FINANCIAL MARKETS LAW COMMITTEE
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CHAIRMAN – LORD BROWNE-WILKINSON

1 December 2004

The Hon Mr Justice Toulson
The Law Commission for England and Wales
Conquest House
37-38 John Street
London
WC1N 2BQ

Dear Roger,

FINANCIAL MARKETS LAW COMMITTEE: REFORM OF LAW ON COMPANY SECURITY INTERESTS - UNCERTAINTY ISSUES RAISED BY LAW COMMISSION CONSULTATION PAPER NO. 176

I am writing with the comments of the Financial Markets Law Committee ("the FMLC") on the proposals by the Law Commission for the reform of the law on Company Security Interests by subsidiary legislation under the proposed new Companies Act. The majority of the issues raised in this letter and our presentation of them are the product of our Working Group on these proposals. I hope this letter will be complementary to the Consultation responses you have received.

The role of the FMLC is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed. This paper therefore addresses only issues of that nature, which we consider it is essential are dealt with if the proposals are to proceed. The FMLC is conscious that many practising lawyers have great reservations about various proposals contained in the Consultation Paper (which introduces many radical changes in the law), but the FMLC has not commented on these reservations save to the extent that uncertainty issues are involved. Also, we express no view on policy issues, but our silence should not be taken as either assent or disapproval of the proposals.

The FMLC's Working Group in this area is chaired by Roger McCormick: the FMLC owes him and the members of the Working Group, listed below, a deep debt of gratitude. The FMLC would also like to express its appreciation to the Law Commission and its staff for taking time to meet with our Working Group and for their readiness to discuss issues with our Working Group openly and constructively. Additional issues were raised at the meeting of the Committee on 11th November and those that were considered material are incorporated in this letter.

Members of the Working Group

Elizabeth Grant	Lloyds TSB
Tim Herrington	Clifford Chance
Matthew Jolly	UBS
Roger McCormick (Chair)	
Martin Thomas	FMLC
Annabelle Vamos	Slaughter & May
Sarah Worthington	London School of Economics

1 General

Any new law, particularly one which is as wide in its scope as the proposals contained in Law Commission Consultation Paper No 176 ("the CP"), is likely to involve a degree of uncertainty until market practice in its interpretation (and perhaps a certain amount of review by the courts) has established a degree of consensus on its meaning. These comments do not deal individually with less significant areas of uncertainty which it believes are likely to be resolved in the natural course as and when the proposals are adopted (if they are adopted) and practitioners have become more familiar with them. The Committee did, however, note that the "bedding down" time for a new system of taking security means that the period in which these less significant areas of uncertainty persist is likely to be measured in decades, rather than years, and this in itself emphasises the need for great care in reviewing the proposals and their drafting. Such areas of uncertainty will be minimised by ensuring that existing case law remains applicable where not inconsistent with the proposals.

The FMLC is very conscious that many practitioners, at the time our Working Party was writing its report, were still finalising their comments on the CP and our Working Party was not able to receive complete comments from many of those it consulted. It may be that other issues will be drawn to our attention which we may consider of significance and we should be grateful if you would receive any further comments of that nature as they arise. Also we are aware that some commentators are examining the drafting in detail. We have looked at the broad principles and limited our drafting comments, so as not to be lost in the detail. Subject to that, the FMLC believes that the issues identified in the following paragraphs represent the significant issues potentially giving rise to uncertainty that it has been able to identify in the CP at this stage. References below to "DR" are to the draft regulations set out in Appendix A to the CP.

2 The "Quasi Security" Proposals

The drafting of the opening lines of DR3(2) use what might loosely be called "sweeper" language, ie the definition does not purport to be exhaustive. This results in some uncertainty as to what other kinds of transaction might fall within the scope of the new definition of "security interest". The position is not helped by the fact that sub-paragraph (3) does not state that the transactions listed there are "deemed" security interests (which is the expression used throughout various commentaries on the proposal) but simply states that "security interest also means...". Since the transactions which are described in the list in sub-paragraph (3) are not *eiusdem generis* with those described in sub-paragraph (2) this could add to the uncertainty as to what might be caught by the "sweeper". It would have been helpful if the drafting could have made it clearer that the "deemed" security interests are just that. In this way, it would be much clearer that the regulations "catch" these transactions in order to require filing, but that the list in sub-paragraph (3) is not to be taken as an indication of what kind of transaction might generally be regarded as a "security interest".

We would add that we share the concerns that have been expressed by some about the inherent vagueness in the expression "if they secure payment or performance of an obligation" in DR paragraph 2 (b). We are aware that the Law Commission are of the view that this paragraph catches finance leases but not operating leases. However, in our view, the wording is wide enough to catch operating leases as well. Much turns on what is meant by "secure" in this phrase. This is a good example of a change introducing new language for which there is no English law precedent as to its exact scope and where several cases will be needed to establish its ambit.

There is a particular uncertainty created by the redefinition of transactions which are not presently regarded as charges as forms of security interest treated in exactly the same way as charges. This uncertainty would need to be addressed or it would have the ability to cause financial instability.

Many security instruments, including long term debenture stock and secured bond issues (maturity of 20 years or more), have negative pledges against the creation of any other security interest. These negative pledges often bite on trading companies in major groups as well as on PLCs: e.g. because the main trading companies hold the tangible assets and book debts of the borrower group and will usually be asked to guarantee major parent company lending.

The terms of these negative pledges may well permit companies to carry out transactions which are not currently recognised in law as security interests. There is a risk that a change in the law will cause existing quasi-security arrangements to fall within the terms of these negative pledges and place the borrower in default. There would be a substantial cost to the borrower (including typically an increased coupon) to obtain agreement to waive the breach and in some cases this may not be available (e.g. if the original terms are fundamentally unattractive as a result of changed market conditions and it would suit the lenders to bring the arrangement to an end, collecting also compensation for early repayment). The alternative of an affected business ending all such quasi-security interests would be to deprive it of efficient means of funding. As many other financial arrangements of the borrower will carry cross default provisions, once a default occurs then there could be a "domino effect" leading to financial collapse.

It is also the case that title retention arrangements on the supply of goods have not been treated as security interests and therefore will not always be the subject of express exclusion from negative pledges - the issues on obtaining an appropriate amendment are as outlined above. Although suppliers will need consent to file in relation to a title retention arrangement, there is real practical risk that consent will be given by purchasing executives with no understanding of the implications of giving consent. Accordingly trading businesses may find it impossible to avoid going into breach as regards this form of quasi-security, except where they have got an express exemption from their negative pledge in place.

The Law Commission should therefore, if the provisions relating to quasi-security are to proceed, consider a provision to "set in stone" the interpretation of negative pledges in pre-existing agreements by reference to the interpretation they would be given prior to the new law coming into effect, to apply even after the transitional period.

As regards title retention on sale of goods, we suggest that the Law Commission should give further consideration to whether, having regard to the legal uncertainty created, it is right to recharacterise title retention on sale of goods as a quasi-security, or whether the present situation is preferable. The present situation recognises the genuine sale character of the transactions and (without registration and by virtue of the postponement of the passing of title for the purposes of sale of goods law) allows title retention clauses to operate to the extent that the goods are identifiable in their original form and have not been paid for. In practice, this situation is acceptable to suppliers and they do not seek to register to obtain

greater rights to trace into the proceeds of sale. This is also an acceptable situation in an insolvency, since the administrator/receiver or liquidator can see which unused raw materials may be affected at the outset, but is able to sell finished goods and deal with the proceeds and does not have to devote resources (which are by definition already inadequate) to dealing with disputes between suppliers asserting a right to trace into the proceeds of sale of goods into which their supplies have been incorporated. If suppliers have to register to preserve their right to goods still in their original form, then they will add tracing rights to the clauses that they register, leading to a proliferation of tracing disputes.

3 The Application of the Law to the Outright Assignments

The proposals clearly require filings to be made of outright assignments. This is completely new law and it may take some time for businessmen to become accustomed to the new requirements. Our Group has raised concerns with the Law Commission as to how easily the business community might adapt to the requirement to file, say, a single outright assignment of a debt. It appears that the Law Commission might also have some misgivings as to whether "isolated" assignments should require filing and this is reflected in paragraphs 3.96 to 3.98 of the CP. The Law Commission's question as to whether or not filing should be unnecessary in the context of an assignment "which does not by itself or in conjunction with other assignments to the same assignee transfer a significant part of the assignor's outstanding accounts" raises questions of uncertainty. Although many would share the view that it would be desirable to exempt "isolated" assignments, concerns are likely to arise as to what might be meant by a "significant part" and how the line should be drawn. Again a series of definitional cases are likely to be needed and this is the type of issue which may be subject to differences of judicial view.

4 Floating Charges and the Relationship with Insolvency Law

The proposals of the Law Commission in relation to floating charges are reasonably clear. However, the question which has been asked by many bankers is: what impact will this have on insolvency? (The concern relates, essentially, to the *"Spectrum"* line of cases regarding fixed/floating charges over book debts etc and how the law reflected in those cases will be affected by the new proposals.) This issue is acknowledged in paragraph 2.60 of the CP. It is possible that the effects of the proposals on the funding of insolvencies could be quite significant and we think it would be very desirable that the relevant amendments to insolvency law should be drafted and consulted upon, so that the proposals can be accompanied by a clear statement of what amendments will be made in relation to the relevant insolvency legislation and we are of course assuming that the consequent amendments to the legislation referred to in paragraph 2.60 will be appropriately implemented.

5 Prohibitions on Assignment

The CP makes proposals for a fundamental change to the law in DR paragraph 45(5). The change is likely to be controversial. There are a number of important uncertainty issues arising from the proposal as it stands:

(a) The proposal is only concerned with a debt owed by an "account debtor". This involves analysis of the definition of "account". There are a number of drafting issues involved here, especially the reference to "a right to payment for money or funds advanced or sold". It is appreciated that the intention is to exclude from the definition loans and typical finance/banking relationships. However, we think that the drafting needs clarification.

(b) It is not clear to us how the provision will apply to a prohibition on an assignment of the whole of a party's rights under a contract (which might for example include rights to damages for, say, breach of warranty). Is the reference to "money due or to become due" intended to confine the provision to stated debts as opposed to contractual rights generally?

(c) We do not understand why the provision relates only to an assignment to "the whole of" the account.

(d) We think that reference to "restricts" may prove to be difficult to interpret. For example, supposing (in an effort to avoid the provision) a debtor says that assignment is possible upon payment to the debtor of a significant "fee". As between the original parties (the debtor and the assignor) that provision should be valid. However, it should also, in effect, be valid as against an assignee who would normally take subject to set off. It is not clear to us how the provision would apply (if at all) in such a case.

(e) We believe that the geographical scope of provision should be clarified. We understand that it is intended to apply only in the situation where the assignor is an English company (but that it could apply even though the contract in question is not governed by English law).

6 Priorities/*Dearle v Hall*

Our Working Group put the following example to the Law Commission:

(a) A is owed a debt by X.

(b) A assigns the debt to B. B makes the appropriate filings under the new legislation, but does not serve notice on X.

(c) A then executes a second (fraudulent) assignment of the same debt to C. C has not checked the register, but subject to that, takes in good faith and serves notice on X.

What happens if X makes payment to C? We understand that it is the intention that X would get a good discharge as a result of the payment to C, but that B would have a right to trace as against C. This may not be quite the result that certain sections of the financial community have been expecting. However, we understand that the Law Commission will be consulting appropriately. We have, in particular, pointed out to the Law Commission that we believe the statement set out at the top of page xx (i.e. immediately before page 1) of the CP, "once they have filed they will ensure their own priority, without having to notify account debtors who owe the receivables", may be misleading. The position is stated more accurately (and fully) in paragraph 2.87 of the CP (especially footnote 121, which should, in the second line, refer to "assignor" not "assignee"). This is an area where inevitably there are competing innocent parties: the position can never be fair, but a notice filing system should be clear and consistent in its results.

7 Commercial Reasonableness and other Reasonableness Standards

We mention this as an area of uncertainty: our Working Group regarded it as "borderline",but the FMLC was mindful of the paramount importance attributed in financial markets to a very high level of contractual certainty and predictability (see my letter on behalf of the FMLC to the Law Commission on Unfair Terms in Contracts of 23rd June 2003 and our subsequent discussions). We believe that the extent of the incorporation of various concepts of reasonableness into the proposals (in relation to

smaller companies likely to apply concurrently with somewhat different language in relation to unfair terms in contracts) would cause a degree of uncertainty for all security takers, which would be troublesome and would run counter to the business and financial communities' expectations of English law. For larger and international transactions, the degree of uncertainty might even disincentivise parties from choosing English law and English corporate vehicles. It seems to us that it is unnecessary to incorporate these provisions because the law on unfair terms in contracts is likely to be amended (for smaller companies) and this, together with the law on insolvency, will provide appropriate safeguards.

Yours ever.

Nico

Nicolas Browne-Wilkinson

This letter will not come as any surprise to you as a member of the FMLC.

Copy to James Robinson