Retention of title and other forms of security

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It is a great and, I confess, a daunting privilege to address this distinguished gathering of the British-German Jurists' Association and the Deutsch-Britische Juristenvereinigung. I begin with two apologies. The first is that I shall do so almost entirely in English. I am, however, comforted by the knowledge that I am addressing an audience whose English is likely to be as good as, if not better than, mine. Indeed, I first came to know about the Association through a German-speaking solicitor and an English-speaking Rechtsanwalt whom I met when instructed in a case, in London, for some German clients. The claim turned on the meaning of a few words in a contract made, in English, between our German clients and an English company. Our German clients were sure that their understanding of the English words was correct and that the English company's understanding of the English words was not. The English judge, I am glad to say, agreed with us.

My second apology is for what I will do later, which is to criticise the title we have been given. 'Retention of title and other forms of security' implies that retention of title is one form of security but that there are others. As we shall see, that is apt to be misleading in English law.

The last thing I need to say by way of introduction is that the subject of security in English

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law is a vast one. One of the leading textbooks is 888 pages long.[1] The report of one of the cases I will mention later runs to over 60,000 words. I am not so ambitious as to think that in the next few minutes I can survey the whole landscape, even in outline. Instead I will look at what seem to me to be some of the interesting features in that landscape. They are, I think, interesting both in themselves, and in what they show about the way English law works in practice: positively, you might call it its great capacity for developing to meet the changing needs of society; negatively, its occasional maddening uncertainty, even on what you might think are quite fundamental questions.

Now the basic problem underlying this whole area of the law is, of course, the danger which is present whenever a trader or a bank gives credit: that the debtor may become insolvent, unable to pay back more than a small proportion of what is owed, if anything at all. Unless we care to reverse the Industrial Revolution by abolishing the institution of credit altogether, that is always likely to be a problem which faces businesses. Businesses are always therefore likely to try to devise solutions aimed at leaving them in a better position than the other creditors if the debtor becomes insolvent. I am going to speak briefly about some of these solutions, and about some of the legal problems to which each gives rise.

It is important, I think, to keep in mind that, with only limited exceptions, these are not forms of security which have been invented by legislators or judges. They are contractual terms which businessmen and women have devised, and to which judges and legislators have had to respond.

1 Beale et al, eds., *The Law of Security and Title-Based Financing* (2nd ed., Oxford: Oxford University Press, 2012).

The first solution is what English law recognises as a security interest, properly so called. It involves the debtor granting the creditor some sort of right in relation to an asset that that debtor owns or has an interest in (or, as we shall see, may come to own or have an interest in). English law recognises, by way of such consensual security interest, the pledge, the mortgage and the charge.

A pledge requires the transfer of possession of a tangible asset to be held as security. That is a useful facility if you are prepared to live without your watch in order to borrow some money for a few weeks; and pledges of documents, for example, are sometimes used in specialised areas of commerce, for short-term finance. But this is not a practical solution for most ordinary commerce, for at least two reasons. First, most businesses do not have significant physical assets available to be handed over as security for their debts; and even if they did, this would probably not be a sensible economic use of those assets. And secondly, the subject of a pledge must be a tangible asset, a thing. Far more useful in much of commerce is the ability for a debtor to borrow against intangible assets, in particular against the debts which the debtor, in its turn, is owed by those it does business with.

So in most cases we are more likely to encounter the mortgage or the charge. These two terms tend to be used interchangeably,[2] but strictly speaking the difference is that a mortgage (except, nowadays, in the case of land) is a transfer of ownership by the debtor with a right to an immediate re-transfer on payment of the debt (often called the equity of redemption), whereas a charge leaves ownership of the assets with the debtor but entitles the creditor to have

2 Gullifer, ed., *Goode on Legal Problems of Credit and Security* (5th ed., London: Sweet & Maxwell, 2013), 1-56.

recourse to those assets to obtain repayment of the debt.[3]

In practice, however, the important distinction in this field is between the fixed charge and the floating charge. I will return to why it is important later.

The fixed charge came first and, if the floating charge had not been invented, would no doubt be called just the 'charge'. It is a charge over a specific asset, as security for indebtedness, and it takes effect at once, in the sense that as soon as it is granted the person to whom it is granted has an interest in the asset. It follows, from that fact, that the debtor is not free to deal with the asset.

That may be acceptable to the debtor, of course, if the asset in question is a factory, or perhaps some machinery which is likely to remain in the factory for longer than the debtor needs the money. But there are limits to the utility of a fixed charge. Lord Scott, in his speech in the House of Lords in the *Spectrum Plus* case[4] in 2005, described the historical context in which what we now call the floating charge developed:

> 'By the middle of the 19th century industrial and commercial expansion in [the United Kingdom] had led to an increasing need by companies for more capital. Subscription for share capital could not meet this need and loan capital had to be raised. But the lenders required security for their loans. Traditional security, in the form of legal or equitable charges on the borrowers' fixed assets, whether land or goods, could not meet the need. The greater part of most entrepreneurial companies' assets would consist of raw materials, work in progress, stock-in-trade and trade debts. These were circulating

3 Beale, n.1, 1.18.
4 *In re Spectrum Plus Ltd (in liquidation)* [2005] UKHL 41, [2005] 2 A.C. 680.

assets, replaced in the normal course of business and constantly changing. Assets of this character were not amenable to being the subject of traditional forms of security.'[5]

So business people started trying to raise money on the security of assets of that, more transient, character. In 1858 a man called James Taylor bought a mill in Yorkshire for £5,000, which he borrowed from two men called Holroyd on the security, they agreed, of the mill, the machinery in it and, importantly, any new machinery which he might put in the mill. Taylor did put new machinery in the mill. He did not, however, pay back the loan, and in 1860 the Holroyds retook possession of the mill, including the new machinery. But a few days later the high sheriff of York, Mr Marshall, seized the new machinery on behalf of an unsecured creditor. Marshall was acting on the basis that he was seizing Taylor's property.

So the question was, who owned the new machinery? The Lord Chancellor held that it was not possible for Taylor to have passed title in the new machinery to the Holroyds by an agreement which he had reached before that machinery had even come into existence. The new machinery belonged to Taylor. But the House of Lords disagreed.[6] English law, in their judgment, *did* allow a debtor to grant a charge over property which was yet to be acquired: the moment the that property *was* acquired, it stood charged as security.

As Lord Scott goes on to explain in the *Spectrum* case, *Holroyd v Marshall* opened the way for creditors to take charges over whatever assets the debtor might possess at any given time. So in 1870, in the case of *Re Panama, New Zealand and Australian Royal Mail Co*[7], the company (and for reasons concerned with the Bills of Sale Acts it is usually a company, not an

5 Para 95.
6 (1862) 10 H.L. Cas. 191.
7 (1870) LR 5 Ch App 318.

individual) simply charged its 'undertaking and all sums of money arising therefrom'. And it came to be understood that this only makes sense if the debtor is free in the meantime to deal with the assets freely, the charge 'floating' above those assets until some event which triggers the appropriation of specific assets.

I mentioned earlier that the law of security has often been a story of judges and legislators responding to solutions devised by business people. One response, as we have just seen, was that of the judges, who gave effect to the wishes of the parties to the agreement for a floating charge. But another was that of legislators, who recognised that it was pretty hard on the other creditors to discover, when the debtor became insolvent, that every single asset was already charged to the floating charge holder. And so, at the end of the 19th century, Parliament stepped in, legislating to protect 'preferential creditors', principally employees who were owed wages, and the government which was owed taxes. They became entitled to be paid ahead of the floating charge holder.[8] Other reforms were the introduction in 1900 of a requirement to note the existence of floating charges in a publicly accessible register; and a rule that floating charges granted in a period shortly before a company became insolvent were invalid except to the extent that they were granted in return for further loans from the creditor. Those innovations have largely survived to this day. The requirement for registration—at least, if you want your charge to be valid when the company goes under—now extends not only to floating charges but to most types of fixed charge. The government is no longer a preferential creditor, but by statute a floating charge holder must now accept that a 'prescribed part' of the floating charge realisations is to be made available to unsecured creditors.

8 Preferential Payments in Bankruptcy Amendment Act 1897.

It is for reasons such as these that in many cases creditors prefer, if they can, to create something which the courts will call a *fixed* charge.

I said just now that I was quoting Lord Scott in the *Spectrum* case in 2005. You might reasonably ask why, in 2005, the House of Lords had to concern itself with the question of what exactly a floating charge is. Surely the rules had been established, and it was not necessary to revisit them regularly like the Mastersingers were said to do with theirs?[9] The answer, again, lies in the efforts of business of business people to devise new and better forms of security. In the *Spectrum* case, it was what the parties *called* a 'fixed charge' over all debts receivable by the debtor. There was a requirement to pay those receipts into a particular account. But, importantly, there was nothing in the parties' agreement to stop the debtor taking money out of that account in the ordinary course of business. Was an arrangement liked this really a fixed charge? Some decisions had said that it was.[10] Others, including a decision of the Privy Council, which sits as the final court of appeal for several British overseas territories and former overseas territories, said not.[11] The issue was settled in the *Spectrum* case, the House of Lords endorsing the latter view: the essential characteristic of a floating charge is that the asset subject to the charge is not finally appropriated as a security for the payment of the debt until the occurrence of some future event, and in the meantime the chargor is free to use the charged asset and remove it from the security. An arrangement that leaves the debtor free to take the money out of the designated account is therefore a floating charge, not a fixed one.[12]

9 'Doch einmal im Jahre fänd' ich's weise, / dass man die Regeln selbst probier', / ob in der Gewohnheit trägem Gleise / ihr' Kraft und Leben nicht sich verlier'!' Richard Wagner, *Die Meistersinger von Nürnberg*, Act 1, Scene 3.
10 *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd's Rep 142; *In re New Bullas Trading Ltd* [1994] 1 BCLC 485, CA.
11 *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710, PC.
12 Lord Scott in *Spectrum* at para 111.

I shall come back to the meaning of 'charge' one more time, but before I do, I want to look at another case which shows how another group of legislators have responded to developments in business and how, in turn, the judges have had to respond. The legislators here are the European Union and the British government; the judges, once again, the Privy Council. The case is *Çukurova.*[13]

One of the Çukurova companies borrowed $1.35 billion from Alfa Telecom Turkey Limited. As security, it granted a charge, governed by English law, over shares in a company registered in the (British) Virgin Islands. This charge constituted a 'security financial collateral arrangement' under the Financial Collateral Arrangements (No 2) Regulations 2003, which give effect in English law to EU Directive 2002/47/EC on financial collateral arrangements but (as sometimes happens) go wider than the Directive requires, in that the Regulations apply not only to public bodies, as the Directive requires, but to ordinary private companies, too.

The reason the Regulations are important is that they introduced a new remedy for a creditor holding a charge, if the charge is over financial collateral: a power to appropriate the security, that is, to 'take the collateral as his own property, at its value under [an] agreed mechanism, subject (if that value exceeds the secured debt) to a liability to pay the excess to the collateral-provider, and with a claim for the balance of the debt if the value is less than the secured debt.'[14]

Well, an event of default did occur, and the charge-holder—Alfa Telecom—appropriated

13 *Çukurova Finance International Ltd v Alfa Telecom Turkey Ltd (Nos 3 to 5)* [2013] UKPC 2, [2013] UKPC 20 [2013] UKPC 25, [2015] 2 WLR 875.
14 Lord Walker, when the same case had gone to the Privy Council on an earlier occasion: *Çukurova Finance International Ltd and another v Alfa Telecom Turkey Ltd* [2009] UKPC 19, [2009] Bus. L.R. 1613 at para 12.

the shares. That might have been the end of the story. But Çukurova wanted the shares back. It raised the money to repay the loan with interest and offered the money to Alfa Telecom, placing it into an escrow account for that purpose. Alfa Telecom said no. It did not want to give the shares back. Indeed, it had an ulterior motive for holding onto them, since holding the shares put it in control of another company which was useful for commercial reasons. It argued that it did not have to give the shares back. They had already been appropriated. It was too late.

Because the shares were registered in the Virgin Islands, the issue came before the Eastern Caribbean Supreme Court, and from there it went to the Privy Council. Here we see again how it is not just 19th century judges and lawyers who were capable of adapting to new business developments. For Çukurova invoked the old principle of 'relief from forfeiture'.[15] This has been called 'the right of courts […] in appropriate and limited cases to relieve from forfeiture for breach of covenant or condition where the primary object of the bargain is to secure a stated result which can effectively be attained when the matter comes before the court, and where the forfeiture provision is added by way of security for the production of that result.'[16] The principle is commonly applied in land law. For example, a lease states that the landlord may have the property back and that the lease will be ended—the tenant must 'forfeit' the lease—if the rent is not paid. The tenant does not pay. The landlord gets the property back. The lease is ended. But 'relief from forfeiture' means that all is not necessarily lost for the tenant. If the tenant offers to pay all of the rent, and interest, and the landlord's legal costs, the court may be persuaded to order the landlord to accept the money and to let the tenant back into possession. If so, the lease comes back to life and the parties continue afterwards as if

15 See generally *Shiloh Spinners Ltd v Harding* [1973] AC 691.
16 *Ib.* at 723.

nothing had happened.

Alfa Telecom argued that this principle had nothing to do with its appropriation of the shares. It was a principle about land, not shares. And neither the Regulations nor the Directive mentioned it. The Privy Council dismissed these objections.[17] There was no reason why the 'relief from forfeiture' principle should not apply to any case where a right to own or possess an asset was given as security for the performance of some other obligation. And the fact that the Regulations and Directive did not mention the principle was not enough to prevent it, as a general principle of English law, from operating in cases to which they applied.

Up to this point, the court, comprising five Justices of the Supreme Court, was unanimous. But how should the principle be applied? The judges agreed about the result. Çukurova should have the shares back on payment of all the money that would have been due under the loan contract if that contract had continued, including interest, *except* in one respect: Çukurova should *not* have to pay interest during that time when the repayment money had been in the escrow account but Alfa Telecom had been refusing to accept it.

But how did the court get to this conclusion? I mentioned earlier the uncertainty, even about what you might think are basic principles, that sometimes accompanies English law's flexibility and adaptability. Our Honorary President, Lord Mance, with whom two other judges agreed, found in the precedents, and applied, a principle that the court had a relatively broad jurisdiction to lay down for itself the terms on which relief against forfeiture would be granted. Lords Neuberger and Sumption, by contrast, regarded this as wrong (and in the latter's view a

17 [2013] UKPC 2, [2013] UKPC 20 [2013] UKPC 25, [2015] 2 WLR 875.

'radical a break with basic principle'.[18]) In their view the effect of granting relief was to bring all the provisions of the contract back to life, including the clause about interest. Alfa Telecom was entitled to insist on full compliance with all terms, unless there was a strong countervailing consideration of equity. The fact that Alfa Telecom had not accepted the money in the escrow account was such a consideration.

So the two groups of judges got to the same destination by two different routes. I hope you will forgive me if I treat the question of who was right and who was wrong as being, especially in the present circumstances, well above my pay-grade. We shall anyway have to wait for a case where it makes a difference.

Being a secured creditor is better than being an unsecured creditor. But, as we have seen, it is not without complications. If you are the seller of goods on credit, why not simply ensure that debtor does not get title until the goods are paid for? Why not, in other words, agree for there to be retention of title until payment is made? Here we get to my mild complaint about the title: 'retention of title and other forms of security.' For strictly speaking retention of title is not a form of 'security'. 'Security' refers to some interest in another person's property. But here the idea is that the item in question does not become part of the debtor's property at all. That is the seller's goal, and if the seller succeeds then none of the complexities of the law of security need trouble the seller.

Here, too, English law has been driven by business people (or, more accurately, their lawyers) devising ways of trying to protect their position as creditors. The business people have by no means all been British ones. On the contrary, this is an area of English law and

18 Para 187.

commercial practice much practice driven by Continental, and in particular by German, trading arrangements.

In its simplest form, 'retention of title' describes an agreement that goods sold under a contract will continue to be owned by the seller until the buyer pays for them. Such an agreement works in English law because there is no compulsory rule about when the goods become the buyer's property. Rather, the basic rule in English law, nowadays to be found in section 17 of the Sale of Goods Act 1979, is that 'Where there is a contract for the sale of specific or ascertained goods the property in them is transferred to the buyer at such time as the parties to the contract intend it to be transferred.' This by itself would be enough to permit parties to agree that the seller should continue to own the goods even after delivery. But it is made clearer still by section 19(1), which says (focusing on the relevant parts) that 'the seller may, by the terms of the contract […] reserve the right of disposal of the goods until certain conditions are fulfilled; and in such a case, notwithstanding the delivery of the goods […] the property in the goods does not pass to the buyer until the conditions imposed by the seller are fulfilled.'

For a single transaction, a simple retention-of-title clause will suffice: the parties may agree that item X will not become the buyer's property until the price of item X has been paid. The courts will give effect to this.

The real battleground has been over attempts by sellers to go further. The first example is the simplest: item X will not become the buyer's property until not only the price of X has been paid but also all monies owing by the buyer to the seller have been paid. We have the authority of the House of Lords that such an arrangement is legally effective: see *Armour v*

*Thyssen Edelstahlwerke AG* [1991] 2 A.C. 339.

More difficult are two other ways in which parties have attempted to extend the notion of retention of title. First, into the proceeds of sale of the goods to which the retention originally applied. And secondly, into new items which are the products of both the goods sold by the seller and goods sourced from elsewhere.

As to the first of these, the main question is as to what must happen with the money received by the buyer when the goods are sold by the buyer. It depends on whether, on a proper understanding of the agreement, the buyer sells for his own benefit or merely on behalf of the seller from whom he or she bought the goods. The seller would like the court to say that the buyer has sold the goods as trustee for the seller, for it is elementary that a person who holds property as trustee for a beneficiary holds the proceeds of any sale of that property on trust also. The buyer's other creditors (for it is only when the buyer is in trouble with creditors that these things matter) would like the court to say that the buyer has sold for his own account, so that the proceeds of sale are his, and so are available to meet creditors' claims.

The most famous example of the courts giving the answer the seller would like is to be found in the case of *Aluminium Industrie Vaassen B.V. v Romalpa Aluminium Ltd* [1976] 1 W.L.R. 676. The agreement, which was on the standard terms of Aluminium Industrie Vaassen BV (AIV), expressly entitled the buyer to sell aluminium foil not yet paid for, but 'on condition that—if AIV so requires—purchaser, as long as he has not fully discharged his debt to AIV shall hand over to AIV the claims he has against his buyer emanating from this transaction.' The court accepted that these and other words, in all the circumstances, were enough to make AIV the owner of the money Romalpa had received from selling foil it had not yet paid for.

Romalpa's general creditors had no right to have recourse to this money.

The *Romalpa* case, however, has come to be seen as the high-watermark for the English courts' willingness to accept such extended retention-of-title clauses.[19] This is unsurprising because this form of extension depends, as we have just seen, on showing that the relationship between buyer and seller is that of trustee and beneficiary or, as one might put it, a fiduciary relationship. The idea that such a relationship might exist between traders in a market is not one that appeals to English commercial law. We might usefully compare *Romalpa* with *Pfeiffer Weinkellerei-Weineinkauf GmbH v Arbuthnot Factors* [1988] 1 WLR 150, yet another case concerning Continental standard terms. *Romalpa* was here said to have depended on special factors which changed the relationship between the parties into a fiduciary one. By contrast, the contract wording in *Pfeiffer* was not consistent with this. In particular, the buyer was not required to hand over *all* of the money received from selling the goods, but only such amount as was equivalent to the amount owing to the seller. This was not consistent with the idea that the buyer was selling the goods on the seller's behalf. For this and other reasons the buyer was therefore held to have sold the goods on its own behalf, with the consequence that the proceeds of sale became the buyer's property. In so far as the retention-of-title clause applied to these proceeds, it did so only as a charge, but one which was void because it had not been registered.

As for new items which are a combination of goods supplied by different sellers, the English courts acknowledge that, in principle, the buyer and the seller may agree that such items will belong to the unpaid seller.[20] But they are reluctant in practice to give effect to such agreements. First, if the thing supplied by the unpaid seller has been so mixed in with the end-

19 Gullifer, n.2, 1-34.
20 *Clough Mill Ltd v Martin* [1985] 1 WLR 111 at 119.

product that it does not exist any more as a distinct thing, then there can be no possibility of any retention of title in it. This was the basis of the court's decision in *Borden (U.K.) Limited v Scottish Timber Products Limited* [1981] 1 Ch 25, a case about resin used to make chipboard. Secondly, even where it would be possible, though very difficult, to take back the seller's goods by dismantling the end-product, the courts are not easily persuaded that the parties really intended that the seller should still own that part of the end-product which comprises his goods. This is shown by *Re Peachdart Ltd* [1984] Ch. 131, where an unpaid seller of leather failed to show that it still owned the leather after it had been made, with other material, into handbags.

Where the buyer and the seller agree that the unpaid seller will own not only that part of the end-product constituting the goods supplied by the unpaid seller but the *whole* of the new product, this is not truly a matter of *retention* of title at all, for the seller never had title in the other elements of the end-product. Rather, the buyer is purporting to grant the seller an interest in this new thing. The courts tend to regard this, in law, as the buyer granting security over a thing which the buyer has not yet acquired, just as Mr Taylor did with his mill in the 19th century. It creates a charge, but one that requires registration if it is to be effective.[21]

21 See again *Re Peachdart Ltd* [1984] Ch 131.

# 3 HARE COURT