GOODE ON LEGAL PROBLEMS OF CREDIT AND SECURITY

FOURTH EDITION

EDITED BY
LOUISE GULLIFER

SWEET & MAXWELL

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FOREWORD TO THE FOURTH EDITION

Having decided some two years ago to try to escape from the law (a quest not yet successful!) and therefore to undertake no new editions of books myself, I was fortunate enough to secure the services of a good friend and colleague, Louise Gullifer, to prepare the fourth edition of *Legal Problems of Credit and Security*. Louise has become an established expert in this field, not only through her teaching and her work as a consultant to the Law Commission in its project on company security interests but also as co-author (with Professors Beale, Bridge and Lomnicka) of *The Law of Personal Property Security*, the first comprehensive textbook on the subject.

Editing a book written by someone else can be a delicate task, particularly when the author is still alive! Louise has succeeded admirably in preserving all the essential features of the third edition while not hesitating to move the discussion on certain issues in a new direction. I welcome this because nothing can be more stultifying than slavish subservience to what was written by the original author. In this new edition the work has been brought completely up-to-date and incorporates a number of new ideas, particularly in relation to security interests in shares. I feel sure that it will receive as a warm a welcome as did previous editions.

Roy Goode
Oxford
September 13, 2008.

DEDICATION

To my patient family: Robert, Emma and Hetty

PREFACE TO THE FOURTH EDITION

I was enormously surprised and honoured to be asked by Professor Sir Roy Goode to edit the fourth and subsequent editions of this book, which has, in its first three editions, become essential reading for practitioners, academics and students. Roy Goode has, over many years, been a hugely valued mentor, colleague and inspiration to me, and it is a great honour to be entrusted with this book which, out of all his books, is the one which is most closely aligned with my research interests. I have known this book throughout my career, and its penetrating analysis as well as its exploration of fundamental questions have informed much of my thinking in the area of security interests and their place in English law.

As befits a first new edition by someone other than the original author, I have sought to change very little except as has been dictated by recent developments in case-law, legislation, academic debate and proposals for reform. The book originated as a series of lectures, and, in the third edition, some parts were still written in the first person. I have sought to rewrite these in a more passive sense, without, I hope, losing the personal nature of some of the anecdotes and comments. I have also tried to continue Professor Goode's spirit of inquiry into difficult legal problems virtually untouched by case-law, by introducing some of the thinking that went into the book on Personal Property Security that I recently co-wrote with Professors Hugh Beale, Michael Bridge and Eva Lomnicka. For example, I have attempted to analyse in some detail what it means to take property 'subject to a floating charge', as where a floating chargor disposes of charged property outside the ordinary course of business or in breach of a restriction in the charge agreement to someone who has notice of this. This was an attempt to take up the challenge laid down by Lord Phillips in the Court of Appeal decision in *Re Spectrum Plus* [2004] Ch. 337.

I have also introduced some further discussion on academic debates originally engendered by the views expressed in previous editions, for example, the question of the validity of a provision for automatic attachment of a security interest in a negative pledge clause, which is now the subject of dicta by the Singapore Court of Appeal in the case of *The Asiatic Enterprises (Pte) Ltd v United Overseas Bank* [2000] 1 S.L.R. 300, and of a significant amount of international scholarship.

In terms of recent developments in case law, pride of place must go to the House of Lords' decision in *Re Spectrum Plus* [2005] 2 A.C. 680, which is the final chapter in the long-running saga of characterisation of charges over

book debts. Even with such a definitive decision, there are still areas of doubt, which I have attempted to identify: this is an area of such importance that discussion will never completely die and, indeed, there have already been a number of important cases on floating charges since *Spectrum*. Other cases which have necessitated discussion have been *Re SSSL Realisations (2002) Ltd* [2004] EWHC 1760 (Ch); [2006] EWCA Civ 7 (subordinated debt and turnover trusts), *Barbados Trust Co Ltd v Bank of Zambia* [2007] EWCA Civ 148 (effect of non-assignment clause and trust of a promise), *Buchler v Talbot* [2004] 2 A.C. 298 (priority of costs of liquidation, now the subject of s.176ZA Insolvency Act 1986), *Burton v Mellham* [2003] EWCA Civ 173; [2006] UKHL 6 and *IATA v Ansett Australia Holdings Ltd* [2008] H.C.A. 3 (two out of a host of new cases on set-off) and *Stotter v Equiticorp Australia Ltd (In Liquidation)* [2002] 2 N.Z.L.R. 686 (effect on creditor's proof on part payment by surety). Many other new cases have been the subject of footnotes and other references.

Legislation relating to companies has recently been reformed and consolidated in the Companies Act 2006. Sadly, there has been very little substantive reform of the law relating to the registration of company charges, despite the excellent report produced by the Law Commission in 2005. However, what used to be Pt XII of the Companies Act 1985 has been replaced by Pt 25 of the new Act, and not only the section numbers but the order of the sections has changed. This edition refers almost exclusively to the 2006 Act numbers (except where a previous section has been referred to in a case that is discussed) despite the fact that the new sections do not come into force until October 1, 2009. The few changes that have been made, or are proposed to be made, to this area of the law are discussed in the text.

Although the reform of insolvency law brought about by the Enterprise Act 2002 was already underway at the time of the last edition, this edition addresses its ramifications in more detail, such as the operation of the 'ring-fenced fund' for unsecured creditors (already the subject of one decision: *Re Airbase Ltd* [2008] 1 B.C.L.C. 437. I have also included discussion of the more recent legislative reforms to specific areas of insolvency, such as the reform of Insolvency Rule 4.90 in relation to set-off, and the extension of Insolvency Set-Off to distribution in administration, in r.2.85. However, for a more definitive and systematic discussion of the new Insolvency regime, the reader is referred to the third edition of Professor Goode's seminal book, *Principles of Corporate Insolvency*. Among the many interesting and informative discussions in that book, is some detailed consideration of the difficulties raised by Arts 2(g), 5 and 13 of the EU Regulation on Insolvency Proceedings (Ch.13). As a result, I have not thought it appropriate or necessary to take up the invitation of one reviewer of the third edition of *Legal Problems of Credit and Security* to discuss these issues in this book.

The law relating to intermediated securities has been the subject of attention from both national and international law reform bodies, and reference has been made in Ch.6 to these recent developments. I have included a number of references to the draft UNIDROIT Convention on Substantive Rules regarding Intermediated Securities, largely by way of

comparison to the current UK law. At the time of writing the book, the final draft was to have been determined at a Diplomatic Conference finishing on September 13, 2008. I have just heard that, despite huge strides having been made in reaching agreement on many extremely difficult issues, there is still need for further drafting and for a final final conference, which will take place in mid 2009. The Financial Collateral Arrangements (No. 2) Regulations 2003 have spawned their first case, albeit in the Court of Appeal of the British Virgin Islands (*Alfa Telecom Turkey Ltd v Cukurova Finance International Limited* HCVAP2007/027), which I was able to include at proof stage, although sadly there has been no judgment yet in the application for judicial review brought by Cukurova in respect of the Financial Collateral Directive.

Many of the issues addressed in this book have been the subject of discussion with colleagues and students, particularly in the Principles of Commercial Law and Corporate Finance courses which I teach at Oxford, and I am grateful to everyone who has helped to form and refine my views. Particular thanks are due to two supervisees, Woo-Jun Jon, for many discussions on the assignment of receivables, and Simon Duncan, for discussions on the floating charge point mentioned earlier. Among my colleagues, I am particularly indebted to Jenny Payne of Merton College, Oxford and Professor Hugh Beale of Warwick University for their patience in reading drafts and discussing particular points. I am also grateful to John Trundle, of Euroclear, for his help on the CREST parts of Ch.6. Although I had no formal research assistance in preparing this edition, I had some invaluable help at the beginning of my task from my daughter, Emma, who downloaded all the footnoted cases so that they were at my fingertips. I have had enormous help and support from James Douse and Fiona MacLeod of Sweet & Maxwell both for their detailed work and their patience in relation to deadlines. I am also greatly indebted to my family, Robert, Emma and Hetty, for their patience and understanding. Most of all, I am hugely indebted to Professor Roy Goode, for writing such a superb book in the first place, for allowing me to prepare this edition, for his help and support in discussing particular points and for all his help and encouragement throughout my career as an academic.

Louise Gullifer
Oxford
September 22, 2008

PREFACE TO THE THIRD EDITION

To my astonishment it is now 15 years since the appearance of the second edition of this little book. In that time much has happened. There have been a great many decisions on security interests, from the High Court to the House of Lords. Issues of characterisation, to which much space was devoted in the previous editions, have continued to feature prominently as courts wrestle with the question whether the contractual arrangements have created a security interest and, if so, whether it is in the nature of a fixed charge or a floating charge. An illuminating example is the series of decisions in the *Cosslett* case culminating in *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend County Borough Council* [2002] 1 A.C. 336. Happily the clarity of *Re Brightlife* [1987] Ch. 200, temporarily blurred by decisions such as *Re NewBullas Trading Ltd* (1993) B.C.L.C. 1389, has been restored by the decision of the Privy Council in *Agnew v Commissioners of Inland Revenue* [2001] 2 A.C. 710. Priority issues also remain a regular feature of case law, throwing up a division of judicial opinion as to whether a negative pledge clause in a charge affects subsequent incumbrancers or is purely contractual in effect and continuing debate as to the resolution of the circularity problem which arises where a company that has given a fixed charge expressed to be subordinate to a floating charge goes into liquidation owing preferential debts.

There have also been some significant cases on the effect of an assignment in breach of a no-assignment clause, in particular the decision of the House of Lords in *Linden Gardens Trust Ltd v Lenesta Sludge (Disposals) Ltd* [1994] 1 A.C. 85.

The legislature has not been idle either, with further restrictions on the enforcement of security given by a small company where the directors obtain an automatic moratorium under the Insolvency Act 2000 by filing prescribed documents with the court and, more dramatically, the almost total abolition of the institution of administration receivership, as well as the elimination of what remained of Crown preference, by the Enterprise Act 2002, though both of these sets of provisions are more relevant to the companion volume in this series, *Principles of Corporate Insolvency Law* (2nd edn), than to the present volume.

This shift in the balance of power from secured creditors to general creditors and the potential beneficiaries of reorganisations of insolvent companies appears to represent a belated reflection of the sympathies of the

incomparable Ambrose Bierce, whose *Enlarged Devil's Dictionary* defines a (secured?) creditor as:

> "One of a tribe of savages dwelling beyond the Financial Straights and dreaded for their desolating incursions",

while "debtor" receives the beneficent definition of:

> "A worthy person, in whose interest the national debt should be so managed as to depreciate the national currency."

This seems particularly appropriate for inclusion in a preface written on Budget day!

A subject that has assumed enormous importance in recent years is the taking of security and quasi-security interests in corporate investment securities. The move from paper-based to electronic issue and transfer systems (e.g. CREST) and, even more significantly, from directly held investment securities to securities held through accounts with intermediaries, has thrown up a complex of problems which in the United States have been largely resolved in the revised Article 8 of the Uniform Commercial Code but with which English law has yet to grapple, including such basic questions as the nature of an account holder's rights in securities credited to his account and whether an account holder can look through his own intermediary to assert claims against higher-tier intermediaries. Of great significance also is the warmly welcomed 2002 EC Directive on Financial Collateral Arrangements, which is designed to protect financial collateral against various possible grounds of avoidance under insolvency law. Finally, in December 2002 there was concluded the Hague Convention on the law applicable to certain rights in respect of securities held with an intermediary, addressing an important. conflict of laws question, yet one on which there has hitherto been no reported English case. These developments have led me to provide a substantial new chapter on security interests in investment corporate securities, which I hope will shed some light on dark places. In addition to the above matters I have taken the opportunity to examine the characterisation of transactions such as repos and sell buy-backs and stock loans.

Apart from these developments, the interval since the second edition has given me time for further reflection on a number of issues, leading to a substantial revision and expansion of the text, including a treatment of security interests by attornment and novation and a rewriting of the chapters on setoff and guarantees. And in relation to charge-backs, the hare which I started in the first edition has now run its course and I have felt compelled to accept that conceptual purity must give way to commercial needs and practices! But my modest suggestion way back in 1982 that charge-backs were conceptually impossible has at least served to stimulate jurisprudential debate, engaging the attention of numerous academic and practising specialists here and abroad and leading to the decision of a High Court judge

(now in the Lords), who adopted the suggestion, obiter dicta by judges in two Court of Appeal cases (in one of which serious doubt was expressed as to the earlier ruling while the other, which supported the ruling, was on behalf of a court which included the quondam High Court judge himself) and an obiter dictum of the House of Lords disapproving of the obiter dictum of the second Court of Appeal! How the doctrine of stare decisis is to be applied in this situation remains unclear!

I have benefited over the years from many helpful discussions with fellow academics, practitioners and students. I am indebted in particular to a number of friends and colleagues mentioned below for their assistance. The new chapter on security interests in investment securities was considerably improved as the result of comments by Philip Wood, Catherine Beahan and Nick Segal of Allen and Overy, Guy Morton of Freshfields, Professor Dan Prentice of Pembroke College, Oxford, Professor Jim Rogers of Boston College, Jack Wiener, managing director and deputy general counsel of The Depository Trust and Clearing Corporation, Kristen Geyer, managing director and general counsel, and Diego Devos, director and deputy general counsel, of Euroclear. Robert Stevens of Lady Margaret Hall, Oxford, and Richard Hooley, currently at Fitzwilliam College, Cambridge, but shortly to take up his appointment to a chair at King's College, London, were kind enough to read through the proofs and saved me from a number of errors and omissions. I should also like to express my thanks to my former research assistants, Rafal Zakrzewski and Bushra Razaq, for their help with literature searches. My last but not least expression of appreciation is to Kate Hayes, Senior Publishing Editor, and Melanie Pepper, Senior Project Editor, of Sweet & Maxwell, for all their expertise and support in the production of this new edition, which I hope will he found of assistance both to practising lawyers and to students.

Roy Goode
Oxford
April 9, 2003

PREFACE TO THE SECOND EDITION

This book began as a series of public lectures delivered at the Centre for Commercial Law Studies, Queen Mary College, in 1982, the purpose of which was to explore a range of fundamental legal concepts relating to security and quasi-security interests, with particular reference to security in personal property. The large attendance at those lectures and the kind welcome given both by academic and by practising lawyers to the first edition of this book revealed a widespread recognition of the practical value of a conceptual approach in this complex field, and an awareness of the problems that can result from a purely mechanical application of a set of detailed rules.

This new edition is not merely a technical update but is in many respects a new book. I have now devoted two distinct chapters to the nature and forms of consensual security and concepts of attachment and perfection. The treatment of negative pledges has been substantially expanded, an analysis offered of the legal nature of sub-participations in loan agreements and the chapter on priorities has been enlarged to include an examination of twelve typical priority problems and their solution. I have elaborated the discussion of the vexed question whether a bank can take a charge over its own customer's credit balance, reinforcing the negative view expressed in the first edition which received judicial vindication in *Re Charge Card Services Ltd* [1986] 3 All E.R. 289. The chapter on set-off has been totally rewritten and substantially extended. Dr. Rory Derham's excellent new book *Set off*, which I had the pleasure of evaluating as an external examiner when it was presented in its earlier form as a doctoral thesis at Cambridge University, reached me too late to be reflected in the above chapter except by way of footnote reference. It is the first modern monograph on the subject and is required reading for anyone interested in set-off.

By concentrating on fundamentals rather than on the minutiae of English law I have sought to provide a text which will be of assistance to lawyers throughout the Commonwealth. In this new edition I have drawn on many Commonwealth decisions, particularly those from courts in Australia, Canada and New Zealand, which have shed light on a number of complex issues and which will, I believe, be as helpful to judges in this country as their own decisions are to courts elsewhere in the Commonwealth.

I am indebted to all those who over the past few years have helped to clarify my thinking or have drawn my attention to cases and problems of which I might otherwise have remained unaware. They are too numerous to mention by name but include my academic colleagues, my students and friends in the practising profession. I owe a particular debt to Philip Wood of Allen and Overy, who has allowed me freely to draw on his encyclopaedic

knowledge of finance and security in general and of set-off in particular; to David Weed of Victor Mishcon & Co, who helped me with a practical point on searches in the Companies Registry; and to the various banks and firms of City solicitors who invited me to present in-house seminars on *Charge Card* and related problems and helped me to sharpen the argument, even at the expense to them of an inconvenient conclusion! I should also like to express my thanks to the editorial team at Sweet & Maxwell, and to Sheila Aked for preparing the index. Finally, I am indebted to Queen Mary College for granting me sabbatical leave to complete a new edition of this and other works.

The law is stated on the basis of the materials available to me at February 1, 1988.

R. M. Goode
Centre for Commercial Law Studies,
Queen Mary College,
London
February 17, 1988

PREFACE TO THE FIRST EDITION

My purpose in delivering the lectures reproduced in this book has been to explore some of the fundamental legal conceptions underlying the more important types of commercial security and to suggest that a number of conventional propositions relied on in everyday practice are conceptually unsound. In some cases the analysis leads to the conclusion that a particular form of security is less effective than previously supposed. Examples are the provision for equal and rateable security in negative pledge clauses; agreements purporting to create a charge in favour of a bank over its customer's credit balance; the registration of details of restrictions in a floating charge; and the use of automatic crystallisation clauses and the mistaken assumption that crystallisation necessarily establishes priority over a subsequent security interest. In other cases, my task has been the more agreeable one of seeking to show that apparent weaknesses in a creditor's security do not in fact exist—for example, the so-called "flawed" asset created when restrictions are imposed on the withdrawal of a deposit; the use of a provision in a guarantee which, far from prohibiting the surety from proving in competition with the creditor, requires him to do so and to hold any dividends on trust for the creditor.

That the practitioner is keenly interested in legal theory, however abstract, affecting commercial transactions was amply demonstrated by the large number of lawyers, bankers and businessmen who attended these lectures. I am indebted to my audience for several thought-provoking questions and illuminating comments, and in preparing the written text I have revised and slightly expanded the material to take account of some of the more important points made. I have also taken the opportunity to update the treatment of the law, which is believed to be correctly stated as at September 14, 1982.

R. M. Goode
Centre for Commercial Law Studies,
Queen Mary College,
London
1982

Table of Cases