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DISCUSSION PAPER SERIES:

ASSET FINANCE AS PART OF THE SECURED TRANSACTIONS REFORM: REGISTRATION WITHOUT RECHARACTERISATION?

DR MAGDA RACZYNSKA

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1 Introduction

One of the key issues in the debate on the reform of the English law of secured transactions is whether a new regime should include transactions used in financing acquisition of equipment by businesses. This includes conditional sale agreements, finance leases or hire purchase agreements, which are collectively referred to as "asset finance devices" in this paper. Financing of inventory by suppliers using retention of title clauses is considered separately (see paras 3.24-3.25 of April 2016 Draft Policy Paper[1]). At present such interests are effective without any registration requirements. When considering a reform three main possibilities exist. The first is that asset finance devices are left outside any reform and so remain unregistered. Another is to introduce registration and full-blown recharacterisation of asset finance devices as security interests, meaning that the rules governing priority and remedies would be the same as those governing security interests. The third option is to require registration but without recharacterisation. The debate will include consideration of all three of these options. While the merits and consequences of the first two have been considered reasonably widely, the third has been relatively little discussed in the UK. In order to facilitate the wider debate, this paper considers in detail the feasibility and possible policy issues concerning that third option.

2 Key considerations and some background to the discussion

There are two key considerations in the discussion on the inclusion of asset finance in the reform of secured transactions law. One is the appetite to include asset finance devices on the register. The other is the desire to preserve the freedom of parties to decide which rights, duties, powers and liabilities should govern their relationship. 'Registration without recharacterisation' is an attempt to strike a balance between those two objectives.

1 https://securedtransactionslawreformproject.org/draft-policy-paper/

2.A WHY REGISTER?

2.A.i *Transparency and easy access to information*

Registration fulfills an important publicity function by providing a relatively cheap and quick means of checking which assets are not the debtor's to dispose of or are subject to security interests. With online registers checking for encumbrances is usually only a few clicks away, which is easier than physical due diligence.

That registration of title-retention devices is useful can be gauged from the fact that commercial organisations such as HPI or Experian already manage registers of finance agreements of vehicles and other equipment. These asset-based registers do not share information with the public registers, which means that searching the (debtor-based) Companies House register will not reveal any asset finance information.

The existing commercial registers are limited in their function and reliability since there are no sanctions for non-registration (even if both the owner and the buyer are finance companies and members of an organization, as was the case in *Moorgate Mercantile Co Ltd v Twitchings* [1977] AC 890 (HL)), where the owner finance company was not precluded from relying on their title despite the fact that it failed to register a hire-purchase agreement).

2.A.ii *Simpler rules*

Inclusion of the asset finance devices in the new regime would be an opportunity to clarify and simplify some of the rules which govern them, such as the exceptions to *nemo dat* rule or tracing rules.

2.B REGISTRATION IN OTHER JURISDICTIONS – BUT WITH RECHARACTERISATION

Registration of asset finance devices was introduced in Personal Property Securities Acts in e.g. Canada, New Zealand, Australia, but it was coupled with their re-characterisation as security interests, meaning that the rules governing perfection, priorities, parties' rights and duties and enforcement applicable to traditional forms of security apply to asset finance devices.

The PPSAs followed generally the approach first taken by Article 9 UCC. One major difference was that by contrast to UCC, PPSAs introduced registration of operating leases for more than a year (but without recharacterisation). This was done for a range of reasons, including:

(i) to reduce the risk of disputes between finance companies and insolvency officers, which were rife shortly after the introduction of Article 9 UCC, over characterisation of leases as operating (not registrable under UCC) or finance leases (registrable under UCC);

(ii) to make it easier to discover such leases for prospective buyers of assets, liquidators, subsequent creditors seeking to take security over debtor's assets.

Introduction of a system of registration of asset finance devices without recharacterisation would to some extent follow the system of registration of operating leases (sometimes referred to as "deemed security interests") as far as requirements of perfection and priority are concerned.

2.C THE EFFECTS OF RECHARACTERISATION

It is important to first understand what consequences recharacterisation would have. Recharacterisation has two key effects (see e.g. Law Commission, *Company Security Interests. A Consultative Report,* CP 176, TSO 2004, paras 2.107-2.119):

One is that the supplier may lose its title if the supplier's interest is not registered and the debtor (lessee/ROT buyer) sells the asset or leases it to a third party.

The other arises when the finance company resorts to the asset to recoup the amount owed and there is surplus left after the enforcement. The effect of recharacterisation is that the surplus is returned to the debtor, not the finance company.

It is unlikely that recharacterisation would have any significant tax implications.

The question that arises is whether these effects would be avoided if asset finance devices were registrable but would not be recharacterised as security interests.

3 Right to surplus under system with registration but without recharacterisation

Taking the issue of surplus first, it would seem that it is a contractual matter to decide who gets the surplus after the asset is sold. If so, it is possible to envisage a system where asset finance interest would be registrable with a default rule that the asset financier has the right to surplus (with ability by the contractual parties to provide otherwise in the agreement, for example that surplus goes to the debtor, as is currently the law and quite possibly still the practice). In some respects, the rule could be quite wide as the right to surplus as between the parties would not need to be dependent on the interest being actually registered or not.

The question arises about the relevance of the right to surplus as far as third parties are concerned. Where the asset finance device is recharacterised as a security interest, the debtor has a proprietary right to surplus proceeds, and so the debtor can create security interests in what we would call equity of redemption.

In a regime where the debtor has (at most) a contractual right to surplus, an issue arises whether the debtor could create a security interest in the contractual right to surplus. The following aspects have to be considered:

(i) The first issue is whether it is conceptually possible to create a security interest in a contractual right to surplus. It is difficult to see why not. One argument is based on an analogy with security interests created over debt owed. From the perspective of the person to whom the debt is owed it is simply a right to be paid. If it is possible to create a security in a debt, it should also be possible to encumber a contractually agreed right to sale proceeds paid upon enforcement.

(ii) There is a risk that the security in a contractual right to surplus could be a weak one. If nothing else, it would be relatively easy to "clog" a contractual right to surplus. It would be unlikely that courts would strike such "clogs" these down, as they have done in relation to equity of redemption. Given the courts' approach to clogs on equity of redemption has recently become laxer, it is even less likely that "clogs" on a contractual right to surplus would be struck down.

(iii) Another issue is for the secured creditors (existing "all-asset" creditors as well as prospective creditors) to discover what the asset finance agreement provides in relation to surplus. This would likely require inclusion of documents on the register.

(iv) By creating a security in the contractual right to surplus, the debtor would not be able to grant by way of security an interest greater than that which he himself holds short of some exception to the *nemo dat* rule such as consent of the asset financier. Thus, the security in the contractual right to surplus proceeds of sale of equipment would not be the same as a security right in the equipment. However, the *legislation could provide*, for example, that where the debtor has a contractual right to surplus, the financier is *deemed to consent to* the debtor disposing of the capital asset (subject to the asset financier's interest). This would amount to *voluntary re-characterisation* as security from the perspective of the asset financier.

4 The purpose of registration and the possible effects of non-registration under system with registration but without recharacterisation

The central issue is, therefore, the purpose of registration and, relatedly, the effect of non-registration of asset finance devices. The working assumption is that the purpose of registration would be to enhance publicity and transparency of information on which assets are not the debtor's to dispose of or which are subject to security interests. Registers cannot fulfill this function if the information contained in them is incomplete or unreliable. Introduction of a more reliable (valuable) source of information would mean introducing a sanction for non-registration, which would at the very least act as an incentive to register.

The question therefore arises what consequences should ensue from non-registration. The options are:

(i) invalidity against parties taking a security interest in the asset;
(ii) invalidity against those who subsequently buy the asset from the debtor (lessee/buyer);
(iii) invalidity against the administrator, liquidator or trustee in bankruptcy.

The risk of any of those consequences occurring would likely be an incentive to register but if the register were to function as a means of ensuring priority of interests, options (i) and possibly (ii) need to be adopted. It seems unlikely that option (ii) above would be adopted on its own, so options (i) and (ii) are considered jointly.

Each option would have a different effect on the shape of the law that would apply to asset finance devices and so these are considered in turn.

4.A INVALIDITY AGAINST PARTIES TAKING A SECURITY INTEREST IN THE ASSET (AND BUYERS/LESSEES) AS A POSSIBLE CONSEQUENCE OF NON-REGISTRATION

For the register to serve as a means of establishing a priority between competing interests, the sanction for non-registration would have to include invalidity against subsequent secured creditors and possibly also buyers and other disponees, that is options (i) and (ii) above.

The register would provide more valuable information if the date of registration reflected the priority. From that perspective it would be a preferable option. This option would be consistent with the general recommendation that priority between registered interests should be established based on the date of registration (unless there is a reason to depart from this rule): see the April 2016 Draft Policy Paper and the Priorities Policy Paper.

4.A.i *Risk of loss of title if asset finance device unregistered*

Adoption of (i) and (ii) would mean that the asset financier who does not register would lose its title as against those taking a security interest (under option (i)) and those leasing or buying the asset (under option (ii)). Compared to the existing law, this would weaken the protection which the supplier enjoys by virtue of holding title. However, there are two possible counter-arguments:

(i) It is not unusual in law for an owner to lose its title where an exception to the *nemo dat* rule applies. Lack of registration of the interest by the supplier would widen the exceptions to the *nemo dat* rule. It would also reverse the effect of *Moorgate Mercantile Co Ltd v Twitchings.*

(ii) A relatively easy act of registration would ensure that the title is not lost.

(iii) Registered asset finance device (under option (i) and (ii)) would provide better protection than under the existing law, at least in relation to conditional sale and hire purchase agreements, as the exceptions to the *nemo dat* rule based on possession and entrustment, which are relevant in these cases, would no longer apply. Registered asset finance devices would bind third parties generally. This gives of course rise to an issue of protection of third party buyers in the ordinary course of business, which is discussed below (see para 4.1.3). Were such buyers to take free of the asset finance device, this would be a new exception to the *nemo dat* rule.

4.A.ii *The issue of possible tiered interest in an asset subject to a registered asset finance device*

A separate question arises whether the debtor should be able to grant security interests in the asset subject to a *registered* asset finance device. Under current English law this is not possible since the lessee/buyer acquires no interest in the asset and so, pursuant to the *nemo dat* rule, has nothing to dispose of or encumber. Under a new regime it would technically be possible to provide that the debtor acquires *rights in the asset* or *power to dispose of rights in the asset* and thus enable the debtor to create another interest in the asset (in relation to a comparable provision under UCC/PPSAs there has been some debate whether "rights in the collateral" arise on the basis of the debtor's possession or possession coupled with the legislative provision. Whittaker commenting on Aus PPSA said it was the latter, so one could draw parallel with that).

However, consideration of any such provision ought to take into account the impact on the right to surplus. Any surplus obtained in enforcement should go to the asset financier, at least as a default rule, if asset finance devices are not to be recharacterised as security interests. There are at least two options.

One is to provide that the debtor has no rights in the collateral until the asset financier is paid off. This would mean that an asset subject to registered asset finance device cannot also be subject to a security interest, at least whilst the asset finance device is in existence. Security interests could attach to the asset after the asset financier is paid off. From the perspective of the secured creditor the security interest in an asset subject to asset finance would be a security interest in after-acquired property.

The second option is that a security interest in the asset could be created if the lease/conditional sale or hire purchase agreement provides that the debtor, not the financier, has the right to surplus upon enforcement. If adopted, one would need to consider whether by obtaining rights to surplus the financier would be deemed to consent to debtor's disposition of the asset, i.e. whether the debtor would effectively acquire "rights in the collateral or power to dispose of the rights in the collateral" (as opposed to merely right to dispose of the surplus proceeds of sale of collateral). This would amount to a system of voluntary re-characterisation (see above).

Analogous considerations arise in situations where an asset subject to a registered asset finance device falls within the category of assets already subject to an existing security. It would not be necessary to provide that the asset financier obtains priority over an earlier-registered security (super-priority) since the asset financier would be able to rely on their title unless the second option (see para above) would be pursued and the asset financier decided to voluntarily recharacterise.

4.A.iii *Sale in the ordinary course of business (and other 'taking free' rules/exceptions to nemo dat)*

It should be added that a provision enabling sale of the asset free of the registered asset finance device would not be contrary to a model without recharacterisation.

From the perspective of the principle, such a provision would replace the existing exceptions to nemo dat (e.g. buyer in possession defence). Outside the new legislation these exceptions would continue to apply.

From the perspective of policy, there are two schools of thought on whether a buyer in the ordinary course of business should take free of asset finance device.

One is that an outright buyer of capital equipment should take free. Such a rule would be consistent with the rule that a buyer in the ordinary course of an asset subject to a security takes free (and in relation to inventory it is a necessary rule to allow the debtor's business to function).

The other is that the buyer of capital equipment should not take free. Equipment is for use by business, not its onward sale, so on this view there are no circumstances when its sale would not be in the ordinary course. From the perspective of the buyer the issue arises whether it is generally possible to ascertain if an asset is of a kind ordinarily sold by the business or not. If so, it is reasonable to require the buyer to check the register. This is very likely to be fact-specific. For example, a shop selling white goods may well have as part of its own equipment a fridge.

4.B INVALIDITY AGAINST THE ADMINISTRATOR, LIQUIDATOR OR TRUSTEE IN BANKRUPTCY

If the sanction for non-registration of registrable asset-finance devices (by contrast to security interests) were *merely invalidity against the insolvency* officer of the debtor, registration would not be necessary in order to make these interests effective. The registration would contain less valuable information at any given time as there would be little incentive to register unless the debtor is nearing insolvency. It is not suggested that this model be adopted. It would resemble the current law without any of the benefits.

If asset finance devices are to be invalid on insolvency of the debtor, this would be in addition to other consequences of lack of registration.

The main debate is therefore between:

(i) a scheme where an unregistered interest loses priority to other security interests AND is void on insolvency (a solution adopted in most other jurisdictions e.g. in Canada and Australia; referred to as the "mandatory registration" model); and
(ii) a scheme where an unregistered interest loses priority to other security interests but is not void on insolvency (which is a solution adopted in New Zealand).

One of the chief arguments against the mandatory registration model is that the asset financier loses its reversion in the capital asset on the insolvency of the conditional buyer/lessee, which effectively amounts to expropriation. Overcoming the risk of expropriation in the New Zealand scheme may well have taken the sting out of making asset finance devices registrable in New Zealand, as has been suggested in the literature (M Gedye).

It would therefore seem that the New Zealand model strikes a good compromise in relation to asset finance devices (although this does not mean that the same is true for security interests).

One consequence of adopting the New Zealand model in New Zealand has been the increased role of the equitable doctrine of marshaling. If an asset financier does not register promptly and an all-asset secured creditor registers first, the asset financier may be subordinated to an all asset-creditor. This effect is only possible as the asset finance device is not invalidated on insolvency, thus making the financier's position as strong as possible in system where asset finance devices are registrable.

5 Conclusion

A system of registration without recharacterisation of asset finance devices would seem possible. The asset financier would still risk losing its title as against (possibly) an insolvency officer of the debtor, against a buyer/lessee of the asset from the debtor and making its interest ineffective as against a secured creditor if the interest were unregistered. The risk would easily be eliminated by registration. Once registered, the asset finance device would likely by protected as strongly as under the current law although it may be necessary to extend the exceptions to the *nemo dat* rule to make the law better suited to the commercial needs of marketability of goods.

DR MAGDA RACZYNSKA

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Appendix A: Surplus

United States – Uniform Commercial Code

Surplus or deficiency if obligation secured.

9-615 (d) If the security interest under which a disposition is made secures payment or performance of an obligation, after making the payments and applications required by subsection (a) and permitted by subsection (c):

(1) unless subsection (a)(4) requires the secured party to apply or pay over cash proceeds to a consignor, the secured party shall account to and pay a debtor for any surplus; and

(2) the obligor is liable for any deficiency.

(e) [No surplus or deficiency in sales of certain rights to payment.]

If the underlying transaction is a sale of accounts, chattel paper, payment intangibles, or promissory notes:

(1) the debtor is not entitled to any surplus; and

(2) the obligor is not liable for any deficiency.

New Zealand – Personal Property Security Act

Mandatory provision on distribution of surplus

s117(1) If a secured party has applied collateral under section 108 [A secured party with priority over all other secured parties may apply an account receivable, investment security, money, or a negotiable instrument in the form of a debt obligation taken as collateral to the satisfaction of the obligation secured] or sold collateral under section 109 [Secured party may take possession of and sell collateral], as the case may be, the secured party **must pay the following persons the amount of any surplus** by satisfying the claims of those persons in the following order:

(a) any person who has registered a financing statement in the name of the debtor over the collateral that is sold where—

(i) the registration was effective immediately before the collateral was applied or sold; and

(ii) the security interest relating to that registration was subordinate to the security interest of the secured party who applied or sold the collateral:

(b) any other person who has given the secured party notice that that person claims an interest in the collateral that is sold and in respect of which the secured party is satisfied that that person has a legally enforceable interest in the collateral:

(c) the debtor.

Canada - Personal Property Security Act 1993 (Saskatchewan):

The provision concerning surplus distribution is merely a default rule:

60 (2) Where a security agreement secures an indebtedness and the secured party has dealt with the collateral pursuant to section 57 or has disposed of it in accordance with section 59 or otherwise, any surplus shall, *unless otherwise provided by law or by the agreement of all interested parties***,** be accounted for and paid in the following order to [emphasis added]:

(a) a person who has a subordinate security interest in the collateral and:

(i) who, before the distribution of the surplus, registers a financing statement using the name of the debtor or according to the serial number of the collateral if the goods are of a kind that is prescribed as serial numbered goods; or

(ii) whose interest was perfected by ---n at the time when the collateral was seized;

(b) any other person with an interest in the surplus, if that person has given a written notice of the interest to the secured party prior to the distribution; and

(c) the debtor or any other person who is known by the secured party to be an owner of the collateral;

but the priority of the claim of any person mentioned in clauses (a), (b) or (c) is not prejudiced by payment to anyone pursuant to this section.

Note on the old law:

Canadian courts at first were keen to draw an analogy between the position of the buyer under a conditional sale and a chattel mortgagor, to allow a right to claim any surplus after repossession or resale (*CC MotorSales Ltd v Chan* [1926] SCR 485, [1926] 3 DLR 712). However, when the security analogy shifted to the seller's claim for deficiency, it was replaced by the conventional sales analysis (*Humphrey Motors Ltd v Ells* [1935] SCR 249, [1935] 2 DLR 705.

Appendix B: Arguments for and against mandatory registration (generally, i.e. including but not specific to asset finance)

Arguments in favour of mandatory registration:

(i) The need to protect unsecured creditors, who might be deceived by the prospective debtor's 'ostensible ownership' or 'false wealth' or at least may not have the resources to conduct due diligence to check whether equipment in debtor's possession is subject to 'hidden' interest of the asset financier.

(ii) To promote integrity of the register.

(iii) To facilitate insolvency administration.

(iv) An international norm.

(v) It has a long tradition (required under bills of sale and companies legislation), so no reason to change status quo.

Arguments against mandatory registration and in favour of the New Zealand model (i.e. no invalidity against the insolvency officer):

(i) There is no need to protect unsecured creditors because the likelihood of deception though lack of registration is non-existent because the unsecured creditors do not rely on the register: "[c]reditors who supply goods or funds on an unsecured basis are generally either not concerned about the presence of outstanding interests, or assume that such interests exist".[2]

(ii) There is no need for the invalidity sanction as far as buyers and secured creditors are concerned because they can be adequately protected through buyer protection (such as dispositions in the ordinary course of business) and priority rules.

(iii) The invalidity sanction harms the interests of the asset financier as it amounts to expropriation: the asset financier loses its reversion in the capital asset on the insolvency of the conditional buyer/lessee, which effectively amounts to expropriation.

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2 This was the view of the majority of the NZ Law Commission's advisory committee: A Personal Property Securities Act for New Zealand (1989) NZLC R8, 115.