1.06 This work seeks to analyse the approach that the English courts have taken when faced with the argument that the commercial or financing transaction before them involving a transfer of assets should be treated as having a legal effect different to the way in which it describes itself, as well as addressing a number of related matters.

1.07 This doctrine is commonly known as recharacterisation, as in 'can the sale transaction be recharacterised from the thing it is called into something else'. The analysis arises in a number of instances. Examples are ownership rights, accounting treatment, taxation and the proper allocation of regulatory capital by financial institutions.

1.08 Recharacterisation is only one element of the broader concept of true sale. Recharacterisation relates to whether a transaction can be treated by the courts as one type of arrangement notwithstanding that the characterisation given by the parties was something else. There are other factors affecting the true sale analysis, such as insolvency clawback risks which result in the assets that have been sold being recovered, or clawed back, by the insolvency estate of the transferor, thereby undermining the original transfer.

RECHARACTERISATION IN OTHER CONTEXTS

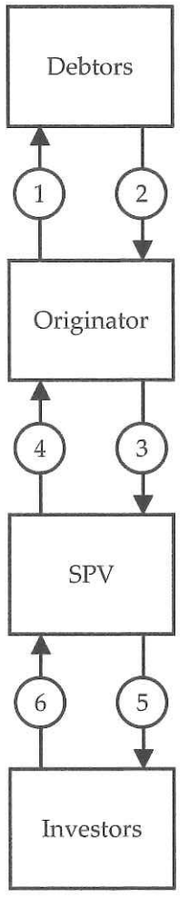
1.09 This work focuses specifically on recharacterisation in the context of true sales – that is, the recharacterisation of a purported outright transfers of property into something which falls short of an outright transfer, such as a security interest. It also addresses related recharacterisation issues, in particular the recharacterisation of a charge purporting to be fixed into a floating charge.

1.10 Recharacterisation also arises in other contexts, such as the recharacterisation of an arrangement purporting to be by way of contractual licence into a lease, which is a proprietary right in real property, or the recharacterisation of a credit derivative into an insurance policy. While we touch on these other contexts briefly in this work, they are a subject matter in their own right, and so we do not consider them in any detail.

THE IMPORTANCE OF THE TRUE SALE AND RELATED RECHARACTERISATION ANALYSIS IN COMMERCIAL TRANSACTIONS

1.11 The confirmation that a sale will be effective as such (and will not have another effect) is crucial in a number of commercial transactions. Part II of this work addresses this in the context of a number of specific transactions, but the following are two examples.

1.12 Example 1: Securitisation



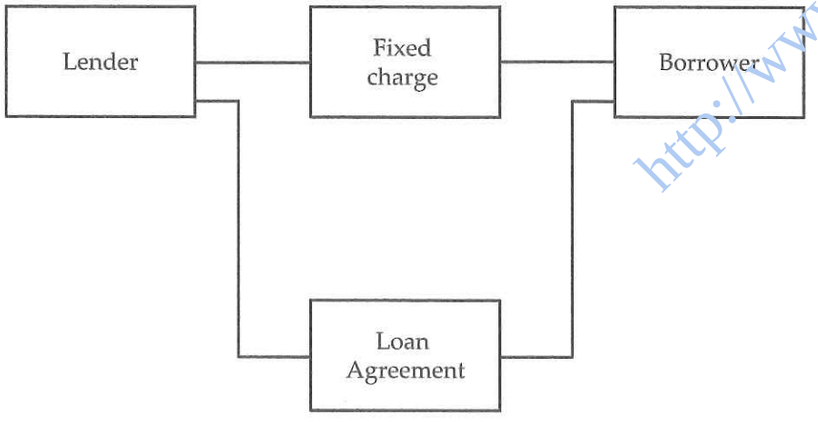
1 Initial advances of credit (receivable)
2 Obligation to repay debt and interest
3 Transfer of rights under receivables
4 Purchase price for receivables
5 Issuance of debt securities
6 Subscription proceeds for debt securities

The owner of financial assets (known as the **originator**), such as credit card receivables or residential or commercial real estate mortgage repayments, will transfer those assets to a single purpose vehicle, or SPV. That SPV will pay for those assets, and in doing so will raise money from investors in the bond market. The investors' recourse for repayment of the bonds is limited to the assets of the SPV, and so the investors need to know that the SPV owns the assets that it has purchased, free of any interest of the originator or any other person, otherwise the investors might find that there are claims on the assets that rank ahead of their right to be repaid from the proceeds of those assets. Similarly, the originator needs to be confident that the assets are no longer owned by it, because if they were they would remain on its balance sheet, restricting its ability to carry on other activity or obtain further funding.

1.13 The principle is the same as buying a house which is (prior to the purchase) subject to a mortgage: the purchaser of the house needs to know that the mortgage will no longer be there, or else the bank holding the mortgage will potentially retain rights over the property that rank in priority to the purchaser.

1.14 The lawyers to the transaction will be asked to advise that the transaction will be upheld as a sale. This advice is typically given in a formal opinion, often known as a true sale opinion. If they are unable to give the opinion, because the circumstances are such that there is doubt in relation to any relevant aspect of the transaction, and the analysis that the transaction is a true sale is therefore questionable, then it is likely that the transaction will not proceed. At a minimum, the transaction is unlikely to obtain a suitable rating from a rating agency, since the true sale analysis is critical to their view of the merits of the structure.

1.15 Example 2: Fixed and floating charge



Here there is no true sale analysis. The arrangement is a charge in any circumstance, the question being whether it is fixed or floating. This distinction is important, because floating charges are treated differently on enforcement to

fixed charges. Certain creditors and costs rank ahead of a floating charge holder, and other differences flow from the distinction. A security taker would rather have a fixed charge than a floating charge, so in our example diagram it describes the charge as fixed. However, there is a recharacterisation analysis, so that if the security provider retains certain rights to deal with the assets, the arrangement may not come within the definition of a fixed charge derived from case law. Will the court uphold the classification using the terms the parties have used, or will it apply the definition from case law and recharacterise the arrangement as floating?

OTHER LEGAL SYSTEMS

1.16 This book relates to the treatment of transactions under English law and does not address the substantive law of any other jurisdiction, and it should be noted in particular that it does not address Scottish law or the law of Northern Ireland, which are separate legal systems. Chapter 9 addresses a number of the issues that arise in relation to cross-border transactions, and the application of different systems of law to transactions. Cross-border transactions are common and a number of systems of law can impact both on true sale and recharacterisation analysis and their relevance to the transaction. That chapter seeks to analyse what systems of law might be relevant, rather than the substantive law of that system.

1.17 Part II of this work then addresses which specific laws might be relevant in the context of identified transactions.

US LAW

1.18 One system of law that is commonly addressed in the context of true sales and recharacterisation issues is US law.

1.19 The law of recharacterisation and true sales has developed in the United States very differently to the manner in which it has developed in England and Wales. Certainly the differences are greater than in most branches of financial transactional law, which are often similar and in many cases identical.[1] While some reference is made to the US position, this work does not seek to provide a detailed analysis of US law, however some understanding of that law is often useful, as it can explain the background to perceived concerns relating to true sale issues. The approach in the US involves the weighing of the various factors to a transaction, to determine whether on balance it constitutes a financing or an outright sale.

[1] Bills of Exchange are an example, though case law on the interpretation of the same statutory wording has diverged to some extent.

TARGET AUDIENCE

1.20 Both the authors of this work are lawyers, with a background in structured finance transactions. We seek to analyse an area of law that is of great practical importance but where the detailed practical application has had relatively little attention from academics and market commentators.

1.21 There is some element of mystique to the true sale analysis, and perhaps because of the very different tradition in the US, a certain level of nervousness about an area of law that is generally reasonably clear. We therefore hope that professionals active in the structured finance market, both lawyers and others, will find this work helpful.

APPROACH OF THIS WORK

1.22 Part I to this work seeks to analyse matters of general application, in particular the central legal background and case law relevant to the true sale analysis and related issues of recharacterisation. Part II applies this to specific transactions.

RETAIL AND CONSUMER PROTECTION LAW

1.23 This work looks at the contractual and legal principles relevant to the analysis of whether transactions constitute true sales. It assumes that all parties are commercial, corporate entities, not individuals or partnerships in respect of which consumer protection laws might apply.

Chapter 2

SUMMARY OF TRUE SALES RULES

2.01 The following is a summary of guidelines suggested in this work. They should be read in conjunction with the relevant Chapter.

Chapter 4: Meaning of a true sale

A 'true sale' is an arrangement that will be upheld in the insolvency of either the transferor or transferee as a transfer of the beneficial ownership of an asset, whereby the ownership of that asset transfers absolutely (and not by way of security) to the transferee and neither remains nor is capable of being clawed back so as to become part of the transferor's estate.

Chapter 5: Does the character of the transaction matter?

Whether a transaction constitutes a true sale may be of differing importance to the parties, and may matter to them for different reasons or not at all.

Chapter 6: English law relating to true sales and their recharacterisation

Rule

An arrangement will not be recharacterised as a security interest if the parties intend to transfer absolute ownership in the asset to the transferee. And the easiest way to determine this is whether the parties expect the seller to have an ownership interest if the buyer defaults. The rest of the analysis is just another way of demonstrating that intention.

Rule

If you do not want your transaction to be recharacterised as a security, do not describe it as being given by way of security.

Rule

If a legal concept has a clear definition or has characteristics, in either case which go to the essence of that concept and only that concept, a transaction will be categorised as falling within that concept if that definition is met or those characteristics are present, irrespective of the description used by the parties.

Rule

Summary of the approach of the courts to true sales issues:

(a) *The first question is whether the arrangement is a sham. If the transaction is a sham, the court will ignore the document to find the true agreement between the parties.*

(b) *If the agreement is not a sham, the courts will approach the characterisation of the contract in two stages, first to ascertain the intention of the parties by reference to the document, then the legal categorisation of the transaction.*

(c) *The English courts do not approach the transaction by seeking to weigh up elements of it that look more or less like the types of legal transactions that might apply, and find where the balance lies.*

(d) *The courts look for the substance of a transaction, but since that can only be ascertained by the form of the document they have used, the distinction between substance and form of itself provides little assistance.*

(e) *If the transaction contains elements that are essential to, and consistent only with, one type of legal characterisation, it will be categorised accordingly, notwithstanding the description of the parties.*

(f) *If the transaction omits elements that are essential to one type of legal characterisation, it will not be categorised as that type of transaction, notwithstanding the description of the parties.*

(g) *The courts will not recategorise a transaction that is expressed to fall into one type of legal classification either because the transaction has elements that are commonly found in another type of classification or does not have elements that are commonly found in the type of transaction that is expressed.*

(h) *The economic effect of the transaction has no relevance to its legal categorisation.*

(i) *A financing can be achieved by way of a transaction of sale or by a transaction of mortgage or charge, so that has no effect on its characterisation.*

(j) *The fact that a transaction that is structured in one form gives rise to the same risk profile of a transaction that is typically structured in another form has no impact on the categorisation, even if there is a mandatory law that applies to transactions in the other form, if that mandatory law does not determine the essence of such a transaction, so the fact that an outright sale might have the same effect as a secured loan but not be registrable in the same way as security has no relevance to its legal categorisation.*

(k) *Subsequent behaviour may be relevant to the categorisation of the transaction.*

Chapter 8: 'Substance over form'

The courts look to the legal substance of a transaction (ie what is the contractual agreement between the parties) in characterising transactions and do not consider the economic substance of those transactions in doing so.

Chapter 10: The operation of the agreement and subsequent behaviour of the parties

Rule

The subsequent behaviour of the parties can affect the characterisation of the transaction: the best analysis of this is that they have altered the terms of the agreement between them so that its characterisation has changed.

Rule

The manner in which the parties operate the transaction should be consistent with the written agreement, to avoid any argument that the written agreement either did not constitute their intention, or that it has been superseded by another different agreement.

Chapter 13: The effect of pricing by reference to financing returns

The fact that a transaction is priced by way of a calculation based on an interest rate has no relevance to the true sale analysis.

Chapter 17: Regulatory and accounting matters and potential liability for wrongful accounting

Rule

The legal and the accounting treatment of a transaction are different things, so that a transaction can constitute a true sale at law irrespective of the accounting treatment of the transaction and whether that asset is retained on the balance sheet of the counterparty.

Rule

The legal and regulatory treatment of a transaction is different, so that a transaction can fall within the scope of a regulatory provision, notwithstanding that it does not meet the exact words of the regulation when read from a legal perspective.

Chapter 3

LEGAL CONCEPTS RELEVANT TO TRUE SALES AND RECHARACTERISATION

SOURCES OF LAW

3.01 Unsurprisingly, given the way in which English law has developed over the centuries and the fact that it is a common law regime, there is no English statute that deals directly with the issue of whether any given transaction might be recharacterised into something else.[1] Even when required to implement European legislation, the English legislators refrained from incorporating into the statute books a written requirement that repurchase transactions over financial instruments (known as repos) and other forms of title transfer financial collateral arrangements would not be recharacterised.[2]

1 Some tax statutes treat transactions as being something else for the purposes of taxing them eg they are taxed the same way as a loan, notwithstanding that they are not legally a loan. See Chapter 18.

2 Article 6 of the EU Financial Collateral Directive (Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements) required member states to ensure that a title transfer financial collateral arrangement can take effect in accordance with its terms or, in other words, that it would be recognised as a title transfer arrangement. The English legislators refrained from addressing this in the Financial Collateral Arrangements (No. 2) Regulations 2003 (SI 2003/3226), presumably on the basis that the issue is already settled as a matter of English law.

3.02 Such law as there is has been generated by the courts. Examples of cases that deal directly with recharacterisation are rare indeed, with the leading authority, from the Court of Appeal[1], dating from 1992.

1 *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148, for which see Chapter 6.

3.03 However, there is enough case law to rely on in this area, and some level of commentary that is helpful.

3.04 Most, if not all, of the case law that exists arose in the context where one party (or its liquidator) or a third party creditor saw an advantage in seeking to claim that the proper treatment of the transaction is different to the way in which it was described, and the instances where a transaction has been recharacterised have tended to centre around circumstances where the initial transactional structure was designed to avoid, or had the effect of avoiding, a

mandatory rule of law that would otherwise apply. In one case (*Street v Mountford*[1]), which is the forerunner to some of the leading cases in this area, the parties used the phrase 'licence' to distinguish the arrangement from a lease, because (at the time) leases were subject to rent control and security of tenure much more favourable to the tenant than is the case today. Landlords therefore sought to deny the existence of a lease. In the case that arose, the House of Lords found the arrangement to be a lease, as it came within the definition of a lease to which the statutory protection applied, and the rules of law that applied to leases therefore applied to it. In other words, the use of language was not sufficient to mask the fact that the arrangement was, in actual fact, a lease, and so the court gave it its true characterisation rather than the one adopted by the parties.

1 [1985] 1 AC 809, [1985] 2 All ER 289, HL.

3.05 The case law has been described as contradictory, particularly by commentators revisiting the position after the decision of the House of Lords in *Spectrum*.[1] Our view is that there is remarkable consistency, when the case law is properly analysed.

1 *Spectrum Plus Ltd, Re; National Westminster Bank plc v Spectrum Plus Ltd* [2005] 2 AC 680, [2005] 4 All ER 209. See Chapters 6 and 7.

3.06 There is little by way of additional guidance from other jurisdictions, other than the United States. The law there is so different as to be almost entirely irrelevant to the English law analysis.[1]

1 Given the degree of similarity between English law and US law, particularly New York law, in the context of structured finance transactions, and the similarity of financing structures used, this might come as a surprise. It need not, since insolvency law, which this relates to, is one area where the laws are very different.

3.07 There is also case law in the context of fixed and floating charges, again because of the different treatment between the two types of arrangement. Fixed charges are subject to fewer priority claims in the insolvency of a security provider, so financiers taking security have sought to make as many assets as possible fall within the fixed charge provisions of a security agreement, with varying levels of success. The law relating to fixed and floating charges relates to an issue of recharacterisation rather than true sales, but it has direct relevance to the analysis of the true sale position both generally and specifically relating to the sale of receivables.

APPLICABLE LAW

3.08 Chapter 9 addresses the conflict of laws issues that arise in cross-border transactions. These are analysed in relation to specific transactions in Part II.

INSOLVENCY LAW

3.09 Laws relating to insolvency provide the context of most of the decided English cases relating to true sales. However, it is important to understand that the law relating to sales and the potential recharacterisation of purported

outright sales, is not a matter of insolvency law. The insolvency of the counterparty may be the reason that the transaction is analysed, and its character brought into question, but it is general principles of contract law, not insolvency law that apply to determine the character of the transaction: as per Lord Herschel in *McEntire v Crossley Brothers*[1]: 'The agreement between the parties must be construed in precisely the same way as if there had been no bankruptcy at all'.

1 *McEntire v Crossley Brothers, Ltd* [1895–99] All ER Rep 829 at 831.

'RECHARACTERISATION'

3.10 This work focuses on the concept of recharacterisation as it relates to the true sales analysis of financing transactions. The phrase 'recharacterisation' is certainly one that is commonly used in the context of true sales analysis. There are many other circumstances where the concept may be relevant, and a number of these are touched on but their detailed analysis is out of the scope of this work.

3.11 The question is always whether the transaction can be recharacterised into something other than the description used by the parties. Perhaps 'characterisation' would be a better word, since the doctrine involves an analysis of what the nature of the arrangement is from the start, rather than changing the nature of the arrangement. There are though circumstances where the nature of an arrangement can change, by agreement of the parties or conduct.

'SUBSTANCE OVER FORM'

3.12 This phrase is often used in the context of whether a transaction constitutes a true sale. It is not, however, a phrase which adds much to the discussion, and it frequently creates more confusion than clarity. It is discussed in detail in the analysis of applicable law and summarised in Chapter 8.

TRUE SALE V NON SALE

3.13 The concept of a true sale should be contrasted with that of a failed sale, or non-sale. A sale may fail to take effect at law or at all for many reasons: the seller did not own the asset, for example, or there were legal formalities to effect a legal transfer that were not followed, such as might be required for the transfer of a registered asset, such as a ship or aircraft.

3.14 There are also numerous instances whereby any transaction (whether a sale, assignment or any other contract) might be void or voidable at law, for example rescission for misrepresentation or a transaction might be void for common mistake. These apply to all transactions and are generally not part of the scope of this work, other than matters that arise frequently as issues in the transactions that this work describes, such as the effect of a purported assignment of a contractual right in contravention of a prohibition on assignment in the underlying contract, discussed at Chapter 19 and often raised in the true sale analysis of such transactions.

3.15 In relation to general matters of contract law, a true sale is as capable of rescission as any other contract.

RECHARACTERISATION V TRANSACTIONS SET ASIDE

3.16 The doctrine of recharacterisation should also be distinguished from instances under laws of general application, whereby transactions can be cancelled, for example the circumstances where insolvency law might set aside a transaction at an undervalue.[1] These are discussed at Chapter 16. A true sale may be set aside for these reasons in the same way that any other transaction may be set aside. Like recharacterisation, the setting aside of a transaction may result in the arrangement failing to constitute a 'true sale', but for different reasons.

[1] Or to take a hopefully extreme example, the power of the Chancellor of the Exchequer under the Banking Act 2009, s 75 to 'amend the law' with the sole fetter on his ability to do so the provision in s 75(3) that 'the Treasury shall have regard to the fact that it is in the public interest to avoid retrospective legislation'.

HOW TO TRANSFER TITLE DEPENDS ON THE NATURE OF THE ASSET

3.17 Whether there is a sale between two parties is a combination of the contractual arrangements between them, the nature of the asset in question and any relevant law regarding the transfer of that asset. For example, a document executed under hand (which will ordinarily be sufficient to transfer most types of asset) will not convey title to land, because English law requires that such document be executed as a deed.

TITLE IS A RELATIVE CONCEPT

3.18 A sale may be a true sale between party A as seller, and party B as buyer, while not being effective against party C. Put another way, title is a relative concept. The question is not whether B owns the asset, but rather whether B's title be upheld against A or indeed C. A good example is title to a passport. Most holders of passports would consider that they hold title to their own passport, and one person would not purport to have title to someone else's passport. However, as between the holder and the issuer (the sovereign or government), title belongs to the issuer rather than the holder.

3.19 A practical example is whether an assignment of a receivable is effective to transfer a proprietary interest between the assignor and the assignee, even if it does not do so between the assignee and the debtor, because of a prohibition on assignment or legal defect.[1]

[1] See Chapter 19.

CHANGE OF CONTRACTUAL OBLIGATIONS BY OPERATION OF LAW

3.20 Periodically, laws are passed that change the legal effect of transactions or the status of legal relationships between parties. The corporatisation of state assets that took place leading up to the privatisations of the 1990s would be an example. On the creation of British Telecom (now BT), a new corporation was formed by statute and all rights and obligations under contracts previously entered into by the relevant part of the Post Office were transferred by operation of law to the new entity. Similarly, on the creation of the euro, by virtue of EU law, all obligations governed by the laws of an EU member state and denominated in the currencies of the Eurozone states were redemoninated into euro by operation of law.[1]

[1] At the time of writing, debate continues to rage as to whether the reverse process is possible.

RECTIFICATION OF CONTRACTS

3.21 Another legal doctrine that is relevant to the true sale analysis but that should be differentiated from recharacterisation is the doctrine of rectification, whereby a court can amend the words of a contract in limited circumstances, for example because the words do not accurately reflect the agreement of the parties. The courts are not recharacterising the transaction, they are merely correcting the written terms of the contract to accurately reflect the common intention of the parties on which agreement was reached. Sham transactions, discussed at Chapter 12, are extreme examples where the contract is rectified to reflect the agreement that the parties reached, and deliberately chose to misdescribe.

TAXATION

3.22 The doctrine of recharacterisation as a matter of contractual interpretation should also be distinguished from the possible treatment of the transaction for tax purposes. Taxation authorities often attempt to look through the legal form of transactions, in order to tax them based on their economic substance. In the United Kingdom, the efforts of HM Revenue and Customs to achieve a case law doctrine of substance over legal form have been limited and, in the context of sales forming part of a structured finance transaction, the position is nowadays governed by explicit statutory rules taxing the transaction as a financing rather than a sale.

ALTERNATIVE METHODS OF PERFORMANCE

3.23 The limited examples where the courts have recharacterised transactions have been where the parties were trying to achieve a desired result which could only legally be achieved in a specific manner (and, in doing so, trying to avoid an undesired result which would be the consequence of effecting the transaction in another manner). The typical approach of the English courts is to respect the freedom of parties to choose how they wish to achieve the same economic result where legally there are different methods of achieving that result, even if the legal consequence of choosing an alternative method is more

favourable to one or both of the parties. The English courts have stated this principle quite clearly in a number of contexts, including the context of receivables financing.

Chapter 4

MEANING OF A TRUE SALE

DEFINITION OF TRUE SALE

4.01 As noted above, there is no statutory or judicial definition of 'true sale'. Even those cases, considered elsewhere in this work, that address the legal concepts such as recharacterisation that ultimately determine whether an arrangement is a 'true sale' do not use such terminology.[1] Nonetheless, the financial markets frequently use that term to describe a specific type of arrangement. In the absence of any statutory or judicial definition, we suggest the following definition:

Rule

A 'true sale' is an arrangement that will be upheld in the insolvency of either the transferor or transferee as a transfer of the beneficial ownership of an asset, whereby the ownership of that asset transfers absolutely (and not by way of security) to the transferee and neither remains nor is capable of being clawed back so as to become part of the transferor's estate.

[1] The phrase was used in *Mercuria Energy Trading Pte Limited v Citibank* [2015] EWHC 1481 (Comm), where the true sale was not at issue.

'TRUE SALE' IN ARRANGEMENTS THAT ARE NOT QUITE 'SALES'

4.02 Consistent with market terminology, we refer in this work to 'true sales' even in circumstances where the arrangement might not quite constitute a 'sale'.

4.03 For example, in a securities lending transaction, the lender transfers to the borrower absolute ownership in the loaned securities, and in return the borrower transfers absolute ownership in the collateral (which may be cash or other assets). Similarly, in the context of title transfer collateral arrangements relating to OTC derivatives, such as an English law Credit Support Annex, the transferor transfers absolute ownership in the collateral to the transferee. In neither case would it typically be appropriate to refer to the arrangement as a 'sale' (which word would typically be reserved for an arrangement in which one party purchases an asset from the other party in exchange for consideration), but market participants nonetheless typically refer to these arrangements as 'true sales'. The reason for this apparent hypocrisy is that, when market participants refer to 'true sales', their emphasis is more on the

'true' than it is on the 'sale'. Put another way, what they are referring to is that the arrangement should be upheld as an absolute transfer of ownership in the asset (otherwise known as a title transfer arrangement), and that it should not be recharacterised as a lesser form of ownership interest (such as a security interest) or otherwise invalidated for the reasons described in this work. It is this concept of 'true sale' in its broadest sense that we consider in this work.

4.04 Looking at the elements of this definition in turn:

upheld in the insolvency of either the transferor or the transferee

4.05 This concept is crucial. The question is whether the sale will be upheld in the insolvency of either the transferor or the transferee. It is all well and good that, as a matter of contract, the arrangement would be upheld as a transfer in the absolute ownership in the asset, but will an insolvency official nonetheless be able to argue successfully that the sale was not effective, and that the asset therefore falls back into the transferor's estate rather than comprising the property of the transferee?

4.06 The concept that the arrangement is enforceable upon the insolvency of either party is relevant for reasons that go beyond pure legal or credit analysis. In particular, it arises in the accounting treatment of the transaction and the determination as to whether the asset should remain on the balance sheet of the transferor. In many transactions the transferor may seek its auditors' confirmation that the asset should not properly be reported on its balance sheet, and in order to do so it may be necessary to demonstrate that the arrangement would be effective as a matter of law upon the transferor's insolvency. As will be noted from numerous examples in this work, the accounting analysis is not relevant to the legal analysis, and this is discussed further in Chapter 17.

4.07 Similarly, the concept that the arrangement is enforceable upon the insolvency of either party may also be relevant in the context of regulatory capital treatment. This is because a financial institution may have the requirement to hold capital against assets as part of the regulatory environment in which it operates. That requirement may vary depending on whether it owns the asset, hence the true sale analysis.

neither remains nor is capable of being clawed back so as to become part of the transferor's estate

4.08 It is important to distinguish between the different reasons why an arrangement might not be upheld on the insolvency of either of the parties. It might be because of the possibility that a transaction can be recharacterised on insolvency, or perhaps because insolvency law can set aside the arrangement, for example because it is a preference or a transaction at an undervalue. These latter principles apply to all transactions, irrespective of their characterisation, and are dealt with in Chapter 16.

upheld . . . as a transfer of ownership

4.09 This element of the definition can actually be broken down into further constituent parts. First, there must be an ownership interest, and second, the arrangement must involve a transfer of that ownership interest.

4.10 In relation to the first point, a 'true sale' can only meaningfully exist if it relates to a party's interest in an underlying asset. In the case of transfers of tangible property such as real estate, this concept is easier to identify, since it is straightforward to identify an owner's rights (eg exclusive possession) in tangible property. In the case of intangibles such as choses in action, the concept is more difficult to identify. For example, is the transfer (by way of assignment or novation) of rights under a contract a question of property or contract? The effectiveness of such a transfer (in particular, the legal regime that might be applicable to such a transfer – see Chapter 9) is likely to depend on the answer to that question. The distinction between contractual rights and rights *in rem* (that is, property rights) in relation to choses in action as a general matter is outside the scope of this work, but does form some part of the analysis of cross-border issues in Chapter 8. However, it is submitted that to constitute a 'true sale' the arrangement must be effective as a matter of whichever type of interest is applicable.

4.11 If the arrangement is not expressed to be a transfer of ownership, it is less likely to be upheld as such. Certainly, it would be unusual for an arrangement which is described as a security interest to be characterised as a true sale – while technically the same analysis would apply, such that it is possible for the arrangement to be recharacterised, in practice it is less likely to occur. It would also be unusual for an arrangement to be silent as to whether it constitutes a transfer of ownership or the creation of some lesser form of interest – typically, arrangements state on their face whether the parties intend to transfer ownership, to create a security interest or to create some other form of interest.

whereby the ownership . . . transfers absolutely (and not by way of security)

4.12 This distinction between absolute transfers and the creation of security goes to the heart of the analysis in this work.

4.13 Must the ownership be the legal estate? English law distinguishes between legal and beneficial interests, and the true sale analysis would extend equally to the transfer of a beneficial interest without the equivalent transfer of a legal interest; for example if a person declares a trust over certain assets, the beneficial interest may transfer absolutely to the beneficiaries while the legal estate remains with the trustee, who must act at the direction of the beneficiaries. Most of the transactions discussed in this work relate to transfers of both legal and beneficial interests combined, but not all. In particular, true sales of receivables are often concluded in such a way that the debtor is not, at least initially, informed of the transfer, which means that only the beneficial interest is transferred.

4.14 It follows that a 'true sale' can occur both when the 'sale' takes effect at law and when it takes effect in equity, ie there may be a legal or an equitable transfer of a legal interest, or a transfer of an equitable interest.

STANDARD & POOR'S DEFINITION OF 'TRUE SALE'

4.15 Standard & Poor's[1], in its legal criteria for the isolation of assets in European structured finance transactions[2], notes both a 'general' and 'legal' aspect to what is considered to be a true sale in the securitisation context. As a general matter, S&P notes that 'the term "true sale" is commonly used in a securitization context to refer to a transfer of ownership of the securitized assets from an originator to [an SPV]'.[3] From a legal perspective, S&P identifies a 'true sale' as being understood to 'result in the assets ceasing to be part of the seller's bankruptcy or insolvency estate', while it goes on to note that other legal mechanisms, apart from true sale, might achieve analogous isolation. What is clear from this approach is that it is still necessary for any meaningful definition to combine the two elements – the transaction itself (the 'transfer of ownership' that S&P refers to as a general matter) with the ultimate legal effect of that transaction (the 'assets ceasing to be part of the seller's bankruptcy or insolvency estate').

1 Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc.
2 *Legal Criteria: Europe Asset Isolation and Special-Purpose Entity Criteria – Structured Finance* (13 September 2013).
3 Single Purpose Vehicle.

4.16 In one of its earlier criteria[1], S&P noted that the word 'transfer' is often used without regard for its scope. It noted that a transfer may fulfil one or more of three objectives:

(i) to be valid and enforceable against a solvent transferor, and result in the transferee having priority against third-party creditors while the transferor is solvent;
(ii) to be valid and enforceable against the regulator (if any), obligor in possession, or an insolvency officer of the transferor, in an insolvency or reorganisation proceeding and against other creditors of an insolvent transferor; and
(iii) to be valid and enforceable against the obligor, enabling the transferee to enforce its rights on the assets directly without relying on the transferor (for example, by giving the transferee the ability to foreclose on a mortgage or repossess an automobile after default on the loan).

1 *Legal Criteria: European Legal Criteria for Structured Finance Transactions* (28 August 2008).

4.17 S&P goes on to note that a perfected transfer of an asset is one that satisfies all three objectives noted above. This is essentially a transfer of legal and beneficial ownership in the asset. A transfer of a beneficial ownership interest only (without a corresponding transfer of the legal ownership) or an unperfected sale, however, is a transfer that may meet only the first two objectives. Notwithstanding this, such a transfer is still typically referred to as a 'true sale' (although in the securitisation context, the rating agencies may require additional pre-insolvency triggers to protect against the risks of the third objective above not having been satisfied).

BAFT DEFINITION OF 'TRUE SALE'

4.18 BAFT is an association for international transaction banking.[1] It publishes proforma documentation that is commonly used in the trade finance market, including a master participation agreement that is designed for use when one party holds trade finance assets and wishes to grant an economic interest in those assets to another party.[2]

1 See www.baft.org.
2 For a discussion of participations, see Chapter 21.

4.19 The guidance notes to its recommended form of master participation agreement for trade transactions define a true sale as follows:

> 'A "true sale" means a transfer of financial assets that, for the purpose of specific laws, accounting principles or regulatory concerns, constitutes a sale of such assets as distinguished from a financing secured by such assets and which would be respected as a sale and not a financing in a receivership, insolvency or bankruptcy of the transferor.'[1]

1 *Guidance Notes for BAFT-ISA MPA English Law Form*, www.baft.org/policy/document-library.

4.20 The BAFT definition is, we suspect, influenced by American market practice and jurisprudence, and it raises some issues that merit commentary.

4.21 The definition refers to financial assets, which is understandable in the context of a participation arrangement, but the concept of true sales is much wider than that, applying to many classes of assets, not just financial ones.

4.22 Note the reference to 'specific laws, accounting principles or regulatory concerns'. Accounting principles and regulatory concerns, while of potentially crucial importance to a transaction or counterparty, are very unlikely to be relevant under English law to the determination of the characterisation of the transaction and whether it legally constitutes a true sale.

4.23 Additionally, note the reference to a financing. Under English law principles, whether or not the transaction can be called a financing is almost certainly irrelevant to the legal categorisation of a transaction. There is no legal definition of what is or is not a financing and no legal impact of that term being applied to a transaction. This element would be important in the US, but is not relevant in the context of English law.

4.24 Since most transactions where true sale analysis is relevant are 'financings' in that they involve the provision of finance, the more important word is 'secured'. A true sale will be upheld as an absolute transfer of ownership, and not as a security interest.

4.25 Note also the reference to insolvency procedures. This is crucial, because in the absence of insolvency, whether the transaction is a true sale or not will probably not matter as a question of law, although it may matter for other reasons, such as those described in Chapter 5.

Chapter 19

RECEIVABLES PURCHASE TRANSACTIONS

SUMMARY OF THE TRANSACTION

19.01 Receivables purchase transactions have been established for very many years. Essentially, one entity buys a receivable (ie a debt) from the entity that generated that receivable in the course of its business. For example, a manufacturer of machinery might sell that machinery to purchasers on 30 or 90-day payment terms. Rather than wait 30 or 90 days for payment, it sells the receivable to a bank or other third party financier, with payment immediately. The bank will pay a discounted price for the receivable, with the discount usually being based on an interest calculation, with a margin determined by the analysis of the credit risk of the payer of the receivable.

APPLICATION TO FINANCING TRANSACTIONS GENERALLY

19.02 The transfer of a receivable or other contractual right is at the heart of many other transactions, discussed in this work, such as securitisations. As such, the law relating to the transfer of receivables is of common application in other structured finance transactions.

PARTIES AND TERMINOLOGY

19.03 In this Chapter, the *assignor* sells a receivable to the *assignee*. The receivable is payable by the *payer*. The transaction is *non-recourse* or *without recourse* if the assignee accepts the credit risk of the payer (ie if the payer does not make payment, the assignee does not have recourse to the assignor)[1], and *with recourse* if it does not accept such a risk (ie if the payer does not pay, the assignor must compensate the assignee).

[1] There will usually still be some circumstances of recourse, such as where the assignee is in breach of its obligations or misrepresents the existence or details of the receivable.

19.04 Typically, the agreement between the assignor and the assignee is called a *Receivables Purchase Agreement* or *RPA*. There are many other titles used, none of which affects the analysis.

19.05 There are a number of labels applied to transactions, such as factoring as opposed to receivables purchase, whole turnover purchases, etc. The

authors' experience is that these labels assist little in the true sale analysis, and in each case it is important to analyse the actual structure of the transaction.

HOW IS A RECEIVABLES PURCHASE TRANSACTION EFFECTED AT LAW?

19.06 English law relating to the transfer of contractual rights is codified by the Law of Property Act 1925 (LPA 1925). Section 136 provides:

> **'Legal assignments of things in action**
>
> Any absolute assignment by writing under the hand of the assignor (not purporting to be by way of charge only) of any debt or other legal thing in action, of which express notice in writing has been given to the debtor, trustee or other person from whom the assignor would have been entitled to claim such debt or thing in action, is effectual in law (subject to equities having priority over the right of the assignee) to pass and transfer from the date of such notice—
>
> (a) the legal right to such debt or thing in action;
> (b) all legal and other remedies for the same; and
> (c) the power to give a good discharge for the same without the concurrence of the assignor.'

19.07 We analyse various issues relating to this provision below, but normally the position is clear: an assignment of a receivable of which notice is given to the debtor will transfer at law the right to receive payment of the receivable and to sue on it.

ASSIGNMENT AS OPPOSED TO NOVATION

19.08 The LPA 1925, s 136 addresses the transfer of rights, not the transfer of obligations. The circumstances where parties can transfer obligations under contracts (whether or not at the same time that rights are transferred) are not relevant to this analysis, because the financier is advancing money and expecting to be paid from the proceeds of the receivables; it is not taking on obligations.

19.09 Transfers of obligations under contracts are effected by means of a novation, whereby the contractual parties change.

19.10 There are typically no obligations relating to receivables, once the goods or services have been delivered or performed. Contrast the discussion on physical repurchase transactions and leasing transactions, where ongoing rights and obligations relating to the asset are relevant.

A common misconception

19.11 Frequently, commercial parties refer to 'assignment' when they mean 'novation' ie the change in a contractual party. It is very common for commercial contracts to prohibit assignment, and almost as frequently, what the parties are seeking to do is to ensure that they continue to deal with each other, not a third party. The parties will not have given any thought to whether the right to receive payment can or cannot be assigned, but a prohibition on assignment may do just that.

EQUITABLE ASSIGNMENTS

19.12 The parties may enter into an assignment where the requirements for a legal assignment are not met. For example, notice of the assignment is not given to the payer, or the right is not in existence at the date of the assignment or the assignment is of part only of a debt.

19.13 Such assignments will take effect in equity, and are capable of constituting true sales as much as legal assignments are. They have differing effects – if the debtor is not notified of the assignment then it remains capable of obtaining a discharge of the debt by making payment to the assignor.

PRIORITY OF ASSIGNMENTS

19.14 Priority in relation to an assignment between assignees of the same receivable is determined by the date of notice rather than the date of the assignment. Priority of assignments is a complex issue and is outside the scope of this work.

PURPOSE OF THE TRANSACTION

19.15 The transaction may be structured as an outright sale of receivables for a number of reasons. All of the following are potential reasons, and any given transaction might be based on any one or a combination of them:

(a) it allows funding at favourable rates;
(b) corporates can set up programmes to give their suppliers cashflow advantages;
(c) it avoids the need to create registrable security;
(d) security may be prohibited by restrictions in financings, while outright sales might not;
(e) lending may be unlawful in the relevant location while purchases of receivables may be lawful;
(f) the counterparty may seek off balance sheet treatment for the transaction;
(g) the financier may receive preferential capital treatment for the transaction; and
(h) it can be put in place quickly and conveniently.

We now look at each of these in turn.

It allows funding at favourable rates

19.16 Because the assignee will own the receivable, it amounts to a direct payment obligation of the payer to the assignee, to which the assignee will apply a discount to the principal value at an interest rate reflecting the credit risk of the payer. If the assignor is relatively uncreditworthy, such as an SME[1], and the payer is a large corporate entity (or perhaps a governmental body) with a better credit risk, the financing will be at lower rates than a loan based on the credit of the assignor. The entity that is not creditworthy therefore obtains financing at the pricing that would be applied to a loan to the

creditworthy entity.

[1] Small or medium-sized enterprise.

Corporates can set up programmes to give themselves and their suppliers cashflow advantages

19.17 Many large corporates which have a great many suppliers, such as manufacturers or supermarkets, find it convenient to work with their financiers to establish programmes that streamline new procurement processes, and also potentially allow the supplier conveniently to discount the invoice at the favourable rate referred to above, and therefore obtain immediate payment.

19.18 Once established, these programmes also allow streamlining of the supply chain through electronic platforms, simplifying the invoicing process for those involved.

It avoids the need to create registrable security

19.19 While research will be needed into the matter in relation to the systems of law applicable in any given transaction, outright sales of receivables are not subject to registration requirements under English law[1].

[1] There has been much work done on law reform in this area, including in relation to a potential registration system. See Chapter 15.

Security may be prohibited by restrictions in financings, while outright sales might not

19.20 Negative pledges in loan documents often restrict the security that the counterparty may grant. This restriction may not extend to outright sales and purchases of receivables. In each case, the wording of the restriction will need to be considered in detail to determine whether the negative pledge does extend to 'quasi-security' interests, which may include sales of receivables. However, corporate finance facilities often contemplate such arrangements: if the receivables purchase is without recourse then the lender under the financing facilities may be delighted that its borrower has turned its receivables (each carrying the risk of non-payment) into cash, and the funds received earlier. It is therefore quite common to see receivables purchases, particularly without recourse receivables purchases, carved out of negative pledges, often subject to parameters.

Lending may be unlawful in the relevant location while purchases of receivables may be lawful

19.21 Lending may be subject to local restrictions or regulations in the country in question, while the outright purchase of receivables by the financier may be freely entered into. In those circumstances, careful consideration is

necessary that the providing of finance through receivables purchase transactions is not caught by the restriction on lending.

The counterparty may seek off balance sheet treatment for the transaction

19.22 The correct accounting treatment for any given transaction is a matter for the auditors of the relevant company, whether it be the financier or the counterparty, and will depend on applicable accounting rules and practice in the relevant jurisdiction. Sales and purchases of receivables may qualify for off balance sheet treatment (ie the transaction is accounted for as a receipt for payment in the ordinary course of business of the assignor, rather than a loan to the assignor), in particular where the transaction is non-recourse.

The bank may receive preferential capital treatment for the transaction

19.23 The regulatory framework of banks and other financial institutions is outside the scope of this work. It may be that, because the financier in a receivables purchase transaction takes the credit risk on the payer rather than on the assignee, the transaction requires less capital to be held by the financier compared to the equivalent lending transaction.

It can be put in place quickly and conveniently

19.24 Transactions for receivables purchases are usually contracted in the form of master agreements, with simple arrangements for each transaction. Once the master agreement is established, transactions can be exchanged in the pre-agreed format very quickly. Security interests typically involve more formality. In particular, security assignments are often executed as needs.

19.25 Many banks and other financial institutions have established online platforms that allow receivables to be discounted very quickly once entities have signed up to the programme. These typically allow parties to upload and confirm invoices and allow for their discounting online.

ECONOMICS OF THE TRANSACTION

19.26 The economics will be that of a financing, with a discount applied to the value of the receivable, with the discount determined by reference to an interest rate and the payment period of the receivable. There may also be a retention of a percentage of the receivable by the assignee so that the assignee pays 90% (for example) of the value of the receivable upfront, and pays the balance (less the discount) once the receivable is paid. This might be because of credit considerations or possibly to ensure that the assignor retains some element of risk in the receivable.

DISTRESSED RECEIVABLES

19.27 There is also a market for distressed receivables, which will trade at lower than par value. The true sales analysis will be the same.

INSURED RECEIVABLES

19.28 Transactions sometimes require the purchased receivables to be insured by a credit insurer. This gives rise to questions as to whether the insurance should also be assigned, but the true sales analysis is not affected.

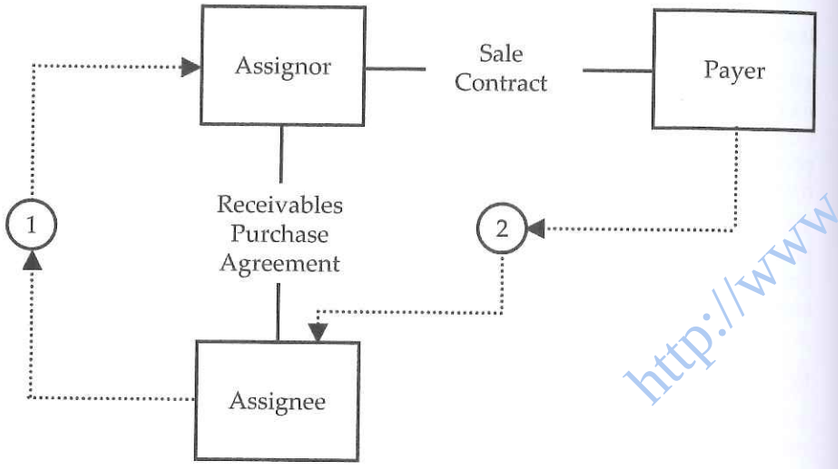
STRUCTURE OF THE TRANSACTION

19.29 The transaction is structured as an outright sale of receivables, whether with or without recourse.

19.30 The market for receivables sales is well established, with many financiers transacting on relatively standard terms dealing with common issues. Receivables can be generated by any form of economic activity, though the most common type of transaction will be receivables generated by sales of goods.

DETAILED STRUCTURE AND DIAGRAM

19.31 There are a number of variations to the structure, but the basic structure is quite simple.



1 Payment of the purchase price for the receivable.

2 Payment of the receivable.

19.32 A common feature is that the assignor may continue to operate the relationship with the payer, perhaps because the receivables form part of a continuous stream or constitute all or a significant percentage of the turnover

with the assignor. The manner in which the payment and receipts accounts arrangements are structured can impact on the true sales analysis.

FORM OF DOCUMENTATION

19.33 Receivables purchase arrangements are typically documented using standard contracts following industry norms, either standalone or drafted as master agreements with forms of offer to be executed for individual transactions documenting the detailed terms of that transaction, such as the description of the receivables and the underlying contracts. The offer by the assignor to sell the receivables is usually accepted by the assignee by making payment of the purchase price.[1]

1 This structure stems from the time when the purchase of a receivable was subject to stamp duty in the UK. Stamp duty is a tax on documents and this structure ensured there was no document that was subject to stamp duty, and hence no stamp duty was payable.

19.34 There is no standard form of sale contract for sales of receivables, such as the standard form contracts published by ISDA[1] or the ICMA[2] or similar market-based terms[3].

1 The International Swaps and Derivatives Association, Inc. www.isda.org.
2 The International Capital Market Association. www.icmagroup.org.
3 Attempts to do so do not always work well, since the close out mechanics of contracts designed for assets traded on exchanges are not designed for commercial receivables. Contrast Chapter 25.

19.35 While differences in the detailed terms of contracts used can affect the true sale analysis, the forms of agreement used as the basis of the transactions tend to follow established norms and the format used is unlikely, of itself, to impact on the analysis.

WHAT IS THE RECHARACTERISATION ARGUMENT?

19.36 The question is whether the sale of receivables can be recharacterised as a loan secured on the receivables.

19.37 The recharacterisation argument is similar to that for other forms of structured financing, that the substance of the transaction is not a true sale, since the parties intend simply to create a financing arrangement secured on receivables, that the transaction is economically a secured loan, and that the assignee never intended to have any meaningful ownership interest in the receivable.

DOES THE CHARACTER OF THE TRANSACTION MATTER?

19.38 The characterisation of the transaction may not matter to one or both of the parties. It will be a question of the circumstances and will require consideration in the context of the parties' aims for the transaction, for example whether the considerations at paras **19.15–19.25** above apply.

19.39 In the UK, if the sale of receivables was recharacterised as a charge, then that charge would be likely to be void against a liquidator of the counterparty

ANALYSIS OF THE POTENTIAL RECHARACTERISATION OF A PARTICIPATION ARRANGEMENT UNDER ENGLISH LAW

21.31 Whether a participation arrangement constitutes a true sale will be determined by consideration of its structure and then applying the relevant true sale analysis to that structure, in particular if it involves some form of assignment or trust arrangement.

Those structures are discussed in detail in Chapter 19.

DOES THE STRUCTURE OF THE TRANSACTION MATTER?

21.32 The structure of the transaction will always matter in a true sale participation, because that structure will have been used for a specific reason, namely to give the participant a proprietary right in the underlying asset. It may not matter equally to the parties; for example the grantor, once it has received payment from the participant in respect of its participation, will be indifferent to the legal true sale analysis, while the participant is likely to care very much indeed.

Chapter 22

REPURCHASE TRANSACTIONS INVOLVING GOODS

SUMMARY OF THE TRANSACTION

22.01 A Chapter on the sale and purchase of goods might appear odd in a work on true sales and recharacterisation of financing transactions. A sale of goods between a seller and a buyer is possibly the most basic legal interaction that can occur, and is one that all systems of law have developed detailed rules to regulate.

22.02 Day-to-day sales of goods are frequently conducted with no written contract at all, and the law, in England the Sale of Goods Act 1979, fills in these gaps effectively.

22.03 There is detailed case law on the Sale of Goods Act and its predecessors, both on contractual terms and remedies. Sales of goods also often form the backdrop of key decisions of English contract law such as the law of misrepresentation and mistake, but there is very little in relation to true sales and recharacterisation.

22.04 True sale issues will have no relevance to normal sales of goods where the seller and buyer are unconnected, and where the buyer pays for the goods, takes delivery and is never heard from again. However, the purchase of goods by a financier combined with the resale of those goods, probably (but not necessarily) back to the same counterparty, is a well-established method of raising finance against those goods and is one where the doctrine of true sales is relevant.

22.05 There is no single name for such transactions in the financing market, and they are generically described here as repurchase transactions.[1]

[1] The terminology 'repurchase transaction' and its derivative 'repo' are also standard in relation to repurchase transactions in relation to financial assets, such as listed bonds and shares securities, described in Chapter 23.

RETENTION OF TITLE DISTINGUISHED

22.06 The transactions discussed in this Chapter should be distinguished from those involving retention of title clauses. A retention of title clause is a provision whereby title to goods that are sold remains with the seller until certain conditions are met (in particular, the payment of the purchase price),

but where the sale otherwise takes place normally. Whether such a provision will be effective will depend on a number of factors, for example whether the goods are still identifiable, but there is no basis to suggest that it would be recharacterised as a security interest under English law principles (and see paras 9.27 ff in relation to *In re Weldtech Equipment Ltd*[1], where this position was apparently accepted without question). Indeed, the moratorium on enforcement of security in the Insolvency Act 1986, Sch B1 refers to retention of title clauses in a separate provision to security interests. Whether such a provision is registrable will depend on applicable laws, in particular the law of the purchaser and the law of the place of the goods. There is no such registration regime in England and Wales.

1 [1991] BCC 16.

PARTIES INVOLVED AND TERMINOLOGY

22.07 In this Chapter, the *counterparty* is the entity that would otherwise own the goods and receives the financing. In the basic structure this would be the entity that originally sells the goods to the bank or other financier and which will repurchase them.

22.08 There will be at least two parties involved, the original purchaser and seller of goods, as well as the seller and purchaser of the goods at the end of the transaction. Other parties may be involved in relation to the physical storage and handling of the goods, such as vessel operators, warehousers etc.

HOW IS A REPURCHASE TRANSACTION EFFECTED AT LAW?

22.09 There are no formalities under English law required to effect a sale of goods, and the provisions of general contract law such as offer and acceptance and consideration apply as they would in any other contract. Normally these are self-evident in the context of a sale of goods.

22.10 Section 2 of the Sale of Goods Act 1979 defines a contract of sale of goods as: 'a contract by which the seller transfers or agrees to transfer the property in goods to the buyer for a money consideration, called the price'.[1]

1 The Sale of Goods Act 1979, s 62(4) excludes from its provisions 'a transaction in the form of a contract of sale which is intended to operate by way of [security]'. There is no reported decision on this section, but it is unlikely to change the recharacterisation analysis, and would not apply where the intention is to give effect to a genuine sale.

22.11 The law draws a distinction between property (or title[1]) to goods and risk of loss in the goods with the possibility that these can pass from the buyer to the seller at different times. Since for many sales of goods these matters are not expressly considered, the Sale of Goods Act provides that title to goods passes when the parties intend.[2] The Sale of Goods Act then has detailed rules for ascertaining this intention[3], and usually this will be on delivery of the goods. Unless the parties agree otherwise, risk in the goods will transfer at the same time that title transfers.[4] Most repurchase transactions in relation to goods will provide for these matters expressly.

1 The Sale of Goods Act refers to 'property' in goods. Title is the more commonly used phrase.

2 Sale of Goods Act 1979, s 17(1).
3 Sale of Goods Act 1979, s 18.
4 Sale of Goods Act 1979, s 20.

PURPOSE OF THE TRANSACTION

22.12 The purpose of the transaction is likely to be to raise finance. The transaction may be structured as an outright sale and purchase for a number of reasons. All of the following are potential reasons, and any given transaction might be based on any one or a combination of them, or for other reasons:

(a) it avoids the need to create registrable security;
(b) it avoids limits on the effectiveness of floating charges over goods;
(c) it allows working capital to be raised on goods where the counterparty retains control of the goods;
(d) security over the goods may be prohibited by restrictions in third party financings, while outright sales might not;
(e) lending may be unlawful in the relevant location while purchases of goods may be lawful;
(f) the counterparty may seek off balance sheet treatment for the transaction;
(g) the financier may receive preferential capital treatment for the transaction; and
(h) the transaction can be put in place quickly and conveniently.

22.13 Looking at each of these in turn:

It avoids the need to create registrable security

22.14 While research will be needed into the matter locally (see para 22.71 below), sales of goods are generally not subject to registration requirements, other than in relation to specific assets, such as cars, aircraft and ships. Such registration would be impractical in the usual course of dealing with goods – sales of goods take place continuously and a registration system would never be followed in the real world other than for assets, such as vehicles, where the relative infrequency of sales combined with the value of asset makes it worthwhile. It would also be unlikely to serve any useful purpose because most legal systems follow a possession-based system in relation to goods, relying on the fact that the seller has possession as being sufficient evidence of ownership unless the contrary is established. Exceptions to this can leave an unwitting purchaser having to return goods to which the seller did not have title, because for example the goods were stolen[1], but the practical advantages of no registration coupled with the protections that purchasers have as part of the statutory code[2], mean that the law generally works well and reflects the reality in practice.

1 See Sale of Goods Act 1979, s 21.
2 For example, a sale by a mercantile agent in the usual course of trade is an exception to the Sale of Goods Act 1979, s 21 and will be effective to pass title under the Factors Act 1889, s 2(1).

22.15 It is for similar reasons that English law has no registration system for pledges supported by possession. Charges created by UK companies are generally registrable at Companies House within 21 days of their creation.[1] Charges created by non-UK companies are not generally registrable in the UK.[2]

1 Companies Act 2006, s 859A.
2 Whether specific assets such as aircraft are registrable is outside the scope of this work.

22.16 If the financier has possession of the goods, whether actual or constructive[1], third parties dealing with the counterparty are not prejudiced as they are unlikely to deal with those goods with the counterparty, since a third party would typically pay for goods against delivery (and only then achieve a proprietary interest in the goods), and delivery cannot occur while the financier has possession.

1 See Calnan, *Taking Security: Law and Practice* (2006), Ch 2, for a detailed discussion of the level of possession, actual or constructive, needed to support a pledge.

It avoids problems created by floating charges over goods

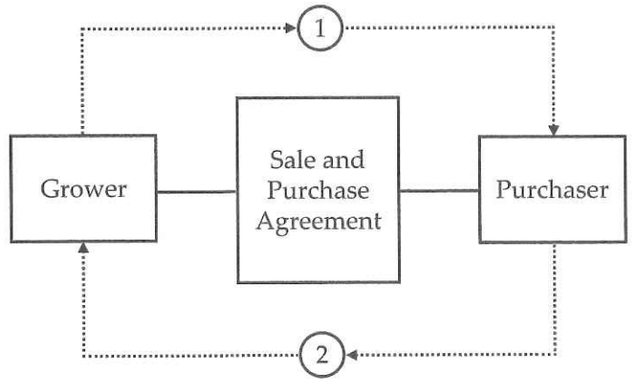
22.17 Floating charges raise practical legal problems. In the UK, certain liabilities of the creator of the charge take priority over a floating charge in insolvency.[1] Importantly, floating charges are not recognised as a concept in many jurisdictions.[2] In such jurisdictions, security over goods may only be created by a pledge supported by possession (or equivalent security with control over the goods being held by the financier) so that if the financier does not have possession, security is impossible to establish.

1 See Part IV of the Insolvency Act 1986. Briefly, these are fixed charges, costs of the insolvency, amounts preferred at law (certain employee contributions and some others), and a retention amount for general creditors, which is limited.
2 Most common law systems recognise floating security. Certain jurisdictions, for example Germany, have concepts that can have a similar result to a floating charge in relation to movable property assets. Many civil law systems, such as Switzerland and the Netherlands, do not.

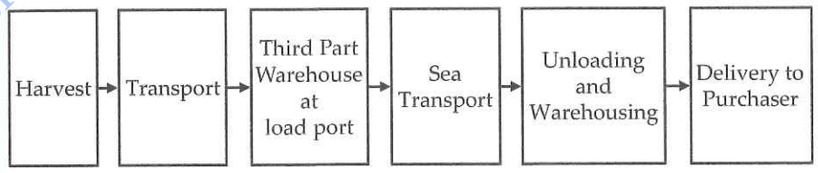
It allows working capital to be raised on goods where the counterparty retains control of the goods

22.18 As noted above, security may not be achievable if the financier does not have possession of the goods, and a floating charge may be undesirable or ineffective in the location of the goods.

22.19 In many situations, the financier and the counterparty may want to finance the goods while they remain in the control of the counterparty. An example is a coffee transaction, where the counterparty, a company that produces coffee for retail sale, purchases raw coffee from a grower on terms that delivery is to a warehouse at the loading port. The contractual arrangements and journey of the coffee from the grower to the purchaser will look like this:



1 Coffee
2 Money



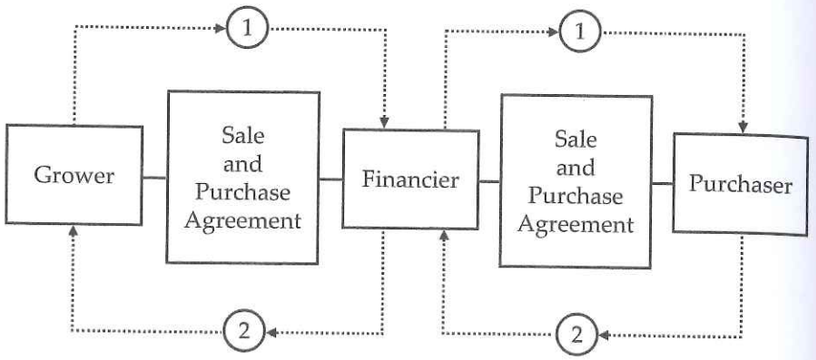
Journey of coffee from grower to purchaser

22.20 Throughout these stages, the counterparty will typically have control of the goods once they are originally delivered to the warehouse at the loading port. During the period while the goods are on the vessel, or in a third party warehouse, it may be possible for a financier to retain control by virtue of possession of documents of title in the form of bills of lading or an attornment by the warehouse keeper.[1] However, this may be impractical as the goods proceed on their journey, and will not be possible while the goods are in storage at the counterparty's premises.

1 An attornment is a confirmation by the warehouse keeper that the goods are held to the order of a third party, in this case the financier.

22.21 Assuming a floating charge is not possible, what may be possible is that the financier can purchase the goods from the counterparty or the original producer. In that case, the requirement of control necessary for a pledge does not apply. There is no legal restriction on goods owned by one party being in the control of another party. The flow of coffee will be the same (with

ownership being with the financier rather than the purchaser), but the contractual matrix will now look like this:



1 Coffee

2 Money

Security may be prohibited by restrictions in financings, while outright sales might not

22.22 Negative pledges in loan documents often restrict the security that the counterparty may grant over its assets to others. This restriction may not extend to outright sale and purchases of goods. In each case, the wording of the restriction will need to be considered in detail to determine whether the negative pledge does extend to 'quasi-security' interests, which may include repurchase arrangements.

Lending may be unlawful in the relevant location while purchases of goods may be lawful

22.23 Lending may be subject to local restriction or regulation in the country in question, while the outright purchase of goods by the financier may be freely entered into. In those circumstances, careful consideration is necessary that the providing of finance through ownership transactions is not caught by the restriction on lending.

The counterparty may seek off balance sheet treatment for the transaction

22.24 The correct accounting treatment for any given transaction is a matter for the auditors of the relevant company, whether it be the financier or the counterparty, and will depend on applicable accounting rules and practice in the relevant jurisdiction[1]. A number of repurchase transactions relating to

physical goods may qualify for off balance sheet treatment, in particular where the counterparty is not obliged to repurchase the goods and so has divested itself of the key risks and rewards of the asset in question.

1 See Chapter 17.

The financier may receive preferential capital treatment for the transaction

22.25 The regulatory framework of banks and other financial institutions is outside the scope of this work. It may be, because the financier in a repurchase transaction owns the goods rather than relying on the performance of the counterparty, that the transaction requires less capital to be held by the financier compared to the equivalent lending transaction.

It can be put in place quickly and conveniently

22.26 Transactions for purchases of goods typically need no formality, and these transactions are usually contracted by short form agreements or in the form of master agreements, with confirmations for each transaction. Once the form of agreement is established, contracts can be exchanged in the pre-agreed format very quickly. Security interests typically involve more formality. In particular, security agreements are executed as deeds.

ECONOMICS OF THE TRANSACTION

22.27 Repurchase transactions in respect of goods will have one consistent theme, which is that they, like most of the structured finance products described in this work, economically amount to financings and are priced as such.

22.28 Pricing may well be by reference to market pricing of the goods in question[1], with that pricing locked in by way of a derivative transaction on an exchange where the goods are traded, typically a commodity exchange.

1 Again, this may be relevant to the accounting treatment, as the risk of price changes is a key risk of the asset.

STRUCTURE OF THE TRANSACTION

22.29 The transaction is structured as an outright sale of goods, with an agreement to repurchase[1].

1 See paras 22.90–22.96 below for potential variations to the structure, in particular the use of options and different counterparties.

22.30 There is a well-established market in repurchase transactions for commodities undertaken by international banks and financiers. The transaction is similar in its structure to securities repurchase arrangements (see Chapter 23), but here the goods are physical goods. Typically, goods will be commodities such as oil in a storage terminal or on a vessel, base metal in an LME[1] or other warehouse or soft commodities such as grains, again whether

in storage or in transit.

[1] The London Metal Exchange, www.lme.com.

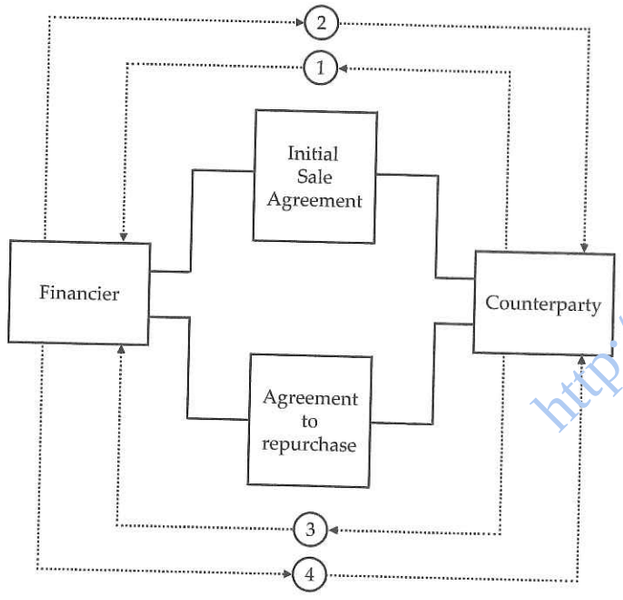
22.31 While transactions in relation to semi-finished goods and finished goods are rarer, they do also occur.[1] The principles are identical, though the practicalities differ.

[1] Examples from the authors' experience include Parmesan cheese, Scottish whisky and (proposed but sadly not implemented) a Rembrandt painting.

22.32 The advantage of commodities is that they are readily capable of valuation and sale if the counterparty does not repurchase them.

DETAILED STRUCTURE AND DIAGRAM

22.33 Initially, the financier purchases goods from the counterparty. The counterparty agrees to repurchase those goods from the financier at some point in the future. The contracts will be entered into simultaneously and provide for initial delivery of the goods to the financier followed by repurchase in the future with redelivery by the financier to the counterparty.



1 Delivery of goods by Counterparty to Financier
2 Payment for goods
3 Payment for goods by Counterparty
4 Delivery of goods by Financier

22.34 Typically, transactions will be short term, with the potential of periodic rollovers.

22.35 The goods in question will need to be looked after. They will ultimately be repurchased by the counterparty and may be in the course of transit to its premises. The counterparty will want to know that it will repurchase the same (or equivalent) goods. Action may need to be taken or decisions made in relation to the goods, such as the mechanism involved in instructing the unloading of the goods from a vessel and their transit to a storage facility at the port of discharge, the potential clearing of customs and other formalities and the continued storage and ultimate release of the goods.

22.36 These actions may be taken by the financier itself or it may appoint a third party as its agent or service provider to look after the goods. In many cases, the counterparty itself will contract to provide these services to the financier via an agency or services agreement.

22.37 There are a number of potential variations on the structure and factual variations, discussed in paras 22.90–22.96 below.

FORM OF DOCUMENTATION

22.38 Repurchase transactions involving goods are typically structured using bespoke contracts, either standalone or drafted as master agreements with forms of confirmation to be executed for individual transactions documenting the detailed terms of that transaction, such as the description of the relevant goods and their location as well as any variations on the agreed terms.

22.39 Transactions are also periodically structured using standard form contracts published by ISDA[1] or similar market-based terms. ISDA has prepared a number of standard annexes for certain physical delivery contracts, such as gold and other precious metals.

[1] The International Swaps and Derivatives Association, Inc. www.isda.org.

22.40 While differences in the detailed terms of contracts used can affect the true sale analysis, the form of master agreement or standard contract that is used as the basis of the transaction is unlikely, of itself, to impact on whether the transaction is a true sale. Put another way, the transactions can be a true sale irrespective of the contractual starting point.

WHAT IS THE RECHARACTERISATION ARGUMENT?

22.41 The question is whether the sale of goods, combined with the obligation of the counterparty to repurchase the goods, can be recharacterised as a loan secured on the goods.

22.42 The recharacterisation argument is similar to that for other forms of structured financing, that the substance of the transaction is not a true sale, since the parties intend simply to create a financing arrangement secured on goods, and that the financier never intended to have any meaningful ownership interest in the goods.