of paying off the sum which is due, and it would seem to be idle to put the creditor to what might be very considerable expense in ascertaining the precise amount due when there is no likelihood that the sum will represent a realistic target at which the debtor can aim. If, on the contrary, the debtor is in a position to pay

off the sum demanded and wishes to know the exact and precise sum, he can communicate with the creditor and ask the creditor what sum he is expecting to be paid.

Notwithstanding the above, it is good practice to demand a stated sum to avoid delay should the debtor enquire the amount due.

The position in relation to statutory demands under the Insolvency Rules 1986, r 6.1 was reviewed by the Court of Appeal in *Re a Debtor (No 1 of 1987, Lancaster)*[6]. Similar principles probably apply to all forms of demand. Nicholls LJ said [1989] 1 WLR at 279:

> The court will exercise its discretion on whether or not to set aside a statutory demand, having regard to all the circumstances . . . There may be cases where the terms of the statutory demand are so confusing or misleading that, having regard to all the circumstances, justice requires that the demand should not be allowed to stand. There will be other cases where, despite such defects in the contents of the statutory demand, those defects have not prejudiced and will not prejudice the debtor in any way, and to set aside the demand in such a case would serve no useful purpose. For example, a debtor may be wholly unable to pay a debt which is immediately payable, either out of his own resources, or with financial assistance from others. In such a case the only practical consequence of setting aside a statutory demand would be that the creditor would promptly serve a revised statutory demand, which also and inevitably would not be complied with. In such a case the need for a further statutory demand would serve only to increase costs. Such a course would not be in the interests of anyone.

The judge concluded that if a statutory demand is served in an excessive amount or is otherwise defective, the court will be alert to see whether those mistakes have caused or will cause any prejudice to the debtor. If there has been prejudice, he observed that the bank would only have itself to blame if the court set aside the demand.

The above case was followed in *Re a Debtor (No 51/SD/1991 ex p Ritchie)*[7] Morritt J declined to set aside a statutory demand which overstated the amount of the debt in US dollars and failed to specify that payment would be accepted in its sterling equivalent at the date of payment. At [1992] 1 WLR 1302, he expressed the test for setting aside a demand in these words:

> The fact that the creditor could have got the demand right but did not seems to me to be irrelevant to the true question of whether the errors would cause injustice to the debtor if the statutory demand were not set aside.

The view of the writer, particularly in view of the continuing lack of definitive guidance from the courts on this point, is that if a bank demands materially more than is due to it, it is at risk that the borrower will refute the wrongful demand[8]. Banks are well advised to omit disputed items in serving demand prior to enforcing security. Such items can always be claimed at a later stage. The purpose of serving the demand is to cause the enforcement powers to arise; the prospects of the demand being met may well be remote!

If a demand becomes stale, it may be contended that it has been waived and a fresh demand should be served.

1 [1987] BCLC 548, CA.
2 (1864) 15 CBNS 701.
3 [1910] 1 Ch 632, CA.
4 [1902] 1 Ch 579 at 597, CA.

5 [1987] Ch 335, [1986] 3 All ER 751.
6 [1989] 2 All ER 46, [1989] 1 WLR 271, CA.
7 [1993] 2 All ER 40, [1992] 1 WLR 1294.
8 See *Cryne v Barclays Bank plc* [1987] BCLC 548, CA and *Re a Company* [1985] BCLC 37 at 41-43 but see: Lightman and Moss, *The Law of Administrators and Receivers of Companies* (4th edn, 2007), Sweet & Maxwell, para 6-030.

11.6 As pointed out in **CH 7**, demands should always be served in normal banking hours and time allowed to enable the person served to draw the necessary funds unless he concedes any attempt to do so would be futile. A demand on a company should be addressed to the company as such, not to any particular officer, and be served in accordance with the notice clause in the security document. No officer will have authority to concede that the company cannot meet the demand unless a valid resolution has been passed requesting the bank to appoint a receiver (see para **7.8**). Detailed requirements as to service of statutory demands are set out in the Insolvency Rules 1986, r 6.3.

Demand on a borrower: specimen

11.7 The following is an example of a demand on a borrower.

[Name and address] . . . . . 20 . . .

Dear Sirs,

£. . . . . *Loan Facility*

We refer to our facility letter dated. . . . . , 20 . . . [as subsequently amended].

Having regard to your inability to meet your liabilities and your request to us to appoint an Administrator/a Receiver [or specify event of default], we hereby make formal demand for payment forthwith of the sum of £. . . . . [. . . . . United States dollars or the sterling equivalent at the date of payment] now due (being the principal sum of £. . . . . together with interest of £. . . . . accrued up to . . . . . , 20 . . .).

Interest will continue to accrue at the rates specified in the facility letter until payment.

We further give you notice that failing payment of the above sum to us [forthwith], we reserve the right without further notice to exercise the power to appoint an administrator in respect of yourselves/an administrative receiver/a receiver over your undertaking property and assets, the power of sale and all other powers conferred on us by law or by the Debenture dated. . . . . , 20 . . . and made between [parties] or by any other mortgage, charge or security created by you in our favour.

This demand is without prejudice to and shall not be construed as a waiver of any other rights or remedies which we may have including without limitation the right to make

further demands in respect of sums owing to us.

Yours faithfully,

For and on behalf of

[Bank]

. . . . . .

It was held in *Re a Debtor (No 51/SD/91) ex p Ritchie*[1] that there is no requirement to state the sterling equivalent in a statutory demand. A demand will only be set aside if the errors would constitute an injustice to the debtor. However, creditors are well advised to exercise care in formulating demands in order to minimise disputes.

1 [1993] 2 All ER 40, [1992] 1 WLR 1294.

11.8 Before making demand, the security position should be reviewed and an attempt made to remedy any deficiencies. The length of notice required before the powers of enforcement arise will depend on the drafting of the security document. The court may consider it oppressive to act too precipitately unless there is good reason to do so but, as can be seen from *RA Cripps & Son Ltd v Wickenden*[1], speedy action can be taken if the demand is served within banking hours or where the debtor makes clear that funds are not available to himself (*Sheppard and Cooper Ltd v TSB Bank plc*)[2].

1 [1973] 2 All ER 606, [1973] 1 WLR 944.
2 [1996] 2 All ER 654.

11.9 Before demand is made on a guarantor, demand must first have been served on the principal debtor within normal banking hours and time allowed for him to meet it. Demand on the guarantor can then be for the sum demanded from the principal debtor unless the guarantee imposes a lower limit.

Demand on a guarantor: specimen

11.10 The following is an example of a demand on a guarantor.

[Name and address] . . . . . 20 . . .

Dear Sirs,

. . . . . *Limited/p.l.c. ('the Borrower')*

By a Guarantee dated. . . . . , 20 . . . you guaranteed payment on demand of all moneys and the discharge of all obligations and liabilities then or at any

time thereafter due owing or incurred to us by the Borrower [with a limit on the amount recovered from you of the principal sum of £. . . . . with interest and costs in manner more particularly set out therein].

We have to inform you that on . . . . . , 20 . . . we made formal demand on the Borrower for payment forthwith of the sum of £. . . . . [. . . . . United States dollars or the sterling equivalent at the date of payment] now due (being the principal sum of £. . . . . together with interest of £. . . . . accrued up to . . . . . , 20 . . .). No payment has been received by us from the Borrower following such demand.

Accordingly, we hereby make formal demand on you for payment forthwith of the said sum of £. . . . . [. . . . . United States dollars or the sterling equivalent at the date of payment] now due. Interest will continue to accrue until payment as indicated in the Guarantee.

We further give you notice that failing payment of the above sum to us forthwith, we reserve the right without further notice to exercise the power to appoint an administrator in respect of yourselves/an administrative receiver/a receiver over your undertaking property and assets, the power of sale and all other powers conferred on us by law or by the Debenture dated. . . . . 20 . . . and made between [parties] or by any other mortgage charge or security created by you in our favour.

This demand is without prejudice to and shall not be construed as a waiver of any other rights or remedies which we may have including without limitation the right to make further demands in respect of sums payable to us by you under the Guarantee or otherwise.

Yours faithfully,

For and on behalf of

[Bank]

. . . . . .

APPOINTMENT OF JOINT ADMINISTRATIVE RECEIVERS: SPECIMEN

11.11 It must, of course, be remembered in considering the following discussion that while provisions relating to receivership generally are still relevant to all security, an administrative receiver may only be appointed pursuant to debentures or other floating charges over all or substantially all of the assets of the chargor granted before 15 September 2003 or in relation to the specific excepted categories set out in the Insolvency Act 1986, ss 72A–72H (capital market arrangements, public private partnerships, project companies, protected railway companies and utility companies and registered social landlords).

Once demand has been duly served, a receiver (or preferably two partners in the same firm) can be appointed as follows.

Appointment of joint administrative receivers

. . . . . **Limited/p.l.c. ('the Company')**

We, ... p.l.c. whose registered office is at . . . . . , being the registered holder of a Debenture dated . . . . . , 20 . . . ('the Debenture') and made between . . . . . Limited (1) and ourselves (2) pursuant to the power conferred on us by the Debenture and of every power enabling us so to do DO HEREBY APPOINT . . . . . and . . . . . both of . . . . . , Insolvency Practitioners to be joint administrative receivers of all the undertaking property and assets of the Company charged by the Debenture upon the terms and with all the powers conferred by the Debenture or by law and so that either of such joint administrative receivers may exercise any such power independently of the other.

Dated this. . . . . , 20 . . .

Signed by [authorised signatory], who is empowered to appoint pursuant to the Debenture, in the presence of:

Witness
Name and address of witness

Written acceptance of appointment by receiver

Rule 3.1

(TITLE)

(a) Insert name and address of person making appointment	To: (a)
(b) Insert full name and address of appointee	(b) hereby accepts appointment as receiver of
(c) Insert name of company	(c)
(d) Insert date	in accordance with the instrument of appointment received on (d)
(e) Insert time	at (e) . . . . . hours

Date: . . . . . .
Time: . . . . . hours
Signed: . . . . . .
Name of signatory: . . . . . .
(BLOCK LETTERS)
(by or on behalf of the appointee)

The above is a statutory form of acceptance of appointment contained in

Part 4 of the Schedule to the Insolvency (Amendment) Rules 1987[1].

1 SI 1987/1919.

11.12 By the Law of Property Act 1925, s 109(1), the appointment of a receiver can be in writing rather than by deed. It was held in *Phoenix Properties Ltd v Wimpole Street Nominees Ltd*[1] that the power of attorney contained in the debenture is effective as far as the receiver is concerned even if the receiver is appointed under hand. Assuming the powers contained in the Insolvency Act 1986, Sch 1 as modified by the debenture are adequate, the receiver may never need to exercise the power of attorney, and in practice many receivers are appointed under hand only. The power of attorney in favour of the receiver (but not that in favour of the bank) will in any event be revoked by a winding-up order or by a resolution for voluntary winding up (*Barrows v Chief Land Registrar*[2]).

1 [1992] BCLC 737.
2 (1977) Times, 20 October.

11.13 The appointment of a receiver is of no effect unless accepted by the receiver or his duly appointed representative before the end of the business day next following that on which it was received[1]. Unless the acceptance is in writing, it must be confirmed in writing within five business days stating both the time and date of receipt of appointment and of acceptance[2]. Subject to being so accepted, the appointment is deemed to be made when the instrument of appointment was received by or on behalf of the receiver[1].

1 Insolvency Act 1986, s 33 and Insolvency Rules 1986, r 3.1(2) and (3).
2 Insolvency (Amendment) Rules 1987 (SI 1987/1919), Sch, Pt 1, para 23.

RECEIVERS

11.14 A receiver should seek legal advice concerning the validity of the debenture under which he is appointed, the validity of his appointment, the extent of the assets charged and of the powers vested in him by virtue of his appointment. He will also need to consider the powers of the company under its memorandum of association, for the company will not have been able to authorise him to conduct as its agent any acts ultra vires the company itself.

If a receiver acts outside the powers vested in him or the security is invalid, he will be accountable as a trespasser and the liability could be serious. However, the extent of such liability in the context of the tort of interference with contractual relations may be limited (requiring either procuring a breach of contract in a manner which creates accessory liability or intentionally causing loss by unlawful means) and there can be no tort of conversion committed by an invalidly appointed receiver in respect of choses in action (*OBG Ltd v Allan*[1]). If the company and its shareholders or directors do not protest at the appointment they (but not necessarily a future liquidator) may be estopped from doing so later (*Bank of Baroda v Panessar*[2]).

The court has power to order the debenture-holder to indemnify the receiver against the consequences of an invalid appointment under the Insolvency Act 1986, s 34. Moreover, an administrative receiver (where one may still be

Chapter 14

LAND

14.1 The use of printed forms obscures the fact that property differs widely in its nature and that security documents should reflect the nature of the asset charged. There are, of course, certain basic requirements referred to below, but the covenants which are appropriate will vary considerably according to whether the property is a private house, a factory, a hotel or agricultural land.

14.2 Some special cases do force their attention on bankers and obtain individual treatment. A town-centre developer may be able to offer as security little more than an agreement for a building lease only capable of being charged by an equitable charge. As the agreement for a lease will usually contain an absolute prohibition against assignment, the consent of the landlord will be required and notice of the charge must be given to him failing which, on completion of the works, the lease might be granted without any reference to the bank which would then lose its security!

Security taken in such a simplistic form is in practice of little value. If the developer runs into difficulties before the building is completed, the landlord will have the right to terminate the agreement and repossess the site leaving the bank without security. If, therefore, the development is dependent on bank finance, the bank should insist on a tripartite agreement with the landlord whereby in the event of default by the customer, it has the right within a defined time scale to step in and arrange for another responsible contractor to finish the project and whereby the landlord agrees not to grant the lease without the prior written consent of the bank (such consent being dependent on the bank being satisfied that the lease is properly charged to it).

14.3 A builder who specialises in developing housing estates has special requirements in that it is essential for there to be an easy release procedure as plots are sold. The bank may be asked to rely on an equitable as opposed to a legal charge in such circumstances. The bank will need to ensure that it can identify what is charged to it, to be satisfied that it has all necessary rights of way, drainage and other easements to the land charged, and in the event of default, power to appoint a receiver with adequate powers to complete the development (if this is commercially appropriate).

14.4 The Cork Report on Insolvency Law Reform pointed out the undesirability of taking a charge solely over a specific asset (such as a factory) because this hampers the sale of the business as a going concern. Accordingly, the Insolvency Act 1986, 'old' ss 10 and 11, where still applicable, preclude steps being taken to enforce security except with the leave of the court once a petition for an administration order is presented. These provisions are now

mirrored in the Insolvency Act 1986, Sch B1, paras 43 and 44 whereby the consent of the administrator or the permission of the court is required to enforce security whilst the charging company is in administration. This reform materially weakens the security value of a legal charge, the policy being to assist the preservation of businesses as going concerns notwithstanding that the mortgagee may be fearful that the value of his property will fall. Equally, both an administrator and, where still relevant, an administrative receiver are empowered to apply to the court for leave to sell properties over which there is a prior legal charge, whether the mortgagee wishes to do so or not, by the Insolvency Act 1986, ss 15(2) (and see now Sch B1, para 71) and 43. These matters are dealt with more fully in **CH 6**.

14.5 Apart from such reforms, if a charge is taken over a factory or a building site which does not extend to plant machinery and other assets essential to carry on operations, the bank will be unable to realise the business to best advantage. A debenture should always be sought from a corporate chargor though this will not in itself resolve the problem if the main underlying asset is an agreement for a building lease, a valuable contract, a film, intellectual property, a ship or an aircraft. In such cases, the security should comprise both a debenture and a specific charge over the special asset.

14.6 Specific charges over land are primarily appropriate for individuals charging a house or farm, individual small traders – such charges being materially weaker from a security point of view than a debenture from a corporate customer – and developers charging a specific project. In this latter case, there would be much merit in transferring all assets from time to time connected with the project into a new subsidiary and taking a full debenture from it in order to be able to prevent the company entering administration (in the case of a 'project company' within the Insolvency Act 1986, s 72E) or, in other cases, at least to retain the ability to appoint an administrator.

EQUITABLE CHARGES

14.7 A full legal charge (by which, strictly speaking, is meant a charge by way of legal mortgage) created by deed and duly registered is the strongest form of security over land. If the security has to be enforced, title under a properly-drawn legal charge can be made quickly and without complication.

However, banks do from time to time lend against equitable charges if the customer objects to creating a full legal charge. Equitable charges come in a variety of strengths: from a memorandum of deposit under seal (and executed by both bank and chargor) containing a power of attorney and protected by registration of a notice of deposit at the Land Registry (or in the case of unregistered land, by possession of the deeds), which is an effective and enforceable form of security; to an informal deposit of documents with some form of memorandum under hand, signed on behalf of both bank and chargor incorporating all the agreed terms in order to comply with the Law of Property (Miscellaneous Provisions) Act 1989, s 2, which does little more than evidence that the documents are charged rather than deposited for safe custody. Such a deposit can only be enforced with the assistance of the court and is highly vulnerable unless properly protected by registration (see *Re Wallis and Simmonds (Builders) Ltd*[1]). Where deeds are deposited by way of charge by a

company but no charge is registered at the Companies Registry, the lien of the bank on the deeds will merge in the void charge and the bank will be ordered to hand the deeds over to the liquidator (*Re Molton Finance Ltd*[2]).

1 [1974] QB 94, [1974] 1 All ER 561.
2 [1968] Ch 325, [1967] 3 All ER 843, CA.

14.8 The Law of Property (Miscellaneous Provisions) Act 1989, s 2 is set out in **CH 3** and prevents effective equitable charges being created by the mere deposit of title deeds[1]. In *Re Alton Corpn*[2], Megarry V-C summarised the basis of equitable charges (created prior to 27 September 1989) as follows:

> . . . I have to remember that the basis of an equitable mortgage is the making of an agreement to create a mortgage, with the deposit of the land certificate . . . ranking as sufficient acts of part performance . . . . But some contract there must be. Furthermore, the creation of a mortgage is a significant transaction, and the courts ought not to be ready to infer that such transactions have taken place save on adequate grounds.

He then held that on the facts the property was not intended to be security for the loan.

1 See, in particular: *United Bank of Kuwait plc v Sahib* [1997] Ch 107, CA (discussed in para **3.47**).
2 [1985] BCLC 27 at 31–32.

14.9 A charge by deed confers the statutory powers of sale and to appoint a receiver and the other ancillary powers contained in the Law of Property Act 1925, s 101. These powers are invariably extended by the charge itself. The problem with an equitable mortgage is the difficulty of obtaining power to convey the legal estate (without which a purchaser will not proceed) and it is this that makes it desirable to include a power of attorney in a deed. The subject is discussed more fully in para **10.23**.

LEGAL MORTGAGES

14.10 The Law of Property Act 1925, s 85(1), enacts:

> 'A mortgage of an estate in fee simple shall only be capable of being effected at law either by a demise for a term of years absolute, subject to a provision for cesser on redemption, or by a charge by deed expressed to be by way of legal mortgage . . . .

Such a charge must be by deed (as to which, see **CH 3**). A legal mortgage enables the bank to exercise its remedies without applying to the court for assistance. In practice, there is no advantage in the somewhat artificial route of taking a demise for a long term of years with a proviso for redemption, and the better practice is to take a legal charge by deed. This is more in accord with commercial reality.

14.11 As pointed out in para **11.29**, it is essential for the legal charge to extend the statutory powers conferred by the Law of Property Act 1925 which are out of keeping with modern needs. In particular, the powers need to be made exercisable on failure to comply with a demand; any receiver appointed needs to be given wide powers, and the powers of leasing conferred on a mortgagor by s 99 of the Act need to be curtailed. The law of mortgages remains in need of reform and has been the subject of working papers nos 99 and 204 issued

by the Law Commission. Notwithstanding the recommendations of the Law Commission (made in 1991), the proposals made in those working papers for the replacement of security interests over land with standardised forms of 'formal' and 'informal' land mortgages have not been implemented.

14.12 Legal charges by individuals should contain a notice clause providing for the service of notices and demands notwithstanding the death of the mortgagor. The Law of Property Act 1925, s 196, does not cover the eventuality of the mortgagor being dead. It has been held in *Barclays Bank Ltd v Kiley*[1] that an express clause dealing with the position on death is effective.

1 [1961] 2 All ER 849, [1961] 1 WLR 1050.

14.13 A charge over land also includes fixtures. This subject is dealt with in para **8.4** et seq.

14.14 Apart from his other powers, a legal mortgagee has a right to take possession if the mortgagor defaults. However, a mortgagee in possession is liable to account strictly upon the basis of managing the property with due diligence (*Noyes v Pollock*[1]). For this reason, banks avoid taking possession and rely on their powers to sell or to appoint a receiver. Furthermore, the modern tendency to impose strict liability upon occupiers of land for certain forms of environmental damage and emissions and discharges from the land acts as a further powerful disincentive to taking possession.

In the case of a charge over a dwelling house, the right to possession is no longer absolute. By the Administration of Justice Act 1973, s 8, the court is empowered to refuse possession if the mortgagor is likely to pay what is due within a reasonable time but the existence of a counter claim by the mortgagor against the bank will not in itself suffice (*Citibank Trust Ltd v Ayivor*[2]). This protection extends to an endowment mortgage over a house securing a fixed sum for a fixed term (*Bank of Scotland v Grimes*[3]), but not to a mortgage securing an overdraft or other loan repayable on demand (*Habib Bank Ltd v Tailor*[4]). Further restrictions upon the mortgagee's right to obtain possession of a dwelling house arise where certain classes of tenancy to which the mortgagee's interest is not subject are in existence. These include an assured tenancy under the Housing Act 1988 and a protected or statutory tenancy under the Rent Act 1977[5].

1 (1885) 30 Ch D 336, CA.
2 [1987] 3 All ER 241, [1987] 1 WLR 1157.
3 [1985] QB 1179, [1985] 2 All ER 254, CA.
4 [1982] 3 All ER 561, [1982] 1 WLR 1218, CA.
5 Mortgage Repossessions (Protection of Tenants etc) Act 2010.

14.15 A mortgagee in possession is strictly accountable not only for what he has actually received but for what he might have received but for his own neglect (*White v City of London Brewery Co*[1], and see para **11.2**).

1 (1889) 42 Ch D 237, CA.

LEASES

14.16 In examining leases, particular attention should be paid to the following:

(a) Is there an absolute prohibition against assignment or charging? If so, the landlord could block any sale and the security will be of questionable value. However, the Landlord and Tenant Act 1927, s 19(1)(b), enacts that in a building lease granted for more than 40 years, any covenant against assignment, under-letting or parting with possession is invalid if the lease still has at least seven years to run provided notice is given to the lessor within six months of assignment.

(b) Does the lease contain an absolute prohibition against change of use, and if so, is the authorised use one for which there is a likely market?

(c) Is the lease liable to forfeiture on the appointment of a receiver? If it is, the bank must recognise that it will not be able to enforce its security by that means unless the landlord so agrees. It could exercise its power of sale and hive down the premises, but the landlord would be unlikely to consent to such an arrangement unless satisfied with the standing of the ultimate purchaser.

(d) If alterations have been carried out adapting the premises to the special requirements of the customer, is there an obligation to restore them to their original condition at the expiration of the lease?

(e) Is the rent review clause in an acceptable form? Are the reviews to take into account the existence of subsequent review dates?

(f) Are there any other onerous obligations on the lessee likely to affect the value of the premises? In particular, have the obligations to keep the premises in repair been complied with?

(g) Has the lessee underlet or allowed third parties into possession in breach of the terms of the lease?

The above list is not exhaustive, but it highlights sources of difficulty which arise in practice and which should be taken into account in valuing a lease. The bank as mortgagee can apply to the court for relief under the Law of Property Act 1925, s 146[1], but relief is dependent on the breach being remedied, and in the instances outlined above, confers little protection. An equitable mortgagee can obtain relief against forfeiture, however, an equitable *chargee* (such as the beneficiary of a charging order) cannot do so directly since a mere chargee is not entitled to possession of the property (*Bland v Ingrams Estates Ltd*[2]). A mere chargee must join the tenant into the proceedings and seek relief by way of an indirect claim effectively through the tenant[3]. To be able to proceed directly would otherwise have the consequence of forcing the landlord to accept a new tenant. Relief may be available to an equitable chargee in circumstances where s 138(9C) of the County Courts Act 1984 applies[4].

1 See as an example: *Escalus Properties Ltd v Robinson* [1996] QB 231, CA.
2 [2001] Ch 767, CA.
3 [2001] Ch 767 at 780-781, per Nourse LJ.
4 [2001] Ch 767 at 786-788 per Chadwick LJ and at 791 per Hale LJ.

AGRICULTURAL LAND

14.17 Schedule 14, para 12 to the Agricultural Holdings Act 1986 (and prior to that, Sch 7, para 2 to the Agricultural Holdings Act 1948), amended the Law of Property Act 1925 so that in respect of mortgages of agricultural holdings granted between 1 March 1948 and 1 September 1995, s 99 of the Law of Property Act 1925 applies notwithstanding any contrary intention expressed in the mortgage. The result is that the mortgagor retains power to grant a lease for up to 50 years at a rack rent. In relation to mortgages granted since 1 September 1995 this provision, obviously of considerable practical concern to lenders, applies only to a limited number of transitional cases by virtue of the Agricultural Tenancies Act 1995, s 4. Moreover, by the Law of Property Act 1925, s 152, if the lease granted is invalid, provided it was made in good faith and if the lessee has entered the premises, the lease takes effect in equity as an agreement for a valid lease subject to such variations as may be necessary in order to comply with the terms of the power of leasing.

Accordingly, for security purposes, agricultural land, at least in relation to existing mortgages granted before 1 September 1995, should be valued on the basis that it is let at a rack rent, any premium obtainable for vacant possession being disregarded.

HOUSES

14.18 In *National Provincial Bank Ltd v Ainsworth*[1] the House of Lords held that the rights of a deserted wife were personal only and did not run with the land. Accordingly, the wife could not resist a claim for possession by a bona fide mortgagee of the property.

Following the above decision, the Matrimonial Homes Act 1967 (subsequently, the Matrimonial Homes Act 1983 and now the Family Law Act 1996, s 31), was passed which allowed a spouse to protect their interest by registration of a class F land charge in the case of unregistered land or a notice under the Land Registration Acts in other cases. In practice, if a spouse has registered their interest, they will be asked to join in the charge. If the mortgage is made with the full knowledge and approval of the spouse, it will rank in priority to their beneficial interest (*Bristol and West Building Society v Henning*[2]). Such approval is implied for a new mortgage which replaces the original charge provided that the spouse's position is not adversely affected (*Equity and Law Home Loans Ltd v Prestidge*[3]).

1 [1965] AC 1175, [1965] 2 All ER 472, HL.
2 [1985] 2 All ER 606, [1985] 1 WLR 778, CA.
3 [1992] 1 All ER 909, [1992] 1 WLR 137, CA.

14.19 The problem area with houses is the spouse who contributed towards the purchase price of the home and claims an overriding interest by virtue of being in occupation. In the case of registered land, occupation constitutes an overriding interest irrespective of whether a third party has notice of it (*Blacklocks v JB Developments (Godalming) Ltd*[1]). Even in unregistered conveyancing, a mortgagee has constructive notice of the interests of occupiers. The rule extends not only to spouses but to all other persons in occupation. It is not always easy to discover who is in occupation, bearing in

mind they may be temporarily absent when the property is inspected. The Law of Property Act 1925, s 199(1) refers to such inspections 'as ought reasonably to be made'. In *Kingsnorth Finance Co Ltd v Tizard*[2], it was held that inspection on a Sunday afternoon by appointment with the husband was insufficient enquiry about who else might be in occupation.

It would seem that a bank or a building society can only safely take a charge over a house from a single owner if all persons in occupation who may possibly have contributed to the purchase price acquiesce and moreover do so without undue influence. Obtaining the formal waiver from all such persons of rights that they may otherwise have in priority to the lender by virtue of their occupation is now normal procedure. This practice arose from the decision in *Williams & Glyn's Bank Ltd v Boland* in which Lord Wilberforce said[3]:

> In the case of unregistered land, the purchaser's obligation depends upon what he has notice of – notice actual or constructive. In the case of registered land, it is the fact of occupation that matters. If there is actual occupation, and the occupier has rights, the purchaser takes subject to them . . . Given occupation, i e presence on the land, I do not think that the word 'actual' was intended to introduce any additional qualification, certainly not to suggest that possession must be 'adverse': it merely emphasises that what is required is physical presence, not some entitlement in law.

He then went on to hold that wives are in actual occupation within the meaning of the Land Registration Act 1925, s 70(1)(g)[4], and do have an overriding interest. He continued[5]:

> What is involved is a departure from the easy going practice of dispensing with enquiries as to occupation beyond that of the vendor and accepting the risk of doing so. To substitute for this a practice of more careful enquiry as to the fact of occupation, and if necessary, as to the rights of occupiers cannot, in my view of the matter, be considered as unacceptable except at the price of overlooking the widespread development of shared interests of ownership.

The relevant time for deciding who is in actual occupation of the property is the date the charge is created (being the date of completion rather than any earlier date on which the charge was executed prior to completion); it is immaterial that persons took up occupation after completion but prior to registration of the charge at HM Land Registry (*Abbey National Building Society v Cann*[6] and *Lloyds Bank plc v Rosset*[7]). It is nevertheless now common for lenders also to require that their consent be sought prior to any new person entering into occupation of mortgaged premises in order to obtain from them a waiver and formal agreement to postpone their rights to those of the lender.

However, the above rule only applies where the legal estate is vested in a single owner. In *City of London Building Society v Flegg*[8], Lord Templeman said.

> In *Williams & Glyn's Bank Ltd v Boland* . . . the interest of the wife was not overreached or overridden because the mortgagee advanced capital moneys to a sole trustee. If the wife's interest had been overreached by the mortgagee advancing capital moneys to two trustees there would have been nothing to justify the wife in remaining in occupation as against the mortgagee. There must be a combination of an interest which justifies continuing occupation plus actual occupation to constitute an overriding interest. Actual occupation is not an interest in itself.

He explained[9]:

Chapter 18

MONEY

18.1 A charge over a credit balance should be ideal security because of the ease with which it can be realised; though if the balance is held by a third party, such party may have rights of set-off (see paras **16.35** and **18.23**). Unfortunately, the Insolvency Rules 1986 and the decision in *Re Charge Card Services Ltd*[1] for some years introduced complications which have thankfully now largely been removed, in the former instance by clarification in the Court of Appeal and the House of Lords, followed by amendments to the Insolvency Rules 1986, and in the latter by the decision of the House of Lords in *Re Bank of Credit and Commerce International SA (No 8)*[2].

There are three circumstances where credit balances are frequently offered as security, namely: (a) as third-party security for the liabilities of another, (b) by a customer who deposits one currency to secure borrowings in another, and (c) by a customer as cover for a guarantee or bond given by the bank.

1 [1987] Ch 150, [1986] 3 All ER 289.
2 [1998] AC 214, HL.

18.2 In all three cases some doubt existed about set-off and it was therefore desirable to take a charge over the deposit (and if by a limited company to register it as a charge over a book debt at the Companies Registry[1]). The question of whether a bank deposit is technically a book debt so as to cause a charge over it to be registrable is dealt with in para **3.20**. Such a charge can cause difficulty, particularly if the depositor has given a negative pledge precluding it from creating security. The writer's view is that it will normally be possible to establish a sufficiently close connection between the deposit and the liability to give rise to equitable set off (see para **8.30**) if the deposit is made a term of the facility.

1 The Registrar of Companies announced following the *Charge Card* case (see para **18.29**) that he would no longer register charges over deposits in favour of the bank holding the deposit. The practice of City solicitors was nevertheless to continue to present such charges for registration in order to have the protection of the *Slavenburg* case (see para **3.27**). As will be seen below, the decision of the House of Lords in *Re Bank of Credit and Commerce International SA (No 8)* [1998] AC 214 has overridden the Registrar's previously held view (showing thereby the value of the practice in the intervening years!)

18.3 If the deposit secures the liabilities of a third party, there can only be a set-off if the third party security over the deposit incorporates a limited guarantee and the deposit is charged in support. Whether contingent liabilities

under a guarantee can be set-off is discussed further below (see para **18.11** et seq).

'BACK TO BACK' DEPOSITS

18.4 If cash is deposited to secure borrowing in a different currency, the question arises whether such cash can be converted into such currency and set off to eliminate or reduce the liability. This was not so in the past, but the law on foreign currency liabilities has developed rapidly since 1976.

18.5 In *Miliangos v George Frank (Textiles) Ltd*[1] the House of Lords recognised that an English court may give judgment in a foreign currency in the case of a monetary obligation to pay foreign currency under a contract, the proper law of which was that of a foreign country if the money of account was other than sterling. Lord Wilberforce indicated that the change in the previous rule that judgments could only be in sterling would enable the law to keep in step with commercial needs and with the majority of other countries. He explained[2] that the judgment could be in the foreign currency 'or the sterling equivalent at the date of payment' which he defined as the date when the court authorised enforcement of the judgment in terms of sterling.

Lord Wilberforce said[3]:

> Suggestions were made at the Bar that as regards such matters as set-off, counter-claim and payment into court, it would be difficult or impossible to apply. I would say as to these matters that I see no reason why this should be so: it would be inappropriate to discuss them here in detail . . . I have no doubt that practitioners, with the assistance of the Supreme Court, can work out suitable solutions . . .

The rules concerning conversion of foreign currency have been further explained in *Re Lines Bros Ltd*[4] and were dramatically illustrated by the result of *A-G (Ghana) v Texaco Overseas Tankships Ltd*[5].

1 [1976] AC 443, [1975] 3 All ER 801, HL.
2 [1976] AC 443 at 468, HL.
3 [1976] AC 443 at 469, HL.
4 [1983] Ch 1, [1982] 2 All ER 183, CA.
5 [1994] 1 Lloyd's Rep 473, HL.

18.6 In *Choice Investments Ltd v Jeromnimon*[1] the Court of Appeal held that a credit balance in United States dollars could be garnisheed, the amount to be stopped being such amount of United States dollars as would, at the buying rate of sterling at the time of the stop order, realise the amount of the sterling judgment.

Lord Denning MR said[2]:

> In my opinion the word 'debts' covers sums in this country payable in a foreign currency . . . This is a very desirable state of the law, especially now that exchange controls have been removed. Otherwise a debtor, who owes to his creditor the debt payable in sterling (but who has a credit in sterling at his bank), could always avoid execution by the simple device of changing his credit at the bank out of sterling into a foreign currency. That cannot be allowed.

He summarised the machinery as follows[2]:

> As soon as they (the Bank) can reasonably do so – after being served with the garnishee order nisi – they should telephone the Exchange Department and ascertain the buying rate of exchange at that moment. They should calculate the dollar equivalent of the sterling judgment: and put a stop order preventing those dollars from being taken out of the customer's account. I will call it the 'stopped dollars'. They should then wait to see if the order is made absolute. If it is, on receipt of the order absolute, they should realise the 'stopped dollars' to pay sterling. If the amount is not sufficient to satisfy the whole of the judgment debt, they must pay over the whole to the judgment creditor. If it is more than sufficient, they should only realise so many of the 'stopped dollars' as are sufficient to satisfy the judgment debt – and return the balance of the dollars for the benefit of their customer.

1 [1981] QB 149, [1981] 1 All ER 225, CA.
2 [1981] QB 149 at 156, CA.

18.7 A debt in a foreign currency can be proved in a liquidation under the Insolvency Rules 1986, r 4.91 or in an administration under r 2.86 and it is now clear that set-off extends to a credit balance in a foreign currency. The prudent banker will naturally take an express right of set-off which specifically authorises him to convert the deposit into the currency of the liability once an event of default has occurred. Is such an express right of set-off registrable? If the set-off arises by operation of law either by the Insolvency Rules 1986, rr 2.85 or 4.90 (for companies) or the Insolvency Act 1986, s 323 (for individuals), or under a banker's right to combine accounts, no registration is necessary. It is submitted that a contractual set-off also does not create a charge; there is no intention to charge.

18.8 However, is an express right of set-off effective if insolvency intervenes? For most purposes it is impossible by contract to increase a creditor's rights of set-off in an insolvency. He will have the rights which arise by operation of law and no more. In *British Eagle International Airlines Ltd v Cie Nationale Air France*[1] the House of Lords held that an attempt by agreement to have a special system of set-off at variance with the normal insolvency rule was contrary to public policy even though entered into for good business reasons. Lord Cross referred to the Companies Act 1948, s 302 which, as re-enacted by the Insolvency Act 1986, s 107, provides:

> Subject to the provisions of this Act as to preferential payments, the company's property in a voluntary winding up shall on the winding up be applied in satisfaction of the company's liabilities pari passu, and, subject to that application, shall (unless the articles otherwise provide) be distributed among the members according to their rights and interests in the company.

In a compulsory winding up, the position is governed by the Insolvency Rules 1986, r 4.181 of which provides:

> Debts other than preferential debts rank equally between themselves in the winding up and, after the preferential debts, shall be paid in full unless the assets are insufficient for meeting them, in which case they abate in equal proportions between themselves.

Lord Cross held that any attempt to contract out of s 302 was contrary to public policy. The only way to obtain priority over the general body of creditors is to take a charge, and if such charge is within the Companies Act 2006, s 860(7), to register it. Notwithstanding this statement (which strictly

speaking was not part of the ratio of the decision), it is now clear that it is possible to agree in a manner effective in an insolvency to rank *behind* the general body of creditors[2]. Similarly, the grant of a limited interest in property continuing only while the holder is not in default (even where 'default' includes the liquidation of the holder) will not be construed as a prohibited provision purporting to divest property upon liquidation (*Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd*[3]).

1 [1975] 2 All ER 390, [1975] 1 WLR 758, HL.
2 See the discussion in para **20.4** and the decisions in *Re Maxwell Communications Corp Plc* [1994] 1 All ER 737, [1993] 1 WLR 1402 and *Re SSSL Realisations (2002) Ltd* [2006] EWCA Civ 7, [2006] Ch 610.
3 [2011] UKSC 38, [2011] 3 WLR 521, [2011] All ER (D) 259 (Jul).

18.9 In a 'back to back' context, although an express right of set-off in general terms is of questionable efficacy once insolvency intervenes in so far as it purports to extend a bank's rights by operation of law, if included as a term of a facility it will link the facility to the deposit in a manner which connects the two and enables set-off to take place under the rule in *Newfoundland Government v Newfoundland Rly Co*[1]. The rule prima facie does not apply if the cross claims are under different contracts. The two transactions must be in some way connected together so as to lead the court to the conclusion that they were made with reference to one another (*Business Computers Ltd v Anglo-African Leasing Ltd*[2]; *Watson v Mid Wales Rly Co*per Bovill CJ[3]). This test should be fulfilled if the deposit is 'back to back' with the loan, but the onus will be on the bank to establish the connection. The subject of equitable set-off is dealt with more fully in para **8.30**.

1 (1888) 13 App Cas 199, PC.
2 [1977] 2 All ER 741 at 746.
3 (1867) LR 2 CP 593 at 598.

18.10 Notwithstanding earlier possible doubts on the matter, the recasting of rr 2.85 and 4.90 has made clear that foreign currency balances must be set off in accordance with those rules. Rule 4.90(6) provides:

> (6) Rules 4.91 to 4.93 shall apply for the purposes of this Rule in relation to any sums due to the company which—
> (a) are payable in a currency other than sterling;
> (b) are of a periodical nature; or
> (c) bear interest.

Rule 4.91 further provides:

> (1) For the purposes of proving a debt incurred or payable in a currency other than sterling, the amount of the debt shall be converted into sterling at the official exchange rate prevailing on the date when the company went into liquidation or, if the liquidation was immediately preceded by an administration, on the date that the company entered administration.
> (2) 'The official exchange rate' is the middle exchange rate on the London Foreign Exchange Market at the close of business, as published for the date in question. In the absence of any such published rate, it is such rate as the court determines.

Similar provision is made by rr 2.85(6) and 2.86 in relation to administrations. In relation to the bankruptcy of individuals, s 323 of the Insolvency Act 1986

has not been amended in a similar manner but it is submitted that similar principles would apply.

CONTINGENT LIABILITIES

18.11 Controversy existed in the past as to whether contingent liabilities (for example under a counter indemnity for a bank guarantee which has not been called) can be set off against a credit balance. The authors of the *Cork Report on Insolvency Law and Practice*[1] were of the view that there was a right of set-off in such circumstances but subject to the rule against double proof. Others took the contrary view that contingent liabilities could not be set off. The position was further complicated by the original form of the Insolvency Rules 1986, r 4.90 and the Insolvency Act 1986, s 323, but as the official view was that these did not change the then existing law, it is perhaps worth examining what the old law was.

1 Report of the Review Committee, Cmnd 8558 (1982) HMSO.

18.12 In *Re Daintrey, ex p Mant*[1] a business had been sold on terms whereby the price was to be a portion of the profits earned by the business during the next three years. It was held that this price could be set off against moneys owed to the purchaser. The case supports the view that contingent liabilities could be set off because no business is bound to make a profit hence the liability to pay a price was 'contingent'. However, that is not the way in which the court approached the matter. Lord Lindley MR said[2]:

> Looking at this agreement, I fail to see that at the date of the receiving order there was nothing payable under the Agreement. Under the circumstances it is clear that when this Agreement was executed very considerable sums would become payable under it.

Romer LJ[3] pointed out that 'it was not necessary that the money payable under the agreement shall be immediately payable to the bankrupt at the date of the receiving order'.

1 [1900] 1 QB 546.
2 [1900] 1 QB 546 at 572.
3 [1900] 1 QB 546 at 574.

18.13 In *Re Taylor, ex p Norvell*[1] Phillimore J positively upheld the view that contingent liabilities could be set off. He said[2]:

> Any obligation prospective or contingent to which the bankrupt is subject, and which, if it becomes an attaching obligation, will result in a money claim, is, under (the Bankruptcy Act) to be estimated as at the date of the receiving order, and if the obligation arises out of mutual dealings between the debtor and the creditor it is the subject of set-off.

The above passage from *Re Taylor*[3] was quoted with approval by Pollock MR in *Re City Life Assurance Co Ltd*[4]. Subject to the rule against double proof it is possible to prove for a contingent liability and therefore s 31 of the Bankruptcy Act 1914 (now repealed) applied to contingent liabilities capable of being proved.

However, although the surety is contingently liable to the creditor, the debtor is under no liability to the surety until the surety has paid the creditor. Only when he has paid the creditor is the surety entitled to be indemnified by the debtor and to prove in the debtor's insolvency. The debtor has an actual liability to the principal creditor (to whom the surety may become subrogated), but no direct liability to a surety who has not paid off the creditor in the absence of an express counter-indemnity which contractually creates such a liability. The subject is discussed more fully in **CH 13**. Unless the surety can prove in the debtor's insolvency, he will have no right of set-off against the debtor.

1 [1910] 1 KB 562, CA.
2 [1910] 1 KB 562 at 568, CA.
3 [1910] 1 KB 562 at 568, CA.
4 [1926] Ch 191, CA.

18.14 In *Re Fenton, ex p Fenton Textile Association Ltd*[1] the Court of Appeal held that the potential liability to indemnify a guarantor could not be set off against moneys owed by the surety to the debtor. Lord Hanworth MR said[2]:

> The right of a surety to be protected from the liability that will fall upon him in case of default by the principal debtor is clear, and is not confined to cases in which he has paid the creditor. As soon as any definite sum of money has become payable to the creditor, the surety has a right to have it paid by the principal and his own liability in respect of it brought to an end . . . The right, however, . . . is for protection and does not enure to the surety so as to justify an order to pay him the sum for which he stands in peril; for the surety who has not paid the principal creditor cannot give discharge as against the principal creditor.

If a surety brings a quia timet action against the debtor, the debtor will be ordered to pay the creditor not the surety. He added[3]:

> No case has decided that he can set-off his contingent liability before he has changed that, by payment to the creditor, into an actual debt due to himself . . . If the contra right were one which was effective before the receiving order, though its quantum was measured afterwards, the system of set off would apply: see in *Re Daintrey*[4] . . .

He concluded[5]:

> In the present case, as I have pointed out, the liability of Fenton at the date of the receiving order was uncertain, though he might have made his position certain by payment. The words of the section [Bankruptcy Act 1914, s 31] seem clearly to connote an account capable of ascertainment on either side if not immediately, yet based upon authority or liability definitely undertaken. I find it difficult to construe those words or adapt that system to dealings in which there was a debt on one side due to the other, and per contra there was not a debt or a certain liability, but one in respect of which there was a right of protection and no more; a liability which could not be turned into a direct contra money claim, unless and until the debt had been paid by the surety, who then, and not till then, would become entitled to give a discharge for the sum paid to him.

The point is that the debtor owes the money to the creditor not to the surety, and is only liable to a surety who has paid the creditor. The surety can bring a quia timet action against the debtor but no order will be made to pay the surety as opposed to the creditor nor will the surety be entitled to prove in the insolvency until he has paid the creditor. It is submitted that *Re Fenton*[6] is

entirely consistent with the earlier authorities cited above, and it must *not* be regarded as authority that contingent liabilities could not be set off. That this is indeed the case was made clear by Chadwick LJ in *Re SSSL Realisations (2002) Ltd*[7].

1 [1931] 1 Ch 85, CA.
2 [1931] 1 Ch 85 at 104, CA.
3 [1931] 1 Ch 85 at 107, CA.
4 [1900] 1 QB 546.
5 [1931] 1 Ch 85 at 109, CA.
6 [1931] 1 Ch 85, CA.
7 [2006] EWCA Civ 7, [2006] Ch 610.

18.15 Lawrence LJ decided *Re Fenton*[1] upon the ground that a surety cannot prove in competition with the creditor because this would be a double proof. He said[2]:

> The reason why, in my opinion, such a claim (although it apparently has the requisite attributes for a set-off under the section and although it is one from which the principal debtor would be released by the order of discharge) cannot be set off is because so long as the estate of the principal debtor remains liable to the principal creditor the surety will not be permitted to prove against the estate of the principal debtor, as such a proof would be a double proof for the same debt, and would therefore be inadmissible as being contrary to the established rule in bankruptcy.

Romer LJ took the same view. He said[3]:

> For contingent liabilities are in general debts provable in bankruptcy, and it is well settled that, provided there be mutuality of dealings, claims provable may be set off . . . But I cannot agree that a surety who has not paid off the principal creditor can prove in the bankruptcy of the principal debtor so as to share in the distribution of his assets unless the principal creditor has renounced in some way his right to lodge a proof himself while preserving, of course, his rights against the surety. To allow such a sharing in the assets would be to subject the assets to two claims in respect of the same debt, and this is contrary to the well established rule in bankruptcy against double proof.

This aspect of the decision in *Re Fenton*[1] was also emphasised by Chadwick LJ in his detailed consideration of the ratio of that case in *Re SSSL Realisations (2002) Ltd*[4].

1 [1931] 1 Ch 85, CA.
2 [1931] 1 Ch 85 at 114, CA.
3 [1931] 1 Ch 85 at 117, CA.
4 [2006] EWCA Civ 7 at [89], [2006] Ch 610 at 651.

18.16 In the somewhat unfortunate case of *Re a Debtor (No 66 of 1955), ex p Debtor v Trustee of Property of Waite (a bankrupt)*[1], the Court of Appeal purported to follow *Re Fenton*[2] and held that the rights of a surety who had not paid off the principal creditor could *not* be set off against money he owed the principal debtor. Lord Eversheld MR said[3]:

> But was there on that date anything 'due' from the appellant to the bankrupt? In my judgment there was not. The rights of the bankrupt against the appellant were the special but contingent rights of a surety who had not been called upon to make any payment by the principal creditor, and had not exercised what has been called the protective right of a surety to require the principal debtor to relieve him of his liability by paying the debt owed to the principal creditor. Nor was the case one in

which all that remained to be done was to quantify the extent of an obligation already incurred, the amount of the indebtedness when finally ascertained being exclusively referable to an obligation to pay that sum entered into prior to the relevant date; such as was the case in *Re Daintrey*[4], *ex p Mant*.

Hodson LJ said[5]:

> That a surety with a contingent liability is a creditor was conceded in *Re Fenton*[2] . . . but a distinction was there drawn between the contingent liability of a surety and an amount actually due in respect of mutual dealings. There is no reported case of a set-off being allowed under the section except where a debt was due at the date of the receiving order. In *Re Daintrey*[4] was a case of a debt actually due. Lord Lindley MR there pointed out that considerable sums would become payable under the agreement entered into between the parties before the date of the receiving order if they carried the agreement into effect. The amount was thus due at the date of the receiving order although it had to be calculated at a subsequent date.

The court apparently applied the reasoning of Lord Hanworth MR in *Re Fenton*[2] and held that a surety could not set off his potential liability under the guarantee against moneys he owed the debtor.

1 [1956] 3 All ER 225, [1956] 1 WLR 1226, CA.
2 [1931] 1 Ch 85, CA.
3 [1956] 1 WLR 1226 at 1230, CA.
4 [1900] 1 QB 546.
5 [1956] 1 WLR 1226 at 1237, CA.

18.17 The position prior to the Insolvency Rules 1986 was exhaustively analysed by Millett J in *Re Charge Card Services Ltd*[1]. He said:

> . . . The legislative history of the section . . . confirms the principle, for which there is abundant Court of Appeal authority, that contingent liabilities of all kinds, including liability for breaches occurring on or after the receiving order of contracts entered into before that date, are debts provable in the bankruptcy, and that in general *all provable debts resulting from mutual dealings* are capable of set-off.
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> . . . Eve J's reasoning in that case was approved by the Court of Appeal in *Re City Life Assurance Co Ltd*[2] which was yet another case in which a policyholder sought to set off the value of his policy against his mortgage debt. *Re Asphaltic Wood Pavement Co*[3] and *Re Daintrey, ex p Mant*[4] were considered at length. Warrington LJ said that both those judgments were clear that what had to be ascertained was whether the claim in question as to which set-off was raised was a claim which could be proved in the bankruptcy or the winding up as the case might be. He said:
>
> > 'Now a future debt, a debt not payable immediately, but payable in future, even payable subject to a contingency, is deemed to be a debt provable in bankruptcy and is, therefore, one of the liabilities referred to in s 31 [of the Bankruptcy Act 1914] as a debt under a receiving order . . . '
>
> . . . By 1956 there was thus a long and consistent line of authority that all provable debts which resulted from mutual dealings were capable of set-off, that these included debts whose existence and amount were alike contingent at the date of the receiving order, as well as liability for breaches occurring on or after the receiving order of contracts existing at that date, which by force of the statute were converted into provable debts, and that the essential requirements were, first, that the liability must be one which would mature, if it matured at all, into a quantified money claim in the natural course of events, that is to say without any fresh agreement but solely by virtue of a contract already existing at the date of the receiving order, and, second, that it had in fact done so by the time the claim to set off was made. *Re Fenton*[5] cast no doubt on these well-established principles, but

> confirmed them. The only qualifications it added were, first, that the surety's right to require the principal debtor to pay the creditor could not be set off, because it was not a right to require payment to himself and so was not commensurable, and, second, that a provable debt could not be set off at a time when, by reason of the rule against double proof, it did not rank for dividend.
>
> . . . In my judgment, the true ratio of *Re a Debtor (No 66 of 1955)*[6] is that to come within s 31 the liability must be exclusively referable not merely to an agreement already existing at the date of the receiving order, but to an agreement between the same parties as the parties to the set-off, and that the liability of the principal debtor to indemnify a surety who has paid the principal creditor does not pass the test. Whether in fact it does so or not, there is nothing in the decision to compel the conclusion that, contrary to all the earlier authorities, liabilities still wholly contingent at the date of the receiving order are, for that reason alone, outside the scope of s 31.
>
> . . . to disallow the set off of a provable debt merely because it was still contingent at the date of the receiving order, where the contingency has since occurred and the liability which has arisen is exclusively referable to and has resulted in the natural course of events from a transaction between the same parties entered into before the receiving order, would in my judgment be productive of the very injustice the section and its predecessors were designed to prevent.

Millett J had earlier clarified the relevant date for set-off as follows:

> The relevant date in bankruptcy is the date of the receiving order. In companies liquidation, it was thought in some of the early cases to be the date on which the winding up commenced, but the correct date has now been shown to be the date of the winding up order: see *Barclays Bank Ltd v TOSG Trust Fund Ltd*[7].

The original author expressed the view in earlier editions of this work that contingent liabilities could always have been set off under s 31 (unless this would result in a double proof), but that the right of a surety to quia timet relief against a debtor does *not* entitle the surety to prove in the liquidation of the debtor and therefore he had no right of set-off. As will be seen below, this has indeed been considered by subsequent judicial pronouncements to be correct and, indeed, is now largely reflected in the amended form of the Insolvency Rules 1986.

1 [1987] Ch 150, [1986] 3 All ER 289.
2 [1926] Ch 191, CA.
3 (1885) 30 Ch D 216.
4 [1900] 1 QB 546.
5 [1931] 1 Ch 85, CA.
6 [1956] 3 All ER 225, [1956] 1 WLR 1226, CA. See also the rejection of a broader interpretation of *Re a Debtor (No 66 of 1955)* as applying to contingent obligations generally in the detailed discussion of that case by Lord Hoffmann in *Secretary of State for Trade and Industry v Frid* [2004] UKHL 24 at [14]–[16], [2004] 2 AC 506 at 512–513.
7 [1984] BCLC 1 at 25.

18.18 As originally enacted, the 1986 insolvency legislation did not resolve all of the questions that remained with regard to contingent debts. The Insolvency Rules 1986, r 4.90 has however always applied where there have been mutual dealings and the creditor is entitled to prove in the liquidation. This is similar to the statement in the passage from the *Charge Card* case cited above that 'in general all provable debts resulting from mutual dealings are capable of set off.'