This is an edited version of chapters 11 and 12 of Alastair Hudson, The Law on Financial Derivatives *(4th ed., Sweet & Maxwell, 2006) which has been prepared for the exclusive use of students on the University of London External LLM programme.*

Chapter 11

Taking security in financial derivativescontracts

THE MEANS OF TAKING SECURITY

An outline of the discussion

11-01 The aim of this chapter is to consider the many legal techniques which are available to a participant in a derivatives transaction when seeking to take security, before considering the specific, technical mechanisms used most commonly in the derivatives markets by way of "collateralisation". This chapter considers the full range of means of taking security which are familiar to commercial lawyers. It is only the category of *collateralisation* – the means of taking security used most frequently by derivatives counterparties – which is perhaps less familiar to commercial lawyers: collateralisation is in truth a range of hybrid means of taking security specific to complex financial transactions. Collateralisation should therefore be thought of as an amalgam of the techniques discussed in this chapter, rather than necessarily a distinct, legal technique in its own right.[1] That range of well-understood techniques will be considered in this chapter before collateralisation receives its own treatment in chapter 12 *Collateralisation and standard credit support agreements*. This chapter will consider the means by which

[1] As evidenced, for example, by the most common market standard collateralisation agreement, ISDA, *Credit Support Annex / Deed*, New York: ISDA, 1998, which enables its users to choose between trust-based structures and pledge-based structures which either do or do not create potentially-registrable security interests.

security is generally taken over commercial contracts to pay money[2] while chapter 12 will focus specifically on the means by which collateral agreements are structured and also on their relationship with standard derivatives products. However, this chapter begins with a short outline of collateralisation structures by way of preface to the discussion of the well-established legal techniques: it being understood in this analysis that collateralisation is a compilation of such techniques generated by market participants and their own lawyers.

The scope of this chapter

11-02 The legal techniques for taking security in commercial transactions fall broadly into four categories. The first category is security by means of taking title in some property. This group of techniques includes the trust,[3] transfer of title provisions[4] and retention of title provisions.[5] In each of these situations the legal technique identifies a proprietary right of some sort in some asset to which the rightholder can have recourse if its counterparty fails to perform its obligations under the contract. Further examples of this category are mortgages[6] under which the rightholder acquires a proprietary right in the mortgaged property: this category falls under the third category below.

11-03 The second category is comprised of a weaker form of security by means simply of contract: that is, a personal obligation to pay money in the event of some failure to perform an obligation under the contract. This is said to be a "weaker" form of security in that the rightholder does not have any identified asset to which it can have recourse on the default of its counterparty; rather, it is reliant on both the counterparty's ability and willingness to pay, either of which may have been the cause of the original failure to perform under the contract. Within this category are events of default,[7] guarantees to make payment,[8] some collateralisation obligations to transfer value to a collateral fund,[9] and some liens.[10]

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[2] There are a large number of texts in this area but some of the more significant dealing severally with trusts, mortgages, charges, pledges and liens include the following: McGhee, *Snell's Equity* (31st ed, Sweet & Maxwell, 2005) 777; Hudson, *Equity & Trusts* (4th ed, Cavendish, 2005); Thomas and Hudson, *The Law of Trusts* (Oxford University Press, 2004); McCormack, *Secured Credit under English and American Law* (Cambridge University Press, 2004); Goode, *Legal Problems of Credit and Security* (3rd ed, Sweet & Maxwell, 2003); Falcon Chambers, *Fisher and Lightwood's Law of Mortgage* (11th ed, Butterworths, 2002); Hayton, *Underhill and Hayton on Trusts and Trustees* (16th ed, Butterworths, 2002); Bridge, *Personal Property Law* (3rd ed, Oxford University Press, 2002); Cousins, *Mortgages* (2nd ed, Sweet & Maxwell, 2001); Smith, 'Securities', in Birks (ed), *Private Law* (Oxford University Press, 2000) 455 *et seq*.; Mowbray et al, *Lewin on Trusts* (17th ed, Sweet & Maxwell, 2000); Ferran, *Company Law and Corporate Finance* (Oxford University Press, 1999) ch 15 "Secured Debt"; Gleeson, *Personal Property Law* (FT Law & Tax, 1997); Sykes and Walker, *The Law of Securities* (5th ed, Law Book Co, 1993); Palmer, *Bailment* (2nd ed, Law Book Co, 1991) ch 22 'Bailment'; Bell, *Modern Law of Personal Property in England and Ireland* (Butterworths, 1989); Tyler and Palmer, *Crossley Vaines on Personal Property* (5th ed, Butterworths, 1973), 447.
[3] Para 11-08.
[4] Para 11-16.
[5] Para 11-20 and 11-21.
[6] Para 11-25.
[7] Para 3-84.
[8] Para 11-43.
[9] Para 12-02.
[10] Para 11-37.

11-04 The third category is comprised of quasi-proprietary rights: that is, a group of rights which purport to grant title in assets but which are nevertheless dependent on some contractual right crystallising so as to transform that right into a proprietary right. Thus a floating charge gives the rightholder rights of a given value over a fund but that right is dependent on the counterparty maintaining that fund appropriately.[11] This contrasts, for example, with a trust arrangement in which a trustee holds the trust fund (particularly where a third party custodian is selected to act as trustee, as considered below) rather than the counterparty itself retaining management control of the security assets.

11-05 The fourth category comprises doctrines such as the pledge and the lien which grant only rights of possession, not ownership, of property but with the ability to petition the court for permission to sell the property so as to recover money owed to the creditor.

Each of these techniques is considered in turn. First, however, this chapter will present a brief introduction to the derivatives markets' favoured means of taking security: collateralisation.

COLLATERALISATION IN OUTLINE

11-06 Collateralisation is considered in detail in the next chapter, being Chapter 12. This section serves merely as a summary of collateralisation. Collateralisation is a means by which a party to a derivatives transaction has provided for it a fund of assets the value of which equals the value of its exposure to its counterparty across all outstanding derivatives transactions of a specified type. At its simplest, a collateralisation arrangement could be structured by that counterparty pre-paying all of its future obligations under its derivative transactions to a third party acting as trustee of that money, such that the party enforcing its security would be entitled to payments from that trust fund to discharge the counterparty's obligations from time-to-time. That trust would also entitle the counterparty to recover money from the trust every time it met its contractual obligations to the secured party.

At its earliest inception, this custodian method was broadly the method used by large financial institutions dealing with counterparties they considered to be of doubtful credit worth. It was therefore a credit department's decision as to the amount of collateral which would have been sought from such a counterparty sufficient to offset the risks associated with doing business with that person. For the counterparty, this was an expensive way of conducting business. The effective pre-payment of all or part of the obligations owed under its transactions created a barrier to entry to this marketplace. Similarly, for the secured party there was a cost in using a third party custodian to act as trustee for the collateral. To reduce this cost, even where the custodian was a subsidiary or group company of the secured party, the secured party sought to have collateral transferred to it outright, subject only to a condition to repay assets of a like kind to the counterparty when the counterparty performed its obligations under the transaction, rather than holding those assets on trust for the counterparty. The right of the secured party therefore became absolute title in the

[11] Para 11-27.

assets transferred with a book debt to transfer either assets of like kind or their cash equivalent at some stage in the future back to the counterparty.[12]

11-07 In the modern marketplace, the obligation to provide and the right to receive collateral are typically owed by both parties. Therefore, even the largest financial institutions will take collateral from each other equal to the size of their current exposure under derivatives transactions. A well-constructed collateral agreement will provide that, while each party is required to post collateral with the other party equal to their net exposure, the amount of collateral actually to be posted by one party will be set off against the collateral to be posted by the other party. Thus, if properly constructed, it will be possible for those obligations to post collateral to be set-off leaving only a small surplus to be posted in fact. The advantage of this arrangement is twofold. First, each party does have a genuine claim to seize collateral in the event that the other party does not perform its obligations. Second, market participants are entitled to bring collateral arrangements into account when calculating their exposure to derivatives for regulatory capital purposes and therefore are able to reduce the amount of regulatory capital to be posted by the amount of such collateral arrangements. The one limitation on this ability to set off will be the extent to which the parties will be able to set off transactions of different types recorded on different books in different branches. Typically, it will be impossible to set off transactions entered into in different currencies. The reasons for these limitations are centred solely on the sophistication of the parties' operations systems.

In practice, the most difficult issues in relation to collateral revolve around the need to identify the current market value of derivatives transactions from time-to-time and to calculate also the value of whatever form of asset is to be posted as collateral.[13] Most frequently, bonds are used as the collateral rather than money or other assets and therefore there is a complexity of valuing the bonds to be added to the complexity of valuing the outstanding derivatives transactions.

In constructing derivatives agreements then, there is a need to decide between a range of legal techniques ranging from trusts and proprietary rights to guarantees and contractual obligations to pay money when taking security, just as with any other commercial contract.

TRANSFERS OF TITLE

11-08 Taking security by means of a transfer of title is comparatively straightforward. What is envisaged is that the party requiring security ("the secured party") is transferred absolute, unencumbered ownership of all of the rights in property by way of an outright gift or assignment (referred to in this book as "absolute title"). That property will be of a value which secures to the secured party's satisfaction its exposure to its counterparty, whether that is the entire, gross amount owed to it, or a net exposure which the secured party has to its counterparty across a number of transactions, or an amount which it calculates off-sets the perceived credit

[12] See para 12-26 ("personal collateral") and para 12-43 ("proprietary collateral").
[13] See para 12-09.

risk that the counterparty will not perform its obligations in relation to an underlying transaction or transactions.[14] By way of illustration, suppose that A owes US$100,000 to B and that B owes US$80,000 to A across their relevant derivatives contracts. If A was concerned with its gross obligations, then A would seek protection in the amount of US$80,000. However, seeking to match the net exposure in this instance would require protection to be provided to B in the amount of US$20,000, being the net exposure which A owes to B across their relevant derivatives contracts. In an ordinary personal collateral structure[15] it would be this net exposure which would be covered. Alternatively, the credit department at B might decide that the risk of B doing business with A would be met if A paid a percentage of that exposure in advance: say US$10,000.

In the event that the counterparty does fail to perform its obligations, or more specifically in the event that the counterparty becomes insolvent, then the secured party is the absolute owner of that property and so title in that property will reduce the exposure which the secured party has to the counterparty's failure to perform.

11-09 Given that the property is transferred outright in this context, the secured party can have no obligation to account for that property in the counterparty's insolvency – always assuming that no question of a transfer at an undervalue with a view to defrauding the counterparty's creditors is deemed to have taken place under English insolvency law.[16] If there had been such a transfer at an under-value with a view to putting assets beyond the reach of insolvency creditors, then the court would be empowered to unpick the transaction and restore the status quo ante so that the creditors can have recourse to those assets in the transferor's hands.[17] However, if the secured party had genuinely given sufficient consideration, for example by entering into the derivatives transactions which are secured by this transfer of assets and valuing the transferred assets at their open market value, then there would not be a transfer at an undervalue. It would be important here to ensure that the obligation to transfer the assets is linked to the net exposure in relation to the underlying, outstanding derivatives transactions, as opposed to some notional amount or some amount which artificially increases the value of the parties' exposure inter se.

11-10 The assumption made here is that the secured party has no obligation at law or in equity as part of the law of property to account to the counterparty nor to make any re-transfer of the specific transferred property to the counterparty. If there was an obligation to hold the original property on trust or to hold that original property separately from all other assets, then the secured party would owe proprietary obligations to its counterparty. In this context, however, the transfer of absolute title to the secured party means that the secured party becomes the absolute owner of that property without any proprietary obligation to account to the counterparty in relation to that property. There may, however, (as in personal collateral structures) be a *contractual* obligation to make a transfer of property of a like kind or of equivalent value (whether in money or money's worth) to the counterparty in the event that the

[14] Where this last example involves a measurement by the secured party's credit department of an amount, typically a proportion of the net exposure of the secured party to the counterparty, which it estimates will be sufficient to offset the risk to it of doing business with the counterparty.
[15] See para 12-26 *et seq*.
[16] Insolvency Act 1986, s.423.
[17] Insolvency Act 1986, s.423.

counterparty performs its obligations under a derivatives contract, or to make a re-transfer of property of a like kind or of equivalent value to the extent that the counterparty has performed its obligations under that contract. It is important that this is merely a contractual obligation to make a transfer because the counterparty will have no proprietary right to any specific assets held by the secured party and therefore will have no claim in property law generally nor in the law of trusts specifically to any such property. Rather, the secured party would owe merely a personal obligation to transfer property of a particular type or cash of a given value to the counterparty, such that there was no specified property which was to be so transferred (even if the secured party happened to hold such property in a distinct account in readiness to perform this contractual obligation). A contractual obligation of this sort is said to be "merely a contractual obligation" because it offers no security against the counterparty's inability or unwillingness to perform its obligations: the law of contract will give the counterparty a right of enforcement but no further right (except perhaps a right to damages) if performance is rendered impossible in practice for example if the counterparty has gone into insolvency. This chapter is therefore concerned with mechanisms for the protection of a party to a transaction in the event that the law of contract offers no viable remedy or recourse as a matter of fact, or lest the law of contract should offer no such remedy or recourse at some time in the future.

11-11 The reason for starting this discussion of taking security in derivatives transactions with this elementary mechanism for taking security is that it is a feature of some collateral structures. Under the ISDA Credit Support Annex, the parties may outright transfers of money or securities (as stipulated in the contract) one to another equal to the payee's net exposure to the payer at the time of calculating the requirement to post collateral.[18] In that contract, the parties usually transfer any amount of money or money's worth required to be transferred under the terms of that contract by means of an outright transfer, such that the recipient is able to treat the property as being absolutely its own, even if it is required to account for the amount of any distribution which the transferor would otherwise have received on any securities transferred under that agreement. The standard market documentation is considered in detail in this regard in the next chapter.[19] However, a number of other legal structures are also used in collateralisation: those structures are considered in the remainder of this chapter.

[18] The expression "to post collateral" is the jargon used in the ISDA documentation and refers to the obligation of a party to transfer property (that is, the collateral property) to its counterparty in a form stipulated in the contract and in an amount calculated by reference to the provisions of that same contract.
[19] Para 12-26 *et seq*.

TRUSTS[20]

The nature of trusts

11-12 Trusts were once the basic techniques used to secure derivatives transactions.[21] However, it should be remembered that much market practice today, based particularly on ISDA collateralisation structures, prefers to use contractual rights and obligations, or alternatively charges and pledges, in many circumstances although trusts law will frequently still have a part to play in relation to the ISDA Credit Support Deed.[22] In more general terms, the trust remains an important means for taking security in bi-partite commercial transactions such that the payer and the payee can hold proprietary rights in the trust property simultaneously, whether one or other of them is the trustee of that property or whether the property is held on trust by a third party custodian for the contracting parties beneficially.[23]

11-13 through 11-15 [*these sections are not reproduced here because they merely set out the basic principles of express trusts*]

11-16 In commercial situations, for example that in *Westdeutsche Landesbank v Islington*, it is important for the parties to know which of them has which rights in the property which is dealt with as part of a contract. A proprietary constructive trust will give a right *in rem* to the beneficiary. That is, a right in the property itself which is enforceable against any other person. If the trustee went into insolvency then the trust property would not form part of the trustee's estate because the beneficial ownership of that property rests with the beneficiaries.[24] If there were no valid trust then there would be only rights *in personam* for the claimant (or, personal rights), as opposed to *in rem* (or, proprietary) rights. A mere *in personam* right would entitle the successful plaintiff to a claim in money only and not to any specific property. In cases of insolvency this would mean that the plaintiff would have no secured rights but only a *pari passu* debt claim with other unsecured creditors. The further shortcoming of the personal claim is that it grants only an entitlement to simple interest on the money claim and not compound interest.[25] The *in rem* right attaching to a beneficiary under a trust comes into operation from the moment that the proprietary right is validly created, under an express trust[26], or at the moment when the defendant has knowledge of the factor which fixes it with liability, under a constructive trust.[27]

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[20] I have written a number of books on trusts law, so readers are referred to Thomas and Hudson, *The Law of Trusts* (Oxford University Press, 2004) and Hudson, *Equity & Trusts* (4th ed, Cavendish, 2005) generally. For those unfamiliar with this area, I have also written a brief introductory guide which explains all of the main principles in an accessible way: Hudson, *Understanding Equity & Trusts* (2nd ed, Cavendish, 2004).

[21] Their use was common practice in the early 1990's before ISDA developed standard mechanisms for taking collateral, as considered in chapter 12.

[22] See, for example, para 12-50.

[23] See Thomas and Hudson, *The Law of Trusts* (Oxford University Press, 2004) generally.

[24] See *Re Goldcorp* [1995] AC 74.

[25] *Westdeutsche Landesbank v Islington* [1996] AC 669.

[26] An express trust is validly created either on a valid declaration of trust by the settlor (*Richards v. Delbridge* (1874) L.R. 18 Eq. 11) or at the time when legal title in the trust property is transferred to the trustee (*Milroy v. Lord* (1862) 4 De G.F. & J. 264).

[27] *Westdeutsche Landesbank v. Islington* [1996] 2 All E.R. 961, 988.

11-17 In asserting an interest in property it is vital that the secured party is able to assert property rights over the assets which secure the derivatives obligations. The following section considers two forms of property right: those created by express trust or contractual provision, and those made available by means of a resulting or constructive trust. The former category refers to the form of structures identified above with reference to collateral agreements, subject to the specific legal issues considered below. The latter category is bound up with the decisions in the local authority swaps cases in relation to derivatives contracts which have been held to be void for some reason.[28] This section considers the growth of recent case law on this latter area and the impact of a number of House of Lords decisions in the last decade on the efficacy of financial contracts: of particular significance are *Westdeutsche Landesbank v Islington*[29] and *Kleinwort Benson v Glasgow City Council*[30] on the contractual and restitutionary effect of void contracts.[31] First, we shall consider the creation of express trusts.

Creation of express trusts

Requirements of certainty

11-18 To create a valid trust, the terms of that trust must be sufficiently certain so that the courts will be able to judge the behaviour of the trustees in the management of the trust and to decide between competing claims to the trust property.[32] There are three forms of certainty which the courts require for a trust to be valid:[33] certainty of intention to create a trust; certainty of the identity of the subject matter comprising the trust fund; and certainty as to the beneficiaries (or "objects") of the trust. [*the remainder of this section is not reproduced here because they merely set out the basic principles of express trusts*]

The particular problem of certainty of subject matter

11-19 The particular problem in relation to financial transactions is the requirement that there be sufficient certainty of subject matter for the trust to be valid. This requires that the property in the trust fund be separate and distinct from all other property.[34] The leading decision of the Privy Council[35] in *Re Goldcorp*[36] related to contracts entered into by a bullion exchange with its clients to the effect that it would not simply recognise in those customers' orders an obligation to acquire bullion for those customers but rather that it would actually procure and hold all of the bullion

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[28] Para 9-50.
[29] [1996] A.C. 669.
[30] [1997] 4 All E.R. 641.
[31] Similarly, the decisions in *Morris v Rayner Entreprises Inc* (unreported, 30 October 1997), and *Re Bank of Credit and Commerce International SA (No 8)* [1998] AC 214 are important on the availability of set-off in case of insolvency. See para 13-18 *et seq.*
[32] *Knight v. Knight* (1840) 3 Beav 148; *Knight v. Boughton* (1840) 11 Cl & Fin 513.
[33] *Knight v. Knight* (1840) 3 Beav 148; *Knight v. Boughton* (1840) 11 Cl & Fin 513.
[34] *Westdeutsche Landesbank v. Islington LBC* [1996] 1 A.C. 669. Cf. *Harland v Trigg* (1782) 1 Bro CC 142; *Wynne v. Hawkins* (1782) 1 Bro CC 142; *Pierson v. Garnet* (1786) 2 Bro CC 226; *Sprange v. Barnard* (1789) 2 Bro CC 585; and *Palmer v. Simmonds* (1854) 2 Drew 221.
[35] As recognised by Lord Browne-Wilkinson, *Westdeutsche Landesbank v. Islington L.B.C.* [1996] 1 A.C. 669.
[36] [1995] 1 A.C. 74.

identified in the customer's order in its vaults. However, despite these well-drafted contracts which obliged the exchange to hold bullion to their customers' order, the exchange began to breach its contractual obligations by taking its customers' money and only holding about as much bullion as was required to meet its delivery obligations on a normal working day. In time the exchange went into insolvency and when the customers came to take possession of their bullion, they found that there was insufficient bullion there to meet their claims.

11-20 The customers claimed to be entitled as beneficiaries under a trust as a result of their contractual rights against the exchange to have bullion equal in value and quality to their orders held to their account. The Privy Council accepted that for those customers who could prove that particular bullion had been segregated from the general holding of bullion in the vaults it would be possible to recognise that they were beneficiaries under a trust of that bullion which had actually been segregated to their account and so entitled to preferential treatment in the insolvency by virtue of their proprietary rights in bullion held on trust by the insolvent exchange. However, for those customers who could not identify specific bullion which had been held on trust for them, because there was no bullion which had in fact been segregated from the general fund, it was held that there was no valid trust in their favour because the identity of the property to which they were claiming entitlement was insufficiently certain. This rule obtained even though the customer's contracts purported to grant them rights in theory in some specific bullion because as a matter of fact no bullion had been segregated to their account.[37]

11-21 By extrapolation, in relation to derivatives contracts, this means that a collateral structure will not be a valid trust unless the property which is to be held on trust is segregated from all other property. The same principle applies to intangible property such as money and securities,[38] subject to what is said below.[39] Where an amount of money is purportedly made subject to an express trust, that trust will not be valid if the money intended to be held on trust is contained in a bank account and mixed with other money.[40] The reason for invalidating that trust is on the basis that the money which was to be held on trust cannot be distinguished from the money which is in the account but not intended to be held on trust. For any such trust structure to be valid, the assets to be provided as security must be segregated from all other property.

11-22 There is a short line of authority which suggests that there is no need to segregate intangible property to be held on trust from other intangible property of like kind where it can make no difference[41] which property is held on trust and which property is not.[42] There is Court of Appeal authority which has been taken to suggest that there is no need to segregate ordinary shares in a company from other shares of the same class in the same company.[43] In that case, however, the principal concern of

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[37] See *London Wine Co (Shippers) Lrd, re* [1986] PCC 121 on the same point.
[38] *MacJordan Construction Ltd v. Brookmount Erostin Ltd* [1992] BCLC 350.
[39] See in particular the discussion of *Hunter v. Moss* [1994] 1 WLR 452 to follow.
[40] *MacJordan Construction Ltd v. Brookmount Erostin Ltd* [1992] BCLC 350.
[41] Thus it has been suggested that this rule would be inappropriate in cases of insolvency where there are more claims to property than there is property to satisfy those competing claims: see Hudson, *Equity & Trusts* (4th ed, Cavendish, 2005), 90.
[42] *Hunter v. Moss* [1994] 1 WLR 452.
[43] *Hunter v Moss* [1993] 1 WLR 934, Rimer QC, Deputy Judge of the High Court; [1994] 1 WLR 452, CA.

Dillon LJ was to prevent an employer from unconscionably denying his obligation to transfer 50 ordinary shares to an employee as required by that employee's contract of employment.[44] It was in a later decision of the High Court that it was explicitly suggested for the first time that there was no need to segregate intangible property such as securities from other property for there to be a valid trust created a part of that fund.[45] So, where a stockbroker contracted in terms that he would hold a given number of securities for his customers but failed to segregate the claimants' securities from other, identical securities, it was held that the trust could be valid in any event because the identical nature of the securities meant that there was no difference in quality between one item of property and another.[46] However, this latter approach has been doubted by most trust law commentators[47] and is contrary to subsequent Privy Council[48] and House of Lords[49] authority, as well as being in contravention of earlier Court of Appeal authority.[50] Indeed, in relation to trusts taken over money there is earlier Court of Appeal authority to the effect that money held in a bank account, a form of intangible property, must be held in a separate account from all other money for there to be a valid trust over that money.[51] While these two streams of authority cannot be satisfactorily reconciled, it is suggested that the weight of judicial authority is with the *Re Goldcorp* line of cases.[52] This issue is of particular importance for derivatives transactions as considered in chapter 12 below.[53]

The rights of beneficiaries

11-23 to 11-35 [*these sections are not reproduced here because they merely set out the basic principles of express trusts considered elsewhere in the course textbook*]

11-36 The property under an express trust must be certain or the trust will be void.[54] There is a question whether the property which is the subject of the constructive trust must be certain in the same way. There are some older authorities which consider that the property must be certain under a constructive trust.[55] It is submitted that this rule

[44] See, doubting this decision, Hayton, (1994) 110 LQR 335.
[45] *Re Harvard Securities, Holland v Newbury* [1997] 2 BCLC 369.
[46] *Harvard Securities Ltd, re; Holland v. Newbury* [1997] 2 BCLC 369.
[47] See *Underhill and Hayton on Trusts and Trustees* (Butterworths, 2002), 79, where *Hunter v Moss* is clearly disapproved; *Lewin on Trusts* (Sweet & Maxwell, 2000), 32, doubting this decision; Hudson, *Equity & Trusts* (Cavendish: 2005), 87 *et seq*, especially 90, where this case is again disapproved; Thomas and Hudson, *The Law of Trusts* (OUP: 2004), para 3.25 *et seq.*. The only commentator giving houseroom to the contrary view is Dr Martin in *Hanbury and Martin Modern Equity* (Sweet & Maxwell, 2005), 101.
[48] *Re Goldcorp* [1995] 1 AC 74.
[49] *Westdeutsche Landesbank v Islington* [1996] AC 669. See also the position in Australia in *Herdegen v Federal Commissioner of Taxation* (1988) 84 ALR 271 which is in accordance with the English senior courts.
[50] *MacJordan Construction Ltd v Brookmount Erostin Ltd* [1992] BCLC 350, CA. Thus the doctrine of precedent ought to have compelled the Court of Appeal in *Hunter v Moss* to have decided differently.
[51] *MacJordan Construction Ltd v Brookmount Erostin Ltd* [1992] BCLC 350, CA.
[52] *Westdeutsche Landesbank v. Islington L.B.C.* [1996] 1 A.C. 669.
[53] See para. 12-61.
[54] *Re Goldcorp* [1995] 1 A.C. 524; [1994] 3 W.L.R. 199
[55] *Re Barney* [1892] 2 Ch. 265, 273.

can only apply to those trusts where a proprietary remedy is sought because it must be possible to establish which property is to be subjected to a proprietary remedy.[56]

The aim of this section is to highlight the manner in which those issues arise in the context of collateral arrangements. The importance of this category of implied proprietary rights in the context of collateral is in cases in which there is a defect in the performance of the collateral agreement or the trustee of the collateral assets, or some other person, makes an unconscionable profit from the use of those assets.

Thus, in the former category, where the trustee fails to maintain the property constituting the collateral separate from other assets, and thus breaches the terms of its fiduciary obligation,[57] issues will arise as to title in substitute assets or the traceable proceeds of the assets which were supposed to be maintained as collateral. For example, where the custodian breaches an obligation to maintain the collateral assets separate from all other property, a mixture of assets would lead to issues of equitable tracing as to which assets were to be considered to be the property of the collateral provider.[58] The finding of a constructive trust over those assets would be an essential pre-requisite of the claimant's recovery of the property which it had lost or of the recovery of property of equivalent value. Similarly, where the collateral is misapplied, the issue would arise whether or not the collateral provider could enforce a claim based on equitable tracing over property acquired by the trustee in consideration for the disposal of the collateral assets.[59] In any case, where the trustee is liable for breach of trust, its obligation will be to restore the trust property, or its equivalent in money, and to provide compensation for any loss that results directly from the breach.[60]

11-37 The imposition of a constructive trust as a response to these sorts of claims would have retrospective effect: rather than coming into existence prospectively from the date of the court order.[61] The court does not make an order at the trial which has effect only in the future. Consequently, for the purposes of insolvency law, if the proprietary right came into existence before the insolvency then the courts will recognise the creditor as having rights in that property which are proof against the insolvency. Rather the order will be deemed effective from the point in time when the trust ought to have been imposed. The constructive beneficiary is treated as having

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[56] Some of the commentators draw a dividing line between constructive trusts which impose a proprietary remedy (and under which the subject matter of the trust must be certain) and those which impose on a personal liability against some person (and under which there is no need to identify property because only personal liability to account in money is required).

[57] The assumption made is that the collateral agreement will impose the office of trustee, or at least fiduciary obligations, on the custodian. However, it is to be remembered that the collateral arrangement used will need to be analysed to ensure that it does create a binding trust arrangement.

[58] Subject always to the defence of change position - *Lipkin Gorman v. Karpnale* [1991] 3 W.L.R. 10, [1992] 4 All E.R. 512, [1991] 2 A.C. 548; in circumstances where a fiduciary relationship existed before the misapplication of the property - *Boscawen v. Bajwa* [1995] 4 All E.R. 769; or by means of the rejuvenated use of common law tracing to identify a clean substitution of and accretion to the misapplied property - *FC Jones & Sons v. Jones* [1996] 3 W.L.R. 703; [1996] 4 All E.R. 721.

[59] *Re Diplock* [1948] Ch. 465; *Chase Manhattan Bank NA v. Israel-British Bank (London) Ltd* [1981] Ch. 105; [1980] 2 W.L.R. 202; [1979] 3 All E.R. 1025 as explained in *Westdeutsche Landesbank v. Islington LBC* [1996] A.C. 669, [1996] 2 All E.R. 961 *per* Lord Browne-Wilkinson;

[60] *Target Holdings v. Redferns* [1996] 1 A.C. 421, [1995] 3 All E.R. 785 HL. See also *Bristol & West Building Society v. Mothew* [1996] 4 All E.R. 698; *Swindle v. Harrison* [1997] 4 All E.R. 705, CA.

[61] *Westdeutsche Landesbank v. Islington LBC* [1996] A.C. 669, [1996] 2 All E.R. 961 *per* Lord Browne-Wilkinson.

had rights under constructive trust principles from that time.[62] The importance of the date of creation of the constructive trust is particularly important in the case of insolvency. Another example of this importance would be where the value of an asset, such as shares quoted on a stock exchange, fluctuates. The beneficiaries will want to demonstrate title to the asset at a time when it was particularly valuable. They would not want, for example, to have rights to receive an amount of money valued before those shares increased greatly in value. They would prefer to have proprietary rights in the shares so that they could claim the shares themselves and sell them at their increased market value.

11-38 Alternatively, a number of alternative claims suggest themselves in response to an attempt to demonstrate title in collateral assets. A claim for subrogation would entitle the collateral provider to be subrogated to the position of another person whose debt with the custodian was discharged by the use of the collateral assets.[63] It has been argued that it ought, in such circumstances, to be possible to trace backwards into the debt discharged.[64] It is also possible that equitable set-off be used in circumstances where the collateral agreement obligations can be set off against amounts owed under the derivatives transactions to be secured.[65] Such alternative claims would be important in circumstances where the right to trace into the collateral assets or into their substitute is lost due to destruction or disappearance of the assets.[66]

Proprietary rights under void contracts

11-39 One of the perennial concerns for the lawyer dealing with financial derivatives is that of the capacity of the counterparty to transact a form of financial engineering which an entity of that type has not created before. The impact of the *ultra vires* rule is that a contract entered into by an entity beyond its powers is treated as having always been void.[67] The result of the majority decisions in the House of Lords in the local authority swaps cases is that it impossible for parties to retain a proprietary interest in property transferred under a commercial contract which is found to have been void *ab initio*. The restatement of the core rules of equity in the speech of Lord Browne-Wilkinson in *Westdeutsche Landesbank v Islington*[68] created a test that a proprietary claim in equity will only be upheld in circumstances in which the defendant had knowledge of the factor which is alleged to impose the office of trustee on him, thus affecting his conscience.

The impact of the continued failure of the derivatives markets to react to the decision in Westdeutsche Landesbank v Islington on systemic risk

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[62] *Ibid*.
[63] *Boscawen v. Bajwa* [1995] 4 All E.R. 769.
[64] See Smith, *The Law of Tracing* (Oxford, 1997) generally.
[65] Para 13-05.
[66] *Roscoe v. Winder* [1915] 1 Ch. 62; *Bishopsgate Investment Management v. Homan* [1995] Ch. 211, [1995] 1 All E.R. 347, [1994] 3 W.L.R. 1270.
[67] See for example, *Hazell v Hammersmith & Fulham* [1992] 2 A.C. 1; *Westdeutsche Landesbank v Islington* [1996] AC 669.
[68] [1996] A.C. 669, [1996] 2 All E.R. 961.

11-40 Let us recap. In *Westdeutsche Landesbank v Islington* the interest rate swap contract between the parties was held to have been void *ab initio* and therefore it was held that there was no contract between the parties at all: that is, none of the terms of the master agreement, nor of the confirmations, nor of any credit support agreement would be of any effect whatsoever. The parties were therefore, entirely correctly, thrown back on the general law to decide whether or not they were entitled to any rights in property. Given that there was no viable express contract between the parties, despite what has been said above about the possible operation of the doctrine of severance,[69] the House of Lords in *Westdeutsche Landesbank v Islington*[70] was unanimous in holding that neither any amount of money paid in advance by the bank in that case nor any of the periodic amounts payable under the interest rate swap were to be held on resulting or constructive trust and thus none of those payments were able to attract compound interest.[71] While there were two dissenting opinions in that case, it is important to note that Lord Goff and Lord Woolf dissented only on the availability of compound interest: the former asserting that it ought to have been available on the grounds of justice, the latter asserting that commercial people would expect that it would be made available.[72] The court was unanimous, however, on the more significant question as to the lack of availability of a proprietary remedy where the underlying contract failed either due to mistake or lack of capacity or failure of consideration at a time when neither contracting party knew of those factors. The persistent failure of the derivatives markets to alter the manner in which they take collateral so as to accommodate this unanimous view of the senior English courts, as to the non-availability of proprietary rights in the event that a derivatives contract fails, is a continued source of enormous systemic risk and something which continues to astonish this writer.

CONDITIONS ON THE USE OF "LOAN PROPERTY" AND "PLEDGED COLLATERAL"

The use of lending arrangements

11-41 The following principles apply primarily in relation to ordinary loan contracts but they are also of significance in relation to any situation in which property is advanced subject to a right to re-transfer that same money or to re-transfer property of like kind and of the same value, such as personal collateral structures. One form of collateral arrangement requires the debtor to transfer outright the collateral property to the creditor, whereas another form requires the debtor to grant possession of that collateral to the creditor but without a transfer of title. There is a fundamental difference in principle *from the debtor's perspective* between an obligation merely to transfer different property from the original property which was posted by a counterparty and an obligation to hold the original property transferred by the counterparty on trust before re-transferring that same property. The former obligation is merely a personal obligation akin to a debt, which provides no security protection in an insolvency; whereas the latter is a proprietary right whereby the creditor will

[69] Para 3-126.
[70] [1996] A.C. 669, [1996] 2 All E.R. 961.
[71] Para 9-46.
[72] Para 9-69.

hold the debtor's collateral property to the debtor's account if the underlying derivatives contract is performed. From the perspective of the creditor the distinction is that in the former arrangement it owes (absent any contractual provision to the contrary) merely a personal obligation to account to the debtor for the collateral transferred to it; whereas in the latter context the creditor will owe fiduciary duties in relation to the safekeeping of that property.

This section considers two significant contexts relating to the lending of collateral property: the first where the debtor retains title in the collateral property and the second in which the debtor places conditions on the use of that property. The effects of using a pledge arrangement or creating a charge or a mortgage are considered later in this chapter. As is considered in chapter 12, the standard collateral agreements frequently use the term "pledged collateral" to refer to property which is in fact lent or transferred outright.[73] For present purposes we will focus on the technical, legal terms of art and reserve discussion of market argot to the next chapter.

Romalpa clauses – retention of rights in property

11-42 A pure retention of title clause operates to retain absolute title in the hands of the counterparty putting up collateral. In truth, there is only a narrow line between a situation in which the counterparty pledges assets by giving up possession while retaining the property rights in those assets, and the situation in which the counterparty agrees to make assets available to secure the other party but retains full title in them because in this latter situation possession is put in the secured party's hands without a transfer of property rights. In the case of the retention of title clause the receiving secured party is at best a mere bailee of those assets in circumstances in which it has possession of those goods, but not legal title.[74] The attraction for the secured party in a retention of title arrangement is that either the secured party itself or some third party has possession of the assets in question and therefore would find it easier to enforce its contractual rights over them without concern as to the counterparty putting them out of reach.

So, a *Romalpa* clause[75] is a contractual provision which enables the titleholder to property to retain common law rights in the property, and not merely equitable rights as with a trust. In relation to a contract in which property is to be used as part of the contractual purpose, that property will remain the property of the provider both at common law and in equity.[76] This analysis remains possible provided that the property does not become mixed with other property so as to be indistinguishable: in such a circumstance this could only leave equitable tracing rights for the claimant[77] because bailment at common law would generally be impossible over such a mixture.[78] In the latter situation it would be a matter for construction of the contract as to the rights which the provider of the property was intended to acquire. In general a

[73] See paras 12-26 and 12-43.
[74] *MCC Proceeeds Inc v. Lehmann Bros International (Europe)* [1998] 4 All E.R. 675.
[75] *Aluminium Industrie Vaassen BV v. Romalpa Aluminium Ltd* [1976] 1 WLR 676.
[76] *Ibid*. Indeed no question of trust or equity arises at all.
[77] *Agip (Africa) Ltd v Jackson* [1991] Ch 547; *El Ajou v Dollar Land Holdings* [1994] 2 All ER 685.
[78] *South Australian Insurance Co Ltd v. Randell* (1869) L.R. 3 P.C. 101; *Chapman Bros Ltd v. Verco Bros Ltd* (1933) 49 C.L.R. 306; *Coleman v. Harvey* [1989] 1 N.Z.L.R. 723.

retention of title under a *Romalpa* clause would prevent the another party to that contract from passing good title to a third party under the *nemo dat* principle[79] although a third party with notice of the contract would be precluded from taking good title in any event.[80]

Quistclose trusts

11-43 A *Quistclose* trust[81] enables a party to a commercial contract to retain their equitable interest in property which is lent to the other party. There is a similarity between *Quistclose* trusts and *Romalpa* clauses in that extent in both case the original titleholder is able to retain rights in the property: in *Romalpa* clauses it is the absolute title which is retained whereas in *Quistclose* trusts it is said to be the equitable title which is retained.[82] While such trusts have been used only in relation to loan moneys hitherto, there appears to be no reason in principle why the same equitable interest ought not to be available in relation to other forms of property.[83]

The principle in *Barclay's Bank v. Quistclose Investments Ltd*[84] derives from a number of earlier decisions such as *Hassall v. Smither*.[85] In short, where a transferor lends money subject to a contractual provision that the transferee is entitled only to use that property for limited purposes, the transferee will be deemed to hold the property on trust for the transferor in the event that the property is used for some purpose other than that set out in the contract. The weight of authority has it that this trust is a form of resulting trust.[86] Significantly, in the event that the transferee purports to transfer rights to some third party in breach of that contractual provision the transferor is deemed to have retained its rights under a trust which will preclude the transferee from acquiring rights in that property. The following discussion will examine the possibilities for taking security which are offered by *Quistclose* trusts and thereby consider the various explanations for the nature of the trust created.

11-44 In the case of *Barclays Bank v. Quistclose*[87] itself a loan contract was formed by which Quistclose lent money to a company, Rolls Razor Ltd, solely for the payment of dividends to its shareholders. That money was held in a share dividend bank account separate from all other moneys. The loan moneys were not used for that purpose before Rolls Razor fell into insolvency: consequently, Barclays Bank, which operated the share dividend account, sought to apply the moneys in discharge of Rolls Razor's overdraft with it. Lord Wilberforce held that this contract created a primary trust whereby the company was empowered to use the money to pay the dividend in accordance with the contractual purpose of the loan. His Lordship further held that at the point in time at which the company sought to use that money for another purpose,

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[79] That is, the principle that one cannot pass good title in a thing over which one has no rights. Literally, "nemo dat quod habet" translates as "one cannot give that which one does not have".
[80] *De Mattos v. Gibson* (1858) 4 De G & J 276, 45 ER 108.
[81] Derived from the decision in *Barclay's Bank v. Quistclose Investments Ltd* [1970] AC 567.
[82] *Twinsectra v Yardley* [2002] 2 All ER 377, 398, *per* Lord Millett.
[83] See Worthington, *Proprietary interests in commercial transactions* (Oxford University Press, 1996), 63.
[84] [1970] A.C. 567.
[85] (1806) 12 Ves 119; *Toovey v. Milne* (1819) 2 B&Ald 683, 106 ER 514.
[86] *Barclays Bank v Quistclose* [1970] A.C. 567; *Twinsectra v Yardley* [2002] 2 All ER 377.
[87] *Barclay's Bank v. Quistclose Investments Ltd* [1970] AC 567.

a secondary trust was automatically created which transferred the equitable interest in the money for the lender on resulting trust. Thus a *Quistclose* arrangement obtains some equitable interest in the loan moneys for the lender of property.

11-45 In relation to collateral arrangements, where the agreement is structured so that the party providing collateral lends assets to the secured party, the lender of those assets is able to control the purposes for which they are used. Therefore, if a collateral arrangement does identify assets as having been lent to the secured party solely for the purpose of securing its obligations under outstanding derivatives transactions, then the equitable title remains in the lender of the assets. It is only if the lender of those assets fails to perform its obligations under the derivatives agreement that the secured party is then entitled to take absolute title in the loaned collateral assets.

11-46 While this form of trust was explained in *Barclays Bank v. Quistclose* itself by Lord Wilberforce as being a form of resulting trust whereby the equitable interest returns to its previous owner, the principle has been also been explained by Peter Gibson J in *Carreras Rothmans Ltd v. Freeman Mathews Treasure Ltd*[88] in terms that:

> "… equity fastens of the conscience of the person who receives from another property transferred for a specific purpose only and not therefore for the recipient's own purposes, so that such person will not be permitted to treat the property as his own or to use it for other than the stated purpose."

In this case it was suggested any third person entitled to receive the trust property would have a right to enforce the trust. This would also be a ground for understanding the trust as coming into existence as a constructive trust and not simply a resulting trust.

11-47 The minority speech of Lord Millett in the House of Lords in *Twinsectra v Yardley* suggested that the *Quistclose* trust should be considered to be akin to a retention of title by the lender whereby the lender effectively retains an equitable interest in the property throughout the transaction such that the property is held on resulting trust for the lender. His Lordship held that:

> '… the *Quistclose* trust is a simple, commercial arrangement akin … to a retention of title clause (though with a different object) which enables the borrower to have recourse to the lender's money for a particular purpose without entrenching on the lender's property rights more than necessary to enable the purpose to be achieved. The money remains the property of the lender unless and until it is applied in accordance with his directions, and in so far as it is not so applied it must be returned to him. I am disposed, perhaps predisposed, to think that this is the only analysis which is consistent both with orthodox trust law and with commercial reality.'[89]

[88] [1985] Ch. 207, 222.
[89] [2002] 2 All 377, 398-399.

The lender could therefore be taken to retain the equitable interest in loan moneys throughout the life of the contract.[90]

11-48 There is, it is suggested, no single, correct analysis of a *Quistclose* trust.[91] While Lord Millett's view is currently in vogue,[92] encapsulating as it does ideas first propounded by Prof Worthington,[93] it cannot be a complete answer to this question. For example, if my loan contract were drafted so as to have the loan moneys held on express trust by the borrower for the benefit of the lender and explicitly to grant the borrower a mere power to use the money for another specified purpose, then even Lord Millett's retention of title analysis would not meet the case exactly. If there were an express trust over the loan property coupled with a power to advance that property for the contractually stipulated purpose then there would be no question of any interest resulting[94] to the lender because the express trust would have created an equitable interest explicitly from the outset rather than having one implied by law as with a resulting trust. Indeed, in structuring such a collateral arrangement in practice one would not leave the security to arise by operation of law as with a resulting trust, instead one would wish to set out the nature and extent of that interest explicitly in the express trust. Thus, Lord Millett's explanation of a *Quistclose* trust, and indeed any of the many explanations which have been posited by various commentators, are satisfying only as formulations of either the vanilla case or on an abstract theoretical formulation. The reader is referred to the literature on the law of trusts for a more detailed account of these issues.[95] In short, it is suggested that an arrangement which used an express trust coupled with a power to advance the loan property is the most appropriate method in practice.

11-49 The real significance of the *Quistclose* trust in practice is often something different, however. What is little discussed in the decided case law is the following practical problem. If a lender lends money to a borrower subject to a contractual provision that the money be used for only a specified purpose, then if the borrower spends the money on some other purpose it is perfectly possible that the money will have "disappeared". By the term "disappeared" in this context I mean that the original loan money will have become inextricably mixed with other money in a bank account or that it will have been paid into and out of a fund so that the expert accountants used in such cases would not be able to trace that money into any single, segregated fund.[96] The same problem would hold for a trust over securities which were similarly passed through different hands, or sold and the sale proceeds paid into a mixed account. In this context the lender's only remedy would be by virtue of an equitable tracing claim

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[90] *Ibid*, 398, para 80. This approach was followed in *Re Margaretta Ltd, Freeman v Customs and Excise* [2005] All ER (D) 262, *per* Crystal QC (sitting as a Deputy Judge in the High Court), para [15] *et seq*.

[91] See GW Thomas and AS Hudson, *The Law of Trusts* (Oxford University Press, 2004), paras 9.98 and 49.20.

[92] *Twinsectra v Yardley* [2002] 2 All ER 377, 398.

[93] S Worthington in *Proprietary Rights in Commercial Transactions* (Clarendon, 1996), 43 *et seq*.

[94] The word "resulting" stems from the Latin meaning "to jump back".

[95] See, in particular, Thomas and Hudson, *The Law of Trusts* (Oxford University Press, 2004), paras 9-74 to 9-98 and 49-14 – 49-27 which examines both the practical and the theoretical aspects of this doctrine.

[96] In this context, "fund" is the word which property lawyers tend to use to encompass any holding or mixture of property which may include a bank account, or a trust fund, or even a heap of tangible property.

into a mixed fund in which the traceable proceeds of the original loan moneys rest.[97] There is no question as to precisely which remedy may be available to the lender until the process of tracing and identifying property against which an action may be brought has been completed.[98]

Such a tracing claim can only be brought in equity; and such an equitable tracing claim can only be brought if the claimant had some equitable proprietary interest in the loan moneys from the outset.[99] A loan contract will not create an equitable interest, unless there is some trust created as part of the contract. A *Quistclose* trust does create an equitable interest for the lender and therefore the *Quistclose* trust will enable the lender to commence an equitable tracing claim. No other claim would grant any property right in such a mixed fund. Therefore, the true importance of *Quistclose* trusts is the creation of an equitable interest in favour of the lender which will permit that lender to commence an equitable tracing claim. Without such a pre-existing equitable interest, no tracing claim would be possible: as considered above. The decided cases have always tended to assume (because they have not been called upon to delve any further) that the loan moneys remain intact and are identifiable in an account unmixed with other property. In truth, once the moneys have been misapplied, it may be impossible to identify the original money in the borrower's hands precisely because the money has been misapplied in breach of contract: therefore, the ability to trace in equity will be the claimant's principal remedy. Tracing was considered in chapter 9.[100]

11-50 Considered as a security interest, the *Quistclose* trust can also be of significance in relation to deep discount swaps or transactions in which money is transferred from one counterparty to another in circumstances in which there is some obligation to repay that money or its equivalent amount. A deep discount swap[101] is the kind used in *Westdeutsche Landesbank v. Islington*[102] whereby an amount of £2.5 million was paid upfront to the local authority by the investment bank at the outset of the transaction, to all intents and purposes by way of loan.[103] In such a situation, a provision that the money was only to be used for identified purposes would have had the result that the investment bank would have been a beneficiary under a *Quistclose* trust, giving it protection against the misuse of that money. However, one issue which remains outstanding, nevertheless, is whether or not the rule in *Re Goldcorp*,[104] requiring that the property be separately identifiable, could be satisfied in this context such that if the money had been irretrievably mixed with other property then there could not be said to be a trust over any identifiable fund of property. This is the

[97] The doctrine of loss of the right to trace will clearly be at issue here.
[98] *Boscawen v Bajwa* [1996] 1 WLR 328, [1995] 4 All ER 769.
[99] *Westdeutsche Landesbank v Islington* [1996] AC 669; *Boscawen v Bajwa* [1996] 1 WLR 328, [1995] 4 All ER 769.
[100] Para 9-40.
[101] Para 9-51 *et seq*.
[102] [1994] 4 All E.R. 890, Hobhouse J.
[103] On the question whether or not that deep discount amount was indeed a loan see Hudson, *Swaps, Restitution and Trusts* (Sweet & Maxwell, 1999), 14. At first instance it was suggested that it was not a loan because it was described by the parties as being part of a swap, thus signally a rare victory for form over substance [1994] 4 All E.R. 890, 901, *per* Hobhouse J; whereas in the House of Lords it was accepted, without the point being an issue at that stage of the appeal, as relating clearly to a loan [1996] 2 All E.R. 961, 965.
[104] [1995] 1 A.C. 74.

problem referred to immediately above that the true significance of a *Quistclose* trust will be the ability it offers to commence an equitable tracing claim, to seek proprietary rights over the traceable proceeds of the original lent property in even a mixed fund belonging to a third party, once that money has been paid away by the borrower. In that sense, the original loan moneys would be unidentifiable if they have been paid away into a mixed account. Thus the *Quistclose* trust may often not offer protection against an untrustworthy custodian who conceals the loan moneys but it will offer a means of proceeding so as to recover the value lost to the lender.

In the *Westdeutsche Landesbank v Islington* case itself, the bank had no proprietary right in any money because at the time the money was spent the payee had no knowledge of the invalidity of the interest rate swap contract. However, if there had been some stipulation in the contract as to the purpose for which the money was to have been used, then the bank would have had an equitable interest under a *Quistclose* trust over that money and – even though the original money had been dissipated by the date of trial – the bank would have been able to attempt to trace into the payees' accounts[105] and would have been able to claim compound interest on that money (which was the principal point raised in the appeal to the House of Lords). It should be recalled that compound interest on a judgment will only be available if the claimant had some proprietary right in the property which is the source of the litigation.[106]

MORTGAGES AND CHARGES

The distinction between mortgages and charges

11-51 Mortgages and charges are subtly distinct concepts. A mortgage grants a mortgagee a proprietary right in property as security for a loan so that the mortgagee may enforce its security by means of sale, repossession, foreclosure or appointment of a receiver, always provided that the mortgagor is entitled to recover unencumbered title of the mortgaged property once the loan has been repaid; whereas a charge, which may be fixed or floating, provides a chargee with a contingent right to seize property in the event that the chargor fails to perform its obligations in relation to an underlying contract. A mortgage grants the mortgagee a proprietary right in the mortgaged property, whereas a charge creates no right in property but rather creates only a right to apply for a judicial sale of property if an underlying contractual obligation is not performed.[107] As Slade J has expressed the distinction: a mortgage involves a conveyance of the mortgaged property to the mortgagee subject to the mortgagor's equity of redemption, whereas a charge makes no such conveyance and grants contingent rights over the property in the event that the underlying obligation is not performed.[108] Mortgages may take effect at law or in equity as legal mortgages or

[105] An operation which would have failed on those facts because there were no traceable proceeds of the moneys left in the payee's hands.
[106] *Westdeutsche Landesbank v Islington* [1996] AC 669.
[107] *Swiss Bank Corporation v Lloyds Bank* [1982] AC 584 at 594, [1980] 2 All ER 419 at 426; *Ladup Ltd v Williams and Glyn's Bank plc* [1985] 2 All ER 577, [1985] 1 WLR 851.
[108] *Re Bond Worth Ltd* [1980] Ch 228 at 250. See, however, the obfuscation provided by Lord Hoffmann in *Re BCCI (No 8)* [1998] AC 214 where his Lordship appeared to speak generally of

as equitable mortgages respectively, whereas charges take effect only in equity. Charges in turn may be fixed or floating, as considered below. These distinctions between the two doctrines are meaningful but have often been overlooked in the decided cases. First, we shall consider mortgages.

Legal mortgages

The nature of the law of mortgages

11-52 Mortgages may be taken over land or over chattels. The principal features of a mortgage are that the mortgagee (the secured party) acquires a right of ownership in the mortgaged property which acts as security for a loan or other transaction between mortgagor and mortgagee, however equity protects the mortgagor's right to recover his property without the encumbrance of the mortgage on the discharge of the mortgagor's obligations to the mortgagee (known as the "equity of redemption").[109] A mortgage contract which purports to exclude or unconscionably limit the equity of redemption will be void. Therefore, a mortgage is a combination of a contract (most commonly a contract of loan) and a property right. As considered below, the rules relating to mortgages of land will apply to mortgages of personalty in general terms, with the exceptions considered below.[110]

Legal mortgages of land

11-53 A legal mortgage is at root a contract of loan, or (for present purposes) a contract for some other financial obligation. The mortgagee lends money to the mortgagor which that mortgagor is required to repay over the contractually specified period together with periodical amounts of interest. As a contract, the mortgage is governed primarily by questions of contract law as to its formation, its terms, and its termination. The mortgage differs from an ordinary contract of loan in that the mortgagee acquires the rights of a mortgagee over identified assets of the mortgagor. The mortgage is said to be a proprietary interest in the mortgaged property because the mortgagee's right can be registered at the Land Registry as such, and because the mortgagee acquires rights to take possession of that property in the event of some breach of the loan contract, or to sell that property, or to have foreclosure of the mortgage contract and so take the mortgagor's title in the mortgaged property. It was

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charges, describing them as ensuring that "the owner of the property retains an equity of redemption to have the property restored to him when the liability has been discharged". It is suggested that these remarks be read as a general description of the role of charges in insolvency proceedings and not as a commentary on the distinction between mortgages and charges.

[109] Law of Property Act 1925, s.116.

[110] See generally McGhee, *Snell's Equity* (31st ed, Sweet & Maxwell, 2005) 777; McCormack, *Secured Credit under English and American Law* (Cambridge University Press, 2004); Goode, *Legal Problems of Credit and Security* (3rd ed, Sweet & Maxwell, 2003); Falcon Chambers, *Fisher and Lightwood's Law of Mortgage* (11th ed, Butterworths, 2002); Bridge, *Personal Property Law* (3rd ed, Oxford University Press, 2002); Cousins, *Mortgages* (2nd ed, Sweet & Maxwell, 2001); Smith, 'Securities', in Birks (ed), *Private Law* (Oxford University Press, 2000) 455 *et seq.*; Ferran, *Company Law and Corporate Finance* (Oxford University Press, 1999) ch 15 "Secured Debt"; Gleeson, *Personal Property Law* (FT Law & Tax, 1997); Sykes and Walker, *The Law of Securities* (5th ed, Law Book Co, 1993); Palmer, *Bailment* (2nd ed, Law Book Co, 1991) ch 22 'Bailment'; Tyler and Palmer, *Crossley Vaines on Personal Property* (5th ed, Butterworths, 1973), 447.

the intervention of the courts of equity in the early case law which ensured that the mortgagor would have an equity of redemption: meaning that, once the underlying obligation had been redeemed, the mortgagor would recover title in the property which had previously been subject to the mortgage unencumbered by that mortgage.

In relation to mortgages of land governed by s.85 of the Law of Property Act 1925 ("LPA") the mortgagee acquires both rights of possession at common law and rights of sale under statute. As provided by s.85 LPA 1925:

> '(1) A mortgage of an estate in fee simple shall only be capable of being effected at law either by a demise for a term of years absolute, subject to a provision for cesser on redemption, or by a charge by deed expressed to be by way of legal mortgage …'

The courts have been astute to ensure that there is equity between parties to a relationship where one party takes out a mortgage without the knowledge or informed consent of the other party. Where the mortgagor is subject to some overriding obligation in equity in favour of some other person, the mortgagee may not be able to enforce its rights to repossession or sale against that other person.[111]

Legal mortgages of personalty

11-54 Mortgages of personalty may take effect as legal mortgages or as equitable mortgages and either as mortgages of choses in action, possibly taking effect by means deposit of title deeds or otherwise by common intention of the parties, or as mortgages of chattels, possibly taking effect by documentation falling under the Bills of Sale Act 1882 as considered below.[112] The mortgagee will have a power of sale and a power of foreclosure, as considered in the next section.[113]

11-55 The mortgage must be distinguished from a mere pledge, considered later in this chapter.[114] A pledgee of property can obtain a sale of the pledged property on application to the court or otherwise under the terms of the contract containing the pledge, which is ostensibly similar to the mortgagee's power to obtain sale, but importantly a pledgee cannot acquire foreclosure in the way that a mortgagee can.[115] A pledge merely gives a right of possession and not a right of ownership, whilst also securing the plegor's obligation to make payment.

11-56 A legal mortgage of chattels will grant the mortgagee the statutory power of sale under s.101 LPA 1925 provided that the mortgage is created by deed, as considered in the next section relation to the mortgagee's remedies. Mortgages of chattels can be created orally provided that the parties demonstrate an intention to

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[111] *Abbey National v. Moss* [1994] 1 FLR 307.
[112] Mortgages over property which will only be owned by the mortgagor at some point in the future are void at common law, and take effect only as equitable mortgages: *Lunn v Thornton* (1845) 1 CB 379; *Tailby v Official Receiver* (1888) 13 App Cas 523.
[113] Para 11-58.
[114] Para 11-85.
[115] *Harrold v Plenty* [1901] 2 Ch 314, Cozens-Hardy J (where his lordship considered, inter alia, that deposit of a share certificate would suggest an intention to create a mortgage and not simply a pledge).

create a mortgage over that property.[116] If the mortgage is not made by deed, then the case law, principally in the courts of equity, has developed a principle to the effect that the mortgagee will have a power of sale analogous to that in the statute, which is exercisable provided that the mortgagee has given reasonable notice or that the mortgage contract provides for a time at which the power of sale can be exercised.[117] The mortgagee of personalty also has a right of foreclosure.[118] One significant distinction on the authorities between a pledge, in the form of a pawn arrangement, and a mortgage in this context is that if the arrangement grants the secured party an immediate right to take ownership of the secured property then that would constitute a mortgage, whereas if the parties' contract merely suggested that the secured party would have certain rights and powers in the future after the happening of some contingency then that would be merely a pledge.[119]

11-57 It should be noted that a mortgagee, under a transaction the documentation of which is governed by the Bills of Sale Act 1882, may have its right to seize and sell the mortgaged property restricted by that Act.[120] In general terms that Act will apply in relation to transfers of goods where the seller retains possession of those goods and the transfer is effected or evidenced by a document so as to take security in that property. An exception to this principle is the situation in which the transfer is a sale of goods made as part of the ordinary course of a trade.[121] However, a mortgage will not be a sale of goods because the mortgagor's equity of redemption evidences an intention not to part with absolute title in the goods.[122] Any such document securing a right to have money repaid will be void between the parties and against third parties if it is not registered under the Act and if the document does not contain a schedule of the goods secured by means of that bill.[123] In the event that the bill is void, the parties retain the right to sue for recovery of loan moneys at common law in an action for money had and received.[124]

The mortgagee's remedies

The available remedies

11-58 A mortgagee of land has four principal remedies, variously the rights to: sale, foreclosure, possession, and the appointment of a receiver.[125] A mortgagee of chattels

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[116] *Reeves v Capper* (1838) 5 Bing NC 136; *Flory v Denny* (1852) 7 Exch 581.
[117] *Deverges v Sandeman Clark & Co* [1902] 1 Ch 579; *Stubbs v Slater* [1910] 1 Ch 632.
[118] *Harrold v Plenty* [1901] 2 Ch 314.
[119] *Mills v Charlesworth* (1890) 25 QBD 421, *per* Lord Esher.
[120] Guest et al, *Benjamin's Sale of Goods* (6th ed, Sweet & Maxwell, 2002) 15 *et seq*.
[121] Bills of Sale Act 1978, s.4.
[122] See *Beckett v Tower Assets Co Ltd* [1891] 1 QB 1; approved on appeal [1891] 1 QB 638.
[123] Bills of Sale Act 1882, ss.4, 5, 8 and 9. Except in relation to oral mortgages of chattels, it seems the Act will have no effect because it strikes only at documents: *Newlove v Shrewsbury* (1888) 21 QBD 41; also *Thompson v Pettitt* (1847) 10 QB 101.
[124] *Davies v Rees* (1886) 17 QBD 408; *North Central Wagon Finance Ltd v Brailsford* [1962] 1 WLR 1288. The most pertinent case relating to this form of action for a derivatives specialist is *Westdeutsche Landesbank v Islington* [1996] AC 669 where the bank's failure to establish any right in property entitled them to a mere personal right to restitution by way of the action for money had and received.
[125] See generally Harpum, *Megarry and Wade on the Law of Real Property* (6th ed, Sweet & Maxwell, 2000) ch 19.

has two remedies: sale and foreclosure. By contrast an equitable chargee under a mere charge has only two remedies: sale and the appointment of a receiver.[126]

The mortgagee's power of sale

11-59 The mortgagee's power of sale in s.101 of the Law of Property Act 1925 ("LPA 1925") apply both to mortgages of land and of chattels, as well as to charges and to liens,[127] provided that the right has been created by deed. The mortgagee acquires statutorily provided powers of sale over the mortgaged property by one of two routes. The first is the specific power of sale set out under s.101 LPA 1925 on the following terms:

> '(1) A mortgagee, where the mortgage is made by deed, shall, by virtue of this Act, have the following powers, to the like extent as if they had been in terms conferred by the mortgage deed, but not further (namely):-
>
> (i) A power, when the mortgage money has become due, to sell, or to concur with any other person in selling, the mortgaged property, or any part thereof, either subject to prior charges or not, and either together or in lots, by public auction or by private contract, subject to such conditions respecting title, or evidence of title, or other matter, as the mortgagee thinks fit, with power to vary any contract for sale, and to buy in at an auction, or to rescind any contract for sale, and to re-sell, without being answerable for any loss occasioned thereby; …'

For this power of sale to be exercisable the mortgage must have been contained in a deed. Furthermore, s.101 LPA 1925 grants a power to sell when the "mortgage money has become due". As is considered in the next section, the definition of "mortgage" for the purposes of the LPA 1925[128] includes charges and liens but the power is limited on its face to circumstances in which the underlying obligation is an obligation to pay money. This power is subject to the provisions of s.103 which require that there have been notice given by the mortgagee of arrears together with three months arrears,[129] or that some interest is in arrears and has continued to be so for two months,[130] or that there has been a breach of some other provision in the mortgage contract.[131] The mortgagee has a power to sell free from any rights or interests to which the mortgage has priority.[132]

The mortgagee may also seek a sale as a person with an interest in the property under s.91 of the 1925 Act, as is considered below in relation to the rights of the mortgagor.

The extension of the power of sale to charges and liens

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[126] See para 11-76 below.
[127] As considered in the next section.
[128] Law of Property Act 1925, s.205.
[129] Law of Property Act 1925, s.103(1).
[130] Law of Property Act 1925, s.103(2).
[131] Law of Property Act 1925, s.103(3).
[132] Law of Property Act 1925, s.104(1).

11-60 The definition of the term "mortgage" for the purposes of the 1925 Act is as follows:

> '"mortgage" includes any charge or lien on any property for securing money or money's worth; "legal mortgage" means a mortgage by demise or subdemise or a charge by way of legal mortgage and "legal mortgagee" has a corresponding meaning …'

Therefore, as is considered below, the statutory remedy of sale under s.101 in relation (on its face) to mortgages applies also in relation to charges and liens provided that those charges or liens have been created by deed.[133] The various positions in relation to charges and liens not created by deed are considered in turn below.

The right of foreclosure

11-61 The right of foreclosure is a right to terminate the mortgage contract and to vest the mortgagee with absolute title in the mortgaged property. This is a relic of the old structure for mortgages whereby the mortgagee would take an outright transfer of title in the mortgaged property in return for the loan, such that any right of use granted to the mortgagor could reasonably be foreclosed so as to vest the mortgagee with unencumbered title. In more modern mortgages law, the mortgagee is still considered to be the owner of the mortgaged property at common law and it is only equity, through the equity of redemption, which recognises rights in the mortgagor.[134]

The right of foreclosure arises once the mortgage moneys have become due at common law.[135] Foreclosure is available when the date for redemption has passed, or when there has been some failure to make payment under the contract in accordance with a term of that contract, or on the occurrence of some other breach of a material term of the contract. If the contract provides for any condition precedent for foreclosure or for any procedure necessary to acquire foreclosure, then those provisions will be binding on the mortgagee.[136] Foreclosure is the most common award for equitable mortgagees.[137] Proceedings are commenced under Part 8 of the Civil Procedure Rules. On award of foreclosure, the mortgagor's equity of redemption is extinguished[138] and the fee simple or term of years, as appropriate, becomes vested in the mortgagee.[139]

The right of possession

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[133] Law of Property Act 1925, s.101(1).
[134] *Heath v Pugh* (1881) 6 QBD 345 at 360. The Law Commission has recommended the abandonment of the use of foreclosure in relation to domestic mortgages because of the ostensible harshness of taking ownership of a home away from its occupants, rather than seeking sale or possession.
[135] *Williams v Morgan* [1906] 1 Ch 804.
[136] *Seaton v Twyford* (1870) LR 11 Eq 591.
[137] *James v James* (1873) LR 16 Eq 153.
[138] Law of Property Act 1925, ss.88(2) and 89(2).
[139] *Carter v Wake* (1877) 4 Ch D 605 at 606, *per* Lord Jessel MR.

11-62 At common law, a mortgagee may seek possession of the mortgaged property, to employ the legend, "even before the ink is dry on the contract".[140] In relation to land, this enables the mortgagee to go into possession of the land so as to turn it to account, for example, while the mortgagee awaits an increase in the sale value of the mortgaged property. The right of possession, consequently, is most commonly a mechanism for protecting an anticipated flow of income in relation to the mortgaged property. Relief may be available in relation to mortgages of land where the mortgagor can demonstrate a reasonable likelihood of being able to repay the mortgage debt in the future.[141]

The right to appoint a receiver

11-63 A mortgagee might prefer to have a management agent appointed to oversee the treatment of the mortgaged property. This is unlikely in the case of collateral for derivatives contracts unless, for example, a commodity were posted physically as collateral such that a professional manager of that commodity would be required. The statutory right to appoint a receiver arises under s.101 LPA 1925 in the following terms:

> '(1) A mortgagee, where the mortgage is made by deed, shall, by virtue of this Act, have the following powers, to the like extent as if they had been in terms conferred by the mortgage deed, but not further (namely):-
>
> (iii) A power, when the mortgage money has become due, to appoint a receiver of the income of the mortgaged property or any part thereof; or, if the mortgaged property consists of an interest in income … a receiver of that property or any part thereof …'

This right is therefore exercisable in relation to mortgages made by deed and in relation to which money has become due. The mortgagee is expected to act in good faith in exercising this power but owes no duty of care to the mortgagor in this regard.[142]

The rights of the mortgagor

11-64 The mortgagor may wish to sell the property if it is expedient to bring the mortgage contract to an end. There is a further means of seeking sale under the LPA 1925. The second means of sale is accessible by '[a]ny person entitled to redeem mortgaged property may have a judgment or order for sale instead …' under s.91(1) LPA 1925. In short, any person entitled to redemption may apply to the court for the property to be sold. In considering s.91 of the 1925 Act, it will emerge that the courts have been active in extending in the powers of the mortgagee to make their own decisions about whether or not to sell the property immediately after repossession. It is clearly in the interest of the mortgagor to sell a property in a falling housing market,

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[140] *Four Maids Ltd. v. Dudley Marshall Ltd.* [1957] Ch. 317; *Western Bank v. Schindler* [1977] Ch. 1; *National Westminster Bank v. Skelton* [1993] 1 All ER 242.
[141] Administration of Justice Act 1970, s.36; Administration of Justice Act 1973, s.8.
[142] *Shamji v Johnson Matthey Bankers Ltd* [1991] BCLC 36.

or in situations in which the outstanding mortgage debt will continue to rise as a result of the mortgagee's decision not to sell the property immediately.

Therefore, s.91 LPA 1925 has generally been used as a defence by the mortgagor to prevent itself from suffering from unconscionable and oppressive actions of mortgagees who are seeking to lock a mortgagor into a mortgage contract over which the debt is increasing. So, in *Palk v Mortgage Services Funding Ltd*[143] Nicholls V-C held that a mortgagor would be entitled to an order for sale when the mortgagee was refusing to agree to sell mortgaged property in relation to which the mortgagor could not meet his repayments in the context of a falling housing market which had locked the mortgagor into a steeply spiralling debt. On the basis that the mortgagor was an individual who had not consented to becoming a speculator on the housing market and because the bargaining power was loaded entirely in favour of the mortgagee, it was ordered that a sale be effected immediately. By contrast with the high-water mark for mortgagor protection in *Palk v Mortgage Services Funding Ltd*, the Court of Appeal has accepted latterly that it is the mortgagee who is entitled to retain control over the business of dealing with the property after repossession.[144] This emerges most clearly from the decisions of Phillips and Millett LJJ in *Cheltenham & Gloucester BS v Krausz*[145] where a premium was placed both on the mortgagee's power to control the process of sale and on the need for the mortgagee to recover its debt.

The important further question is then as to the manner in which the mortgagee is required to act in relation to its power of sale. In relation to the power to sell under s.101 LPA 1925, the mortgagee is not obliged to act as a fiduciary for the mortgagor and is entitled to conduct the sale as it wishes in its own interests[146] provided that it acts neither negligently nor fraudulently in so doing.[147]

11-65 A mortgage contract may be set aside if the mortgage contract was procured through some undue influence or misrepresentation exercised over the mortgagor or any surety.[148] For the detail of this doctrine in this context, the reader is referred to the literature on the law of real property.[149] There is a final, general mechanism to relieve the mortgagor: if the mortgagee is seeking to enforce its rights under the mortgage for purposes other than the preservation of its security then a court of equity may prevent a sale of the property for that ulterior purpose.[150]

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[143] [1993] 2 WLR 415.

[144] *Cheltenham & Gloucester Building Society v Krausz* [1997] 1 All ER 21.

[145] *Ibid*.

[146] *Cuckmere Brick v. Mutual Finance Ltd.* [1971] Ch. 949. See also *Parker-Tweedale v. Dunbar Bank plc* [1991] Ch. 12; *Halifax B.S. v. Thomas* [1995] 4 All ER 673; *Medforth v. Blake* [1999] 3 All ER 97.

[147] *Tse Kwong Lam v. Wong Chit Sen* [1983] 3 All ER 54 PC; *China and South Sea Bank Ltd. v. Tan Soon Gin* [1990] 1 AC 536.

[148] *Barclays Bank v. O'Brien* [1994] 1 AC 180; *CIBC Mortgages v. Pitt* [1994] 1 AC 200; *Royal Bank of Scotland v. Etridge (No 2)* [2001] 3 WLR 1021 HL.

[149] See Harpum, *Megarry and Wade on the Law of Real Property* (6th ed, Sweet & Maxwell, 2000) 19-125 *et seq*.; *Snell's Equity* (Sweet & Maxwell, 2005) 789 *et seq*.; Hudson, *Equity & Trusts* (4th ed, Cavendish, 2005) 950 *et seq*.

[150] *Quennell v. Maltby* [1979] 1 All ER 568.

Equitable mortgages

The nature of an equitable mortgage

11-66 An equitable mortgage can arise in one of four circumstances. First, it might be that the mortgage is taken out over a merely equitable interest in property.[151] As such the mortgage itself could only be equitable. An example would be the situation in which it is an equitable lease or an equitable interest under a trust which is used as security for the loan moneys.[152]

11-67 Second, it might be that there is only an informally created mortgage insufficient to create a legal mortgage, for example a mortgage of over land which does not comply with ss.85 and 86 of the Law of Property Act 1925 for the creation of a mortgage which constitutes a legal interest in land. In applying the equitable principle that equity looks upon as done that which ought to have been done, the contract is deemed to grant rights in specific performance to the contracting parties and therefore to create a mortgage in equity in line with the doctrine in *Walsh v. Lonsdale*.[153] It was required that the money have been advanced before such a contract would become specifically enforceable as a contract and not merely remediable by payment of damages.[154]

11-68 Third, the charge might be created as merely an equitable charge, for example in circumstances in which property is charged by way of an equitable obligation to pay money. Such a charge arises on the cases only in situations in which the charge so created exists to effect discharge of a debt.[155] The effect of this form of charge would be that the court would decree a sale of the property if the moneys were not repaid.[156]

11-69 Fourth, in relation to land, an equitable mortgage takes effect by way of deposit of title deeds.[157] Under that doctrine, the deposit of title deeds over property by the mortgagor with a mortgagee was, of itself, taken to create an equitable mortgage by dint of being an act of partial performance of that mortgage under s.40 of the LPA 1925. While s.40 has now been repealed,[158] the doctrine of proprietary estoppel continues to provide that where an assurance has been made by one party to another that that other party shall receive some property right and that other party acts to their detriment in reliance on that assurance, then proprietary estoppel gives the court the discretion to award that right. The case of *Yaxley v. Gotts*[159] has seen the courts uphold a doctrine similar in effect to the old doctrine of part performance by holding that, despite the enactment of s.2 of the Law of Property (Miscellaneous Provisions) Act 1989, the court will award the property rights sought to avoid

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[151] Ordinarily it is considered that such a circumstance would not give rise to obligations under the Bills of Sale Act 1882 (see *Crossley Vaines on Personal Property*, *op cit*., 449), although a document might be required to transfer an equitable interest further to s.53(1)(c) LPA 1925 as part of a larger transaction disposing of personalty.
[152] *Rust v. Goodale* [1957] Ch 33.
[153] (1882) 21 Ch D 9.
[154] *Sichel v. Mosenthal* (1862) 30 Beav 371.
[155] *London County and Westminster Bank v. Tomkins* [1918] 1 KB 515.
[156] *Matthews v. Gooday* (1816)31 LJ Ch 282.
[157] *Tebb v. Hodge* (1869) LR 5 CP 73; *Russel v. Russel* (1783) 1 Bro CC 269.
[158] Law of Property (Miscellaneous Provisions) Act 1989, s.2.
[159] [2000] 1 All ER 711.

detriment being suffered by the claimant. In consequence, an equitable mortgage could be effected still if one party could demonstrate that the other party to the putative mortgage had induced them to suffer some detriment in reliance on the creation of that mortgage.

The nature of charges

11-70 Charges, as opposed to mortgages, take effect only in equity.[160] This section will consider charges which do not take effect by way of mortgage, whereas mortgages were considered above. Charges grant a right to seize property in the event that the chargor does not perform some underlying obligation, for example to pay money under a contract of loan; importantly, though, a mere charge does not grant the chargee an immediate right in the charged property in the manner that a mortgage grants the mortgagee such an immediate right of ownership in the mortgaged property.[161] As the current authors of *Fisher and Lightwood's Law of Mortgage* put the matter:

> 'A charge is a security whereby real or personal property is appropriated for the discharge of a debt or other obligation, but which does not pass either an absolute or a special property in the subject of the security to the creditor, nor any right to possession. In the event of non-payment of the debt, the creditor's right of realisation is by judicial process.'[162]

Thus a chargee has a right to apply to the court to seek a right to seize the charged property and to sell it so as to realise the amount owed to it.[163] Any surplus realised on sale will be held on constructive trust for the chargor.[164] Charges are created by agreement of the parties, whether by means of contract, settlement, will or by the appropriation of personalty for the discharge of the chargor's obligations to the chargee. There is no specific formality for the creation of a charge over personalty.[165] Rather, the court will look to the intention of the parties. By contrast, a charge by way of a contract over land or an interest in land must be contained in a single document

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[160] *Re Coslett Contractors Ltd* [1998] Ch 495. Explained in Gleeson, *Personal Property Law* (FT Law & Tax, 1997) 235, to be the case because title may not be divided at common law. However, of course, title at common law may be held in common, for example by trustees.

[161] It should be noted that the judges are not always so discriminating between charges and mortgages, often using the terms synonymously. See, for example, Slade J in *Siebe Gorman v Barclays Bank* [1979] Lloyd's Rep 142, 159 where the terms are used interchangeably in the following passage: "… a specific charge on the proceeds of [the book debts] as soon as they are received and consequently prevents the mortgagor from disposing of an unencumbered title to the subject matter of such charge without the mortgagee's consent, even before the mortgagee has taken steps to enforce its security."

[162] Falcon Chambers, *Fisher and Lightwood's Law of Mortgage* (11th ed, Butterworths, 2002) 25.

[163] *Johnson v Shippen* (1703) 2 Ld Raym 982; *Stainbank v Fenning* (1851) 11 CB 51; *Stainbank v Shepard* (1853) 13 CB 418. This doctrine is also considered in the following cases: *Swiss Bank Corporation v Lloyds Bank Ltd* [1982] AC 584 at 595, [1980] 2 All ER 419 at 425, CA, [1982] AC 584, [1981] 2 All ER 449, HL; *Carreras Rothmans Ltd v Freeman Mathews Treasure Ltd* [1985] Ch 207, [1985] 1 All ER 155 at 169; *Re Charge Card Services Ltd* [1987] Ch 150 at 176, [1989] Ch 497 CA; *Re BBCI (No 8)* [1998] AC 214, [1997] 4 All ER 568, HL; *Re Coslett Contractors Ltd* [1998] Ch 495 at 507, *per* Millett LJ.

[164] Cf Law of Property Act 1925, s.103.

[165] *Cradock v Scottish Provident Institution* (1893) 69 LT 380, affirmed at (1894) 70 LT 718, CA.

signed by the parties containing all of the terms of that contract.[166] A charge over after-acquired property will not be effective.[167] Thus a charge over a mere *spes* (or, expectancy of receiving property in the future) will not be effective either because the chargor would have no right in the property at the time of purporting to create the charge.[168] However, where consideration is given for the grant of the charge, then there is authority for the charge taking effect at the time stipulated in the contract.[169]

Distinguishing charges from other structures

11-71 There is a doctrinal distinction between mortgages and charges due to the immediate right of ownership granted to a mortgagee by a mortgage which is not granted by an ordinary charge.[170] In contrasting an equitable charge with an equitable mortgage, the following dicta of Buckley LJ illustrate the great similarity between the concepts which has appeared in a number of the decided cases but also illustrate the need to maintain a distinction between those two concepts:

> 'An equitable charge may, it is said, take the form either of an equitable mortgage or of an equitable charge not by way of mortgage. An equitable mortgage is created when the legal owner of the property constituting the security enters into some instrument or does some act which, though insufficient to confer a legal estate or title in the subject matter upon the mortgage, nevertheless demonstrates a binding intention to create a security in favour of the mortgagee, or in other words evidences a contract to do so … An equitable charge which is not an equitable mortgage is said to be created when property is expressly or constructively made liable, or specially appropriated, to the discharge of a debt or some other obligation, and confers on the chargee a right of realisation by judicial process, that is to say, by the appointment of a receiver or an order for sale.'[171]

An equitable charge, then, grants the secured party some right by virtue of the parties' contract to sell the assets provided by way of security,[172] whether that property is held at the time of the creation of charge or whether it is only capable of first coming into existence once the specific property comes into the hands of the chargor.[173] The key

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[166] Law of Property (Miscellaneous Provisions) Act 1989, s.2.
[167] *Re Earl of Lucan, Hardinge v Cobden* (1890) 45 Ch D 470.
[168] *Re Brook's ST* [1939] 1 Ch 993.
[169] *Wellesley v Wellesley* (1839) 4 Myl & Cr 561.
[170] There is debate as to the extent to which some of the older cases have, inadvertently or advertently, apparently merged the two categories: see *Fisher and Lightwood's Law of Mortgage* (11th ed, Butterworths, 2002) 26. However, there are a number of recent cases which have asserted the importance of the difference between these categories: see e.g. *Swiss Bank Corporation v Lloyds Bank* [1982] AC 584 at 594, [1980] 2 All ER 419 at 426; *Ladup Ltd v Williams and Glyn's Bank plc* [1985] 2 All ER 577, [1985] 1 WLR 851. Cf. *Re BCCI (No 8)* [1998] AC 214 at 225, *per* Lord Hoffmann. It is suggested that there is a distinction between these two categories – principally the ownership right granted by the mortgage which is not granted by the ordinary charge – and that those dealing with commercial contracts should be astute to observe the distinction between the two.
[171] *Swiss Bank Corp v. Lloyds Bank* [1982] A.C. 584, 594, *per* Buckley LJ.
[172] *Rodick v. Gandell* (1852) 1 De. G.M. & G. 763; *Palmer v. Carey* [1926] A.C. 703.
[173] In which case there will be no such right until the property is taken legally into possession by the chargor: *Holroyd v. Marshall* (1862) 10 H.L. Cas. 191; *National Provincial Bank v. Charnley* [1924] 1 K.B. 431.

to that charge being an equitable charge is that it is specifically enforceable by virtue of the contract: it is therefore the equitable remedy of specific performance which gives rise to the right as an equitable right.[174] A floating charge is an example of an equitable charge, also arising in equity rather than at common law. The existence of such a charge may be deduced from the circumstances provided that the property to be subject to the charge, provided that it is a fixed charge, is sufficiently ascertainable.[175]

Whether or not a charge may create a proprietary right

11-72 Ordinarily, as considered above, a charge does not technically create a proprietary right for the chargee but rather creates a right to judicial process which will then empower the chargee to seize the charged property if an underlying debt or other obligation has not been satisfied in good time or in accordance with the terms of the appropriate contract.[176] Nevertheless, there are two recent decisions of the House of Lords in which it has been suggested that charges create proprietary rights,[177] in spite of the strict position under the case law which has distinguished between charges and other structures which create proprietary rights such as trusts and mortgages. Lord Hoffmann perhaps demonstrated the judicial attitude to such technical niceties when he held that 'the law is fashioned to suit the practicalities of life and legal concepts like "proprietary interest" and "charge" are no more than labels given to clusters of related and self-consistent rules of law.'[178] It was recognised by Lord Hoffmann in *Re BCCI (No 8)*[179] that, while a charge may be described as creating a proprietary right, nevertheless a "charge is a security interest created without any transfer of title or possession to the beneficiary".[180] Thus, any proprietary right is not achieved by means of a transfer of title (by which it is assumed his Lordship meant a transfer of outright title, as opposed merely to a transfer of an equitable interest) nor by means of a transfer of possession. Nevertheless, it is suggested that it is only in relation to a fixed charge that there could be said to be such a proprietary right. Thus Lord Scott has held that

> "the essential characteristic of a floating charge, the characteristic that distinguishes it from a fixed 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."[181]

Thus, in relation to a floating charge, there is no appropriation of any property subject to the charge until the event happens which is defined in the terms of the charge as crystallising that right. Consequently, it is suggested, there cannot be a right in any identified property before crystallization occurs under a floating charge. By contrast,

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[174] *Walsh v. Lonsdale* (1882) 21 Ch. D. 9.
[175] *In re Nanwa Gold Mines Ltd* [1955] 1 W.L.R. 1080. Cf. *Moseley v. Cressey's Co.* (1865) L.R. 1 eq. 405.
[176] *Swiss Bank Corp v. Lloyds Bank* [1982] A.C. 584, 594, *per* Buckley LJ.
[177] *In re BCCI (No 8)* [1998] AC 214, 226, *per* Lord Hoffmann; *In re Spectrum Plus Ltd* [2005] UKHL 41, [2005] 2 AC 680, paras [138] and [139], *per* Lord Walker.
[178] *In re BCCI (No 8)* [1998] AC 214, 227, *per* Lord Hoffmann.
[179] [1998] AC 214, 226, *per* Lord Hoffmann.
[180] *Ibid*.
[181] *In re Spectrum Plus Ltd* [2005] UKHL 41, [2005] 2 AC 680, para [111], *per* Lord Scott.

in relation to a fixed charge, there must necessarily be some property which is segregated or separately identified so that it can be subjected to the charge: consequently, it might be possible to think of this fixed charge as creating a right in property. However, even in relation to a fixed charge the property right is contingent on the underlying debt not being paid and an application being made to seize the charged property: therefore, if the chargee's right under a charge is a proprietary right, it is not a proprietary right equivalent to the rights of a beneficiary under a trust (which comes into existence at the time of the creation of the trust[182]). As Lord Walker has expressed the operation of a fixed charge:

> 'Under a fixed charge the assets charged as security are permanently appropriated to the payment of the sum charged, in such a way as to give the chargee a proprietary interest in the assets.'[183]

Thus, the chargee is considered to have rights permanently segregated so as to be subjected to the charge. The element, it is suggested, which is missing from this definition is the contingent nature of even a fixed charge: there is no right, unless something to the contrary is made clear in the terms of the charge, to seize the charged property unless and until there has been some default under the payment obligation under the charge. By contrast, in relation specifically to mortgages, the mortgagee has a right of possession at common law "even before the ink is dry on the contract".[184]

11-73 Unlike equitable liens (considered below[185]) and particular types of charges created by statute, charges are ordinarily created by agreement between the parties. Equitable liens are imposed by operation of law, albeit that the right of seizure under an equitable lien will generally give rise to an equitable charge which empowers the secured party to sell the property.[186]

The following sections consider, respectively: fixed charges, floating charges, and then more specifically charges over book debts.

Fixed charges

The nature of a fixed equitable charge

11-74 A fixed charge grants contingent proprietary rights to the rightholder (subject to what was said in para 11-72 above) entitling the rightholder to take full proprietary rights over the charged property, the contingency being that the chargor must have defaulted in some defined obligation.[187] The essential nature of a charge has been expressed in the following terms:

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[182] *Saunders v Vautier* (1841) 4 Beav 115.
[183] *In re Spectrum Plus Ltd* [2005] UKHL 41, [2005] 2 AC 680, para [138], *per* Lord Walker.
[184] *Four Maids Ltd. v. Dudley Marshall Ltd.* [1957] Ch. 317; *Western Bank v. Schindler* [1977] Ch. 1; *National Westminster Bank v. Skelton* [1993] 1 All ER 242.
[185] Para 11-90.
[186] *Re Welsh Irish Ferries Ltd* [1986] Ch 471; see also *Re Kent and Sussex Sawmills Ltd* [1947] Ch 177.
[187] A fixed charge may also be over future property, for example future book debts: *Siebe Gorman & Co. Ltd v. Barclays Bank Ltd* [1979] 2 Lloyd's Rep. 142.

> '… any contract which, by way of security for the payment of a debt, confers an interest in property defeasible or destructible upon payment of such debt, or appropriates such property for the discharge of the debt, must necessarily be regarded as creating a mortgage or charge, as the case may be. The existence of the equity of redemption is quite inconsistent with the existence of a bare trustee-beneficiary relationship.'[188]

Thus the distinction between a fixed charge and a trust is that the interests of a beneficiary under a trust are not capable of being expunged simply by payment of a debt, whereas that is precisely the nature of the property rights under a mortgage or charge. The equity of redemption is precisely that expression of the need for a mortgage or charge to be valid that the chargor be able to extinguish those property rights in the chargee by discharge of the debt.[189]

It is possible, however, for a retention of title clause to mutate into a charge: that is, if the property retained were segregated under the terms of the contract explicitly so that if the other party performed its obligations then it would be entitled to that property, then it could be said that a charge had been created over that segregated property. However, this charge would fail if the other party failed to make the payments required by the contract. Alternatively, if the property were not so mixed or, even if the property were separately identifiable, the contract made clear that no rights by way of a charge were intended to have been created then the property would remain absolutely the property of the person who retained those rights of ownership.

Certainty of subject matter

11-75 In relation to a fixed charge, it is necessary that the charged property is sufficiently identifiable.[190] Therefore, the reader is referred to the discussion of certainty of subject matter (in relation to trusts) earlier in this chapter.[191] Without such certainty of the subject matter of the charge, that charge cannot be valid, unless its proper analysis is as a floating charge, as considered below.

The remedies of the chargee

11-76 The remedies of a chargee are sale and the appointment of a receiver. An equitable chargee will not be entitled to foreclosure[192] nor to possession:[193] these two remedies arise only in relation to mortgages.[194]

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[188] *Re Bond Worth* [1980] 1 Ch 228, 248, *per* Slade J. See also *Re George Inglefield Ltd* [1933] Ch. 1.
[189] See e.g. *Reeve v. Lisle* [1902] A.C. 461; *Samuel v. Jarrah Timber Corporation* [1904] A.C. 323.
[190] *Illingworth v. Houldsworth* [1904] A.C. 355, 358, *per* Lord Macnaghten.
[191] Para 11-19.
[192] *Tennant v Trenchard* (1869) 4 Ch App 537; *Re Lloyd* [1903] 1 Ch 385 at 404, CA.
[193] *Garfitt v Allen* (1887) 37 Ch D 48, 50.
[194] Para 11-76.

Floating charges

11-77 By contrast with a fixed charge, in which the rights attach to identified property, a floating charge has a defined value which takes effect over a range of property but not over any specific property until the point in time at which it crystallises.[195] A floating charge is different from a fixed charge in that the chargor is entitled to deal with the property over which the charge floats without reference to the chargee, unlike a fixed charge which restrains the chargor from dealing with the charged property without accounting to the chargee.[196]

A floating charge will usually be identified by reference to the following factors:

> '(1) If it is a charge on a class of assets of a company present and future; (2) if that class is one which, in the ordinary course of business of the company, would be changing from time to time; and (3) if you find that by the charge it is contemplated that, until some future step is taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way so far as concerns the particular class of assets I am dealing with.'[197]

Therefore, a floating charge enables the owner of that property to continue to use it as though unencumbered by any other rights.[198] The only difficulty then arises on how to deal with the property once the chargee seeks to enforce its rights. In this sense there is a narrow line in many cases between a floating charge and either a fixed charge or a trust. For example, a provision which purported to create a trust over "the remaining part of what is left" from a fund would not be sufficiently certain to create a trust nor a fixed charge because the identity of the precise property at issue could not be known.[199] The alternative analysis of such provisions is then that they create a mere floating charge such that the person seeking to enforce the arrangement would acquire only a right of a given value which related to a general pool of property without that right attaching to any particular part of it. Such a structure would be weaker than a proprietary trust right in the event of an insolvency because the rightholder could not identify any particular property to which the right attached.[200] One means of identifying the difference between a fixed and a floating charge is the following one:

> 'A [fixed, or] specific charge … is one that without more fastens on ascertained and definite property or property capable of being ascertained and defined; a floating charge, on the other hand, is ambulatory and shifting in its nature, hovering over and so to speak floating with the property which it is intended to effect until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp.'[201]

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[195] *Re Yorkshire Woolcombers Association* [1903] 2 Ch. 284; *Illingworth v. Houldsworth* [1904] A.C. 355; *Evans v. British Granite Quarries Ltd* [1910] 2 K.B. 979; *Re Bond Worth* [1980] 1 Ch. 228.
[196] *Royal Trust Bank v. National Westminster Bank plc* [1996] B.C.C. 316.
[197] *Re Yorkshire Woolcombers Association Ltd* [1903] 2 Ch. 284, 295, *per* Romer LJ.
[198] *In re Spectrum Plus Ltd* [2005] UKHL 41, [2005] 2 AC 680, para [111], *per* Lord Scott.
[199] *Sprange v. Bernard* (1789) 2 Bro CC 585.
[200] *Re Goldcorp* [1995] 1 A.C. 74.
[201] *Illingworth v. Houldsworth* [1904] A.C. 355, 358, *per* Lord Macnaghten.

What, perhaps, that statement does not encapsulate however is the acid test for the distinction between floating and fixed charges: whether or not the chargor is entitled to deal with the property as though the charge did not exist, something which is a feature of a floating but not a fixed charge.

11-78 A floating charge comes into existence by virtue of some contractual provision which grants the chargee rights of a given value over a fund of property which is greater in size than that right or which contains property the identity of which may change from time-to-time.[202] So, in *Clough Mill v. Martin*[203] a supplier of yarn had entered into a contract with a clothes manufacturer under which the supplier was granted proprietary rights in any unused yarn and, significantly, in any clothes made with that yarn until it received payment from the clothes manufacturer. It was held by the Court of Appeal that there was insufficient intention to create a trust over any particular stock of clothing. In part, the court considered the fact that the identity of the property over which the supplier's proprietary rights were to have taken effect changed from time to time and that those proprietary rights took effect over a stock of property larger than the value of the rights which the supplier was to have received. It need not matter that the charge is expressed by contract to be a fixed charge if in fact the court considers that it can only be a floating charge due to the changeability of the fund of property held.[204]

11-79 That the rights of the chargee do not bite until the charge itself has crystallised creates a complex form of right.[205] The right is necessarily contingent on the chargor committing some default under the terms of the contract giving rise to the charge. The chargor is able to dispose of the property in the fund and deal with it in the ordinary course of events.[206] Once that default has been committed, it is said that the charge will crystallise at that time but, simply as a matter of logic, it is not always clear even then over which property this charge bites. Suppose that there is more property in the fund than is necessary to discharge the value specified in the contract giving rise to the charge: in that case it cannot be the case that the chargee can acquire property rights in that surplus. Similarly, in the event that there is less than the amount required to discharge the charge in the fund and, perhaps, if there were more than one such claim against the fund, it could not be said that the chargee necessarily has property rights in the fund which could necessary take priority in an insolvency. However, the floating charge would give rise to some rights in the holders of those rights against that general fund.[207]

Charges over book debts

Registration of a book debt as a charge

[202] Such as a stock of goods held in a warehouse by a manufacturer where some of those goods will be shipped out and other goods added to the fund from time-to-time.
[203] [1984] 3 All ER 982.
[204] *Re Armagh Shoes Ltd* [1984] B.C.L.C. 405; *Re Brightlife Ltd* [1987] Ch. 200.
[205] *Re Woodroffes (Musical Instruments) Ltd* [1986] Ch. 366.
[206] *Wallace v. Evershed* [1899] 1 Ch. 891.
[207] *Cretanor Maritime Co. Ltd v. Irish Marine Management Ltd* [1978] 1 W.L.R. 966.

11-79 One particular, recurring problem with taking charges in the context of financial transactions is that of taking charges over book debts. There have been two particular issues in the decided cases. The first issue is how a charge can be taken over a debt, in particular a debt which may only be paid in the future.[208] The second issue is this: if a bank holds an account for its customer, which is therefore a debt owed by the bank to its customer while that account is in credit, can that bank take a charge over that account even though the account is in itself a debt which it owes to its customer? A "book debt" need not refer only to bank accounts – although that is the clearest example in relation to financial transactions – but rather can refer to any debt accrued in the course of a business and owed to the proprietor of that business.[209] This question is considered in chapter 13 *Set-off and netting* specifically in relation to set-off on insolvency;[210] whereas this section considers the possibility of a charge over such book debts in general terms.

The importance of identifying an agreement as being or not being a book debt is that such a charge may require registration under s.395 and s.396 of the Companies Act 1985.[211] Section 395 provides that:

> '(1)… a charge created by a company registered in England and Wales and being a charge to which this section applies is, so far as any security on the company's property or undertaking is conferred by the charge, void against the liquidator [or administrator] and any creditor of the company, unless the prescribed particulars of the charge together with the instrument (if any) by which the charge is created or evidenced, are delivered to or received by the registrar of companies for registration in the manner required by this Chapter within 21 days after the date of the charge's creation.
> (2) Subsection (1) is without prejudice to any contract or obligation for repayment of the money secured by the charge; and when a charge becomes void under this section, the money secured by it immediately becomes payable.'

Those types of charge which require registration are defined in s.396 in the following manner:

> '(1) Section 395 applies to the following charges –
> (a) a charge for the purpose of securing any issue of debentures,
> (b) a charge on uncalled share capital of the company,
> (c) a charge created or evidenced by an instrument which, if executed by an individual, would require registration as a bill of sale,
> (d) a charge on land …,
> (e) a charge on the book debts of the company,
> (f) a floating charge on the company's undertaking or property,
> (g) a charge on calls made but not paid, …

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[208] As has been recognised since the decision of the House of Lords in *Tailby v Official Receiver* (1888) 13 App Cas 523.
[209] *Shipley v. Marshall* (1863) 14 C.B.N.S. 566; *Independent Automatic Sales Ltd v. Knowles and Foster* [1962] 1 W.L.R. 974. Cf. McCormack [1989] L.M.C.L.Q. 198; McCormack, *Reservation of Title* (2n edn., Sweet & Maxwell, 1995), 105 *et seq*.
[210] Para 13-18.
[211] Companies Act 1985, s.396(1)(e).

(4) … "charge" includes mortgage.'

Therefore, within the terms of the legislation, "a charge on the book debts of the company" is caught within those forms of charge which require registration. It has been held that a "customer's balance with a bank is not within the expression "all book debts and other debts"',[212] although the authorities which have advanced this proposition have been doubted in general terms.[213] Lord Hoffmann in *Re BCCI (No 8)*[214] refused to rule definitively on the question whether or not an ordinary bank deposit constituted a "book debt" of that bank, but he did not disapprove (and perhaps could be read as having approved) the judgment of Lord Hutton in *Northern Bank v Ross*[215] to the effect that "in the case of deposits with banks, an obligation to register [under s.395] is unlikely to arise".

For the purposes of taking security in derivatives transactions references to charges on book debts and floating charges are of particular significance, although the remaining forms of charge and mortgage may potentially be significant. Under a personal collateral structure, as considered in chapter 12, whereby assets are transferred outright to a secured party such that that secured party bears only a debt to repay an equivalent amount in the event that its counterparty performs its obligations under the derivatives contract properly, then it is suggested that such a repayment under the collateral agreement may constitute a book debt. Thus, failure to register such a charge renders that charge unenforceable[216] and in consequence the chargee loses its priority in relation to an insolvency.[217] Furthermore, every officer of the company in default is liable to a fine.[218] In circumstances where at the date of the creation of an agreement there is a charge over property, then that charge is registrable;[219] whereas if no charge is created at the time of the creation of the agreement then there will not be a book debt requiring registration as a charge, even if such a charge might be created subsequently.[220]

The question of whether a charge is to be considered a fixed or a floating charge in general terms was considered above[221] and is considered below in relation specifically to charges over book debts.

The particular problem of future book debts

11-80 As a consequence, the possibility arises that a registrable charge may be created over future book debts; that is, some obligation which has not yet become payable.[222] This type of asset include debts which remain uncollected but which are

[212] *In re Brightlife Ltd* [1987] Ch 200; *Northern Bank Ltd v Ross* [1990] BCC 883.
[213] See *In re BCCI (No 8)* [1998] AC 214; *In re Spectrum Plus Ltd* [2005] UKHL 41, [2005] 2 AC 680.
[214] *In re BCCI (No 8)* [1998] AC 214, 227.
[215] [1990] BCC 883.
[216] *Re Bond Worth* [1980] Ch. 228.
[217] *Ibid*.
[218] Companies Act 1985, s.399(3).
[219] *Independent Automatic Sales Ltd v. Knowles and Foster* [1962] 1 W.L.R. 974.
[220] *Paul and Frank Ltd v. Discount Bank (Overseas) Ltd* [1967] Ch. 348.
[221] Para 11-27.
[222] *Tailby v. Official Receiver* (1888) 13 A.C. 523; *Independent Automatic Sales Ltd v. Knowles and Foster* [1962] 1 W.L.R. 974.

recorded as assets on the company's books. That rights taken over such uncollected debts could constitute a registrable charge under s.396 of the Companies Act 1985 or whether they should grant priority rights in an insolvency are propositions which have caused great difficulty on the case law. At one level the case law has been concerned to distinguish between situations in which such charges are fixed charges or merely floating charges, a question considered above[223] which turns on whether or not the chargor has the right to use the property subject to the charge freely as though its rights were unencumbered by any fixed charge.

11-81 At this stage were are concerned with the second issue which related to the particular question of whether or not the chargee could take the benefit of a fixed charge in relation to the priority it accords and yet grant the chargor the right to use the proceeds of the charged property as though there were no charge. The House of Lords in *Re Spectrum Plus Ltd*[224] has doubted the feasibility of such structures, as considered below. Nevertheless, there was a line of authority which had approved such structures: including the now-overruled decision of Slade J in *Siebe Gorman & Co Ltd v Barclays Bank*[225] So, in *Re Brightlife*[226] a company purported to grant a fixed charge over its present and future book debts and a floating charge over all its other assets to its bank. While the company was not entitled to factor or otherwise deal with the debts it had collected, it was entitled to pay all uncollected debts into its general bank account. It was held that, on a proper construction of the parties' agreement, this general bank account was outwith the scope of the fixed charge and therefore it was held that the debts paid into the general bank account were subject only to a floating charge.

The decision in *Re Brightlife*[227] and other cases[228] created problems for banks and their customers. It was important for the customer that it be free to use all the money in its bank account as part of its circulating capital, but for the banks it became advantageous to have some form of control over the customer's use of its bank account to retain the rights attributable to a fixed charge.[229] In consequence a new form of charge structure was created which purported to create two charges: one which imposed a fixed charge on the uncollected book debts and a floating charge over the proceeds of those debts once collected. In consequence the bank would have a proprietary right in all of the debts which remained to be collected in but the customer would have free use of all of the cash when it had actually been collected in. This was the structure which came before the Court of Appeal in *Re New Bullas Trading Ltd*.[230] Nourse LJ held that uncollected book debts were more naturally the subject of a fixed charge because they rested immobile on the chargor's books until they were paid off, and that it was only once they were paid off that their cash proceeds were more likely to be applied to the circulating capital of the enterprise and

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[223] Para 11-27.
[224] [2005] UKHL 41, [2005] 2 AC 680.
[225] [1979] 2 Lloyd's Rep 142.
[226] [1987] Ch. 200.
[227] *Ibid*.
[228] E.g. *Hart v. Barnes* [1983] 2 V.R. 517; *Supercool Refrigeration and Air Conditioning v. Howerd Industries Ltd* [1994] 3 N.Z.L.R. 300. Cf. *Siebe Gorman & Co. Ltd v. Barclays Bank Ltd* [1979] 2 Lloyd's Rep. 142; *Re Keenan Bros Ltd* [1986] B.C.L.C. 242.
[229] It is suggested that some form of *Quistclose* trust, as considered above, would have been a better method of controlling the customer's use of their account.
[230] [1994] 1 B.C.L.C. 485.

so subject only to a floating charge. In consequence, Nourse LJ held that it was not open to the company to argue that it was entitled to remove the proceeds from the ambit of the fixed charge simply because they were entitled to use them as part of its circulating capital on the terms of the contract with the chargee.

11-82 This approach was disapproved of by the Privy Council in *Agnew v. IRC ("The Brumark")*[231] on the basis, *inter alia*, that to identify uncollected book debts as being the natural subject of a fixed charge would be to suggest that unsold trading stock was similarly the natural subject of such a charge because it was resting unused on the company's books. Rather, such assets were identified as being a part of the trader's ordinary cash flow and therefore equally likely to be part of its circulating cash flow and therefore equally likely to be the subject of a merely floating charge.[232]

Significantly the Privy Council in *Agnew v. IRC* considered that the suggestion in *Re New Bullas Trading Ltd* that these questions were simply questions of construction of the agreement, to see which category it occupied from case to case, was flawed. Rather, Lord Millett advocated a two-step process whereby the court should, first, consider the rights and obligations which the parties granted each other under their agreement and then, secondly, seek to categorise the charge only after such an identification of the true intentions of the parties.[233] The acid test would then be, on the construction of the agreement, whether the assets were under the free use of the chargor such that they could be subtracted from the security offered to the chargee, or whether they were under the restrictive control of the chargee so that they could not be subtracted from the chargee's security.[234] To follow the *New Bullas Trading* reasoning would be "entirely destructive of the floating charge"[235] by virtue of the fact that, if the contract granted the chargor the right to dispose of the proceeds of the book debts freely as part of its circulating capital, then that right should be upheld by the court and not interpreted of necessity as constituting a fixed charge. The central question is, on analysis of the agreement, whether the chargor is entitled to free use of the proceeds for its own benefit. The approach of Lord Millett in *Agnew* was approved in the House of Lords in *Re Spectrum Plus Ltd*.[236]

The book debt and its proceeds capable of being subject to separate security interests

11-83 The preceding discussion still leaves open the question whether or not the cash proceeds of a book debt can be subject to a separate charge from the uncollected book debt itself. Importantly, Lord Millett held in *Agnew v. IRC* that the "[p]roperty and its proceeds are clearly different assets."[237] Thus, it was accepted that a book debt and the proceeds of that book debt are capable of constituting separate items of property and capable of being subjected to charges in different ways. In this instance, one by

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[231] [2001] 2 AC 710; [2001] 3 WLR 454; [2001] UKPC 28; [2001] 2 B.C.L.C. 188, 199, *per* Lord Millett.
[232] *Ibid*., 200.
[233] *Ibid*., 201; where his lordship drew a parallel with the case of *Street v. Mountford* [1985] A.C. 809 in which the courts look for the true intentions of the parties in the analysis of leases and licences before allocating any particular agreement to either category.
[234] *Ibid*., 200.
[235] *Ibid*., 201.
[236] [2005] 2 AC 680.
[237] [2001] 2 B.C.L.C. 188, 203; [2001] 2 AC 710; [2001] 3 WLR 454; [2001] UKPC 28.

way of a fixed charge and the other by way of a floating charge. It is suggested that this is a difficult proposition precisely because the book debt's value is necessarily bound up in the cash flow which results from its collection and therefore to take security over the debt and a separate security over the proceeds of the collection of that debt is to take security twice over the same intrinsic value. It is to effect double counting. That contention requires some elucidation.

It is true that English law has accepted that the benefit of even a non-transferable contract has been recognised as constituting an item of property and so can be settled on trust[238] – that is, the benefit which flows from such a contract can be treated as property distinct from the contract itself – but to do so in relation to non-transferable contracts is to recognise that the contract itself will not be transferred and therefore that the value deriving from it can safely be promised contractually to some other person without fear of double counting. The point made by Lord Millett in *Agnew v. IRC* is that if a charge is assigned, the assignor receives sale proceeds in consideration for the sale and the charge continues in existence in the hands of its purchaser. By contrast, it is said by his lordship, when the debt underlying the book debt is collected, that book debt ceases to exist. Therefore, it is said the book debt can be separated from its proceeds when it is assigned because the book debt continues to exist in the hands of the purchaser and so do its sale proceeds in the hands of its seller. However, all that this analysis recognises is that the owner of the book debt has property rights of a given value whether as the owner of the book debt, or of the sale proceeds of the book debt, or of the collection proceeds of that book debt: in any event, the chargor has property of equivalent value whatever form its takes, that much is a staple of well-established principles of property law like tracing since time immemorial. It is not decisive of the question whether or not to accept that the value of the book debt is distinct from the book debt itself.

To talk of the book debt being a separate item of property from the value that attaches to it, whether its future collection value or its assignment value, is not a wholly convincing analysis. Rather, what is done by the attempt to segregate book debts from their value in practice is the following thing: the chargee and chargor agree that the chargee's rights shall attach to any of a number of possible choses in action which the chargor has against its debtors which remain as uncollected book debts, whereas once those debts are collected in or are turned to account by means of assignment (where permitted under contract) those cash proceeds pass into the hands of the chargor in place of the book debt.[239]

A "specific charge" over book debts

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[238] *Don King Promotions Inc v. Warren* [1998] 2 All E.R. 608, affirmed [2000] Ch. 291; *Swift v. Dairywise Farms* [2000] 1 All E.R. 320; *Re Celtic Extraction Ltd (in liquidation); Re Bluestone Chemicals (in liquidation)* [1999] 4 All E.R. 684.

[239] A better analysis of this situation would be to suggest that the chargor holds all of its relevant assets on a contingent trust such that any uncollected book debts are held on trust for the "chargee" as beneficiary until their collection; whereas once those debts are collected they are held on trust for the "chargor" as beneficiary from the moment of collection (at which time the book debt ceases to exist); and once segregated to another account those collection proceeds are capable of being declared the absolute property of the "chargor". Cf. Goode, "Charges over book debts: a missed opportunity" (1994) 110 L.Q.R. 592.

11-84 The House of Lords in *Re Spectrum Plus Ltd*[240] considered a transaction in which by means of a debenture the issuing company created a charge "by way of specific charge" in favour of the National Westminster Bank over the company's book debts to secure the money owed by the company to the bank. The issue arose, *inter alia*, whether this charge over present and future book debts was a fixed charge – as the bank contended – or whether it constituted a floating charge. Significantly, the company was prevented from dealing with the uncollected book debts but, once the debts had been collected, there was no control placed on the company's ability to use those debts in the terms of the debenture. Consequently, it was held that the receipts derived from the book debts held in the company's account were free to be used by the company. Therefore, regardless of the bank's attempts to have the charge drafted so as to appear to be a fixed charge, the charge was properly to be analysed as a floating charge. This decision, quoted above on numerous occasions, approved the decision of the Privy Council in *Agnew v IRC*.[241]

PLEDGES

11-85 Pledges grant the pledgee ("the secured party" or creditor) a right to possession of the pledged property but not to ownership of those assets. The secured party retains possession of that property until the pledgor performs its obligations under the contract between the parties: in relation to a derivatives contract that would be the obligation to make payment or delivery in relation to all outstanding transactions. In the event that the pledgor fails to perform its obligations in full, then the secured party may seek the authorisation of the court to sell the pledged property so as to discharge the pledgor's contractual obligations to it. A pledge can take effect either by the actual delivery of property into the possession of the secured party with the intention of providing that property as security for some contractual obligation, or the pledge can be inferred from the circumstances in which a debtor has delivered property into its creditor's possession as disclosing such an intention to provide the possession of that property by way of security.[242]

The secured party in a pledge transaction (before the secured party seeks to enforce its security) has no ownership of the pledged property; and even though in commercial practice it is often described as having a "special property" in the pledged assets,[243] nevertheless that does not constitute ownership of the pledged property. The type of property which may be the subject matter of a pledge is therefore restricted to property over which possession can be transferred, such as chattels and documents evidencing title over property (such as bills of lading or bearer securities). The detail of the manner in which pledges are created at common law has been described in the following way:

> 'At common law a pledge could not be created except by a delivery of possession of the thing pledged, either actual or constructive. It involved a bailment. If the pledgor had the actual goods in his physical possession, he

[240] [2005] 2 AC 680.
[241] [2001] 2 AC 710.
[242] *Official Assignee of Madras v Mercantile Bank of India Ltd* [1935] AC 53 at 58.
[243] See e.g. *Matthew v TM Sutton Ltd* [1994] 4 All ER 793.

> could effect the pledge by physical delivery; in other cases he could give possession by some symbolic act, such as handing over the key of the store in which they were. If, however, the goods were in the custody of a third person, who held for the bailor so that in law his possession was that of the bailor, the pledge could be effected by a change of the possession of the third party, that is by an order to him from the pledgor to hold for the pledgee, the charge being perfected by the third party attorning to the pledgee,[244] that is acknowledging that he thereupon held for him; there was thus a change of possession and a constructive delivery; the goods in the hands of the third party became by this process in the possession constructively of the pledgee.'[245]

Therefore, a pledge can take effect by means of constructive delivery of possession or by means of attornment.[246] Alternatively, a "trust receipt" can be given in circumstances in which the pledgee permits the pledgor to sell the pledged assets subject to the pledge obligations so that the pledgor acts as the pledgee's agent in effecting that sale.[247] The pledgor then becomes trustee of the sale proceeds for the pledgee.[248]

The form of pledge used in some ISDA documents, which is in truth a transfer of title

11-86 This form of pledge as used in ISDA collateral arrangements is different from a pledge as usually understood by commercial lawyers, as set out in the preceding section, because a pledge does not transfer absolute title in the pledged property and nor does the secured party acquire a right to re-hypothecate[249] the pledged property in the ordinary course of events. Nevertheless, these are two features of the form of "pledge" which is created in an ISDA Credit Support Annex,[250] as discussed in chapter 12,[251] whereby there is an outright transfer of "all right, title and interest"[252] in the collateral property.

11-87 A pledge, as ordinarily understood,[253] would involve the owner of property – in the circumstances of a derivatives contract, the party required to post collateral – parting with possession of the property by delivering it to the secured party without giving that secured party the right to deal with that property as though its absolute owner.[254] The secured party is prevented from dealing with the property as its absolute owner until such time as its proprietary rights crystallise, typically by reason

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[244] That is, the person in possession of the pledged property can acknowledge that henceforth it holds that property to the order of another person, with the pledgee's concurrence.
[245] *Official Assignee of Madras v Mercantile Bank of India Ltd* [1935] AC 53 at 58.
[246] That is, the person in possession of the pledged property can acknowledge that henceforth it holds that property to the order of another person, with the pledgee's concurrence.
[247] *North Western Bank Ltd v Poynter* [1895] AC 56; *Re David Allester Ltd* [1922] 2 Ch 211.
[248] *Re David Allester Ltd* [1922] 2 Ch 211.
[249] Meaning an absolute right to sell, mortgage or otherwise deal with property as though absolutely entitled and without any prior encumbrances over that property.
[250] See ISDA Credit Support Annex, 1995, para 5(a) whereby there is an outright transfer of "all right, title and interest".
[251] Para 12-39.
[252] ISDA Credit Support Annex, 5(a).
[253] The most common example of a pledge would be an arrangement with a pawnbroker.
[254] *The Odessa* [1916] 1 A.C. 145.

of the counterparty's failure to pay under the main transaction or as otherwise provided for in the pledge agreement. In the event that those rights crystallise, thus vesting almost absolute title in the secured party, the secured party is entitled to sell the pledged asset to make good the counterparty's failure in performance.

However, the secured party is described as having "*almost* absolute title" in these circumstances because any surplus generated by the sale of the pledged assets over the amount owed by the counterparty must be paid to the counterparty and as such it is therefore not quite accurate to suggest that the secured party is absolute owner of the pledged assets at that time. The secured party will be trustee, it is suggested, of any such surplus between the time it is received and the time of its payment to the counterparty. Where the surplus has not been segregated from the amount which the secured party is entitled to retain in discharge of the counterparty's failure to pay, then the entire sale proceeds of the pledged assets are held on trust by the secured party in proportion to the amount to which each party is entitled.[255] It is important that the pledgee's rights are to apply the property to discharge the pledgor's obligations and are not a transfer of absolute title because such a transfer of title would entitle the pledgee to retain any surplus in the value of the property over the debt owed to the pledgee.[256]

The foregoing discussion has assumed that form of pledge typically discussed by commercial lawyers.[257] However, in financial derivatives transactions it is frequently the case that credit support agreements will express the pledgee as being in fact the absolute owner of the property provided by way of collateral. Therefore, the form of pledge used in derivatives transactions will be an atypical form of pledge which is in truth an outright transfer of title subject to a purely personal obligation to return property of a like kind or a similar value in the event that the pledgor does perform its obligations under the derivatives contract.[258]

11-88 What is most significant is that the precise rights of the secured party will turn on the manner in which they are expressed by the pledge agreement. A pledge agreement may provide, quite simply, that the secured party is entitled to absolute title in the pledged assets in the event of non-performance by its counterparty, thus establishing a different case to that set out immediately above. Significantly, such an arrangement may not be a pledge properly so-called because the secured party would acquire an absolute interest in the property as opposed to merely a right of possession of that property. More commonly, a contract would provide that the secured party is entitled to take absolute title in the pledged assets only up to the value of any amount owed to it by its counterparty. Within this second analysis, the pledge contract might provide that the pledgee takes no proprietary title until some default of the pledgor identified in the agreement, and has merely a possessory interest until that time. As witness to this analysis it was held in *The Odessa*[259]:

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[255] *Re Goldcorp* [1995] 1 A.C. 74, *infra.*
[256] *Re Hardwick, ex p Hubbard* (1886) 17 Q.B.D. 690. Cf. *Carter v. Wake* (1877) 4 Ch. D. 605; *Fraser v. Byas* (1895) 11 T.L.R. 481.
[257] Worthington, *Personal Property Law* (Hart, 2000); Goode, *Commercial Law* (3rd ed., Penguin, 2003).
[258] Para 3-145 *et seq*.
[259] [1916] 1 A.C. 145, 159.

> 'If the pledgee sells he does so by virtue of and to the extent of the pledgor's ownership, and not with a new title of his own. He must appropriate the proceeds of the sale to the payment of the pledgor's debt, for the money resulting from the sale is the pledgor's money to be so applied.'

It is suggested that that analysis must necessarily be contingent on the precise terms of the pledge agreement and the form of rights which they purport to grant to the secured party.[260]

11-89 There are then two options: either the secured party is entitled to take title in the assets themselves or is entitled only to sell the assets and take such proportion of those sale proceeds as is required to offset the counterparty's outstanding obligations. In deciding which is applicable, recourse must be had to the precise terms of the pledge agreement.

The ISDA Credit Support Annex provides that title in property will be transferred outright to the secured party.[261] The principal issues arising from that standard documentation are considered in detail in the next chapter.[262] Put briefly, the secured party is therefore entitled to use the assets as though absolutely entitled to them, thus granting it full title and not merely possession. This issue was considered in chapter 3 *Standard market documentation.*[263]

LIENS

11-90 Liens typically arise by operation of law without the need for the consent of both parties – with the exception of contractual liens – and entitle the rightholder to retain property in his possession until a payment to which he is entitled from the owner of the property is made to him. A lien therefore secures payment without necessarily transferring title initially, although the rightholder may be entitled to sell the property to generate funds to make the payment owed to it. A common law lien is predicated on possession of the property at issue and constitutes a right to detain that property until payment, whereas an equitable lien confers a right to apply to the court for sale and arises irrespective of possession, as considered below. Diplock LJ described the common law lien as a "primitive remedy"[264] of a "self-help" variety whereby the claimant has a right exercisable over goods already in his possession and operates as a defence to the other party's claim for recovery of those goods.[265]

Possessory lien

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[260] See generally Palmer and Hudson, "Pledge", in *Interests in Goods*, ed. Palmer and McKendrick (2nd edn., London: Lloyd's of London Press, 1998).
[261] ISDA, *Credit Support Annex*, para 3-145 and para 12-26.
[262] Para 12-26.
[263] Para 3-151.
[264] Primitive in the sense that it reeks of brute force and the common-sensical notion that if you owe me *x* and I have property of yours in my possession equal to the value of *x*, then I should simply keep your property unless you make payment of *x* to me.
[265] *Tappenden v Artus* [1964] 2 QB 185.

General lien

11-91 A possessory lien falls into two types. The *general lien* enables someone who is already in possession of property to retain that property as security for payment of some obligation owed to it. There are particular contexts in which the common law has accepted that such general liens will arise: in relation to solicitors,[266] bankers,[267] stockbrokers[268] and factors[269] due to a market practice which accepts that such professionals are entitled to retain goods lodged with them by their customers to ensure payment of their fees.[270] That possession may either be a legal possession of that property or simply possession of property as a matter of fact. Importantly the lien is a right only to detain property pending satisfaction of an obligation and not a right to sell it.[271] If the rightholder wishes to sell the property to recover amounts owed to it by the counterparty, then she must apply to the court for permission to effect such a sale.[272]

Particular lien

11-92 Under a general lien, there need not necessarily be any link between the property detained and the account on which the obligation to make payment arises. This is to be distinguished from a *particular lien* which entitles the rightholder to detain property to secure payment in relation to specific services tendered in connection with that property.

A particular lien, like a general lien, arises at common law by operation of law. In relation to a particular lien it is typically the case that the lien will only arise if the rightholder was required to improve or to maintain the property in some way beyond simply acting as bailee of it by way of simply holding it for safekeeping.[273] This is problematic in relation to custodians of bonds used in collateral transactions because it is not clear whether or not the custodian will be entitled to deal with the bonds in such a way as to give a right to a lien beyond mere bailment. However, it is suggested that in most collateral transactions in which a custodian is used to hold the collateral property, that custodian will typically be best analysed as being a trustee who takes legal title in the property.[274] The distinction between a bailment and a trust is that in the former the custodian would merely take possession of the property without any acquisition of property rights; whereas in the latter a trustee is vested with the legal title in the property,[275] a trustee is holds the equitable interest in that property for the beneficiaries of the trust,[276] and a trustee is also encumbered with the fiduciary

[266] *Barratt v. Gough-Thomas* [1951] Ch. 242.
[267] *Brandao v. Barnett* (1846) 12 Cl. & Fin. 787.
[268] *Re London and Globe Finance Corp* [1902] 2 Ch. 416.
[269] *Kruger v. Wilcox* (1755) Amb. 252.
[270] *Plaice v. Allcock* (1866) 4 F & F 1074.
[271] *Hammonds v. Barclay* (1802) 2 East 227.
[272] *Larner v. Fawcett* [1950] 2 All E.R. 727.
[273] *Re Southern Livestock Producers Ltd* [1964] 1 W.L.R. 24.
[274] Para 11-08.
[275] Para 11-13.
[276] Para 11-23.

obligations which are ordinarily associated with trusteeship.[277] In consequence, a question of a particular lien would only arise if there was no trust.[278]

It has been suggested by some commentators that such a common law lien is similar to a pledge in that it is a right to ensure payment which bites both on the pledgor's failure to pay and on the basis that possession of goods has been lodged with the plaintiff.[279] Indeed it is also difficult in many circumstances to draw clear lines between liens and vested property rights. Nevertheless, it is suggested that the following distinction is the key: a lien does not grant any present right in property to the rightholder whether at common law or in equity until the court makes an order entitling the rightholder to sell the property at issue and refuting its obligations to return that property to its previous owner.[280] As considered above,[281] a pledge will typically not grant property rights either until some provision of the contract entitling the rightholder to sell the property crystallises. A contract providing that the pledgee has property rights is in truth a situation of outright transfer or trust and not a pledge properly so called.

Contractual lien

11-93 A contractual lien arises by virtue of some contractual provision. Importantly, the lien arises in relation to property which is already in the secured party's possession so that the secured party is able to retain that property in discharge of an obligation owed to it by the owner of that property. There is a narrow line between a charge and a contractual lien.[282] A lien permits the rightholder to detain the property and does not, *ab initio*, recognise any right in the property in like kind to a right under a fixed charge, as considered above.[283] Similarly, pledges and contractual liens seem similar at first blush. Contractual liens recognise existing possession of property which the holder of the property is able to retain possession of that property as security for some obligation owed to it, whereas a pledge requires delivery of the property to the pledgee for the purposes of security from the outset.[284] While the law relating to the interpretation of liens is frequently equivocal, on the balance of the authorities it does appear that such a contractual lien is not exercisable unless and until the rightholder is in possession of the property to be detained.[285]

Equitable lien

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[277] These duties were considered above at para 11-27 *et seq.*; see generally Thomas and Hudson, *The Law of Trusts* (Oxford University Press, 2004).
[278] Cf. *Wharfingers Bock v. Gorrissen* (1860) 2 De GF & J 434; *Singer Manufacturing Co. v. London and South Western Railway Co.* [1894] 1 Q.B. 833.
[279] Gleeson, *Personal Property Law* (FT Law & Tax, 1997), 247.
[280] *Larner v. Fawcett* [1950] 2 All E.R. 727, *infra.*
[281] Para 11-17.
[282] See *Re Hamlet International plc* [1999] 2 BCLC 506.
[283] Para 11-70.
[284] *Re Cosslett (Contractors) Ltd* [1998] Ch 495, Millett LJ.
[285] Cf. *George Barker (Transport) Ltd v. Eynon* [1974] 1 W.L.R. 462.

11-94 An equitable lien does not arise out of contract and therefore arises without the need for the common intention of the parties.[286] An equitable lien is a manifestation of a jurisdiction accepted by courts of equity to detain property by imposing an equitable charge over it.[287] That equitable charge in turn grants the chargee a right to apply to the court for an order for sale of that property by means of a writ in the Chancery Division of the High Court endorsed with a claim to be entitled to an equitable lien,[288] and otherwise in the manner considered above in relation to equitable charges.[289] Oddly, for a lien, therefore, the equitable lien does not depend upon pre-existing possession of property but rather can be best understood as being a part of the equitable jurisdiction under which the court will award an equitable lien when it is deemed appropriate to do so. Ordinarily, the courts will award equitable liens in a narrow range of well-established contexts.[290] Examples of equitable liens include an equity to secure the discharge of indebtedness,[291] the solicitor's lien on property recovered,[292] a trustee's lien in relation to her expenses,[293] and in relation to contracts for the sale of land there are the vendor's lien over the purchase money and the concomitant purchaser's lien over any deposit advanced.[294] The equitable lien is predicated on there being some obligation to pay money or to do some similar act. Equity will impose a charge in such circumstances to reflect this obligation.

There may be circumstances in which the imposition of an equitable lien will resemble the creation of a right under proprietary estoppel principles where the plaintiff has acted to her detriment in relation to the defendant's property in reliance on a representation made to her that she would thereby, for example, acquire some interest in that property.[295] However, the distinction would be that under proprietary estoppel principles the plaintiff may acquire some right in the property[296] whereas under an equitable lien the plaintiff will acquire only the rights of a chargee to apply for sale of the property, as already mentioned.

An equitable lien will be extinguished in circumstances in which the secured party has taken some other right as security for the transaction.[297] So, where a vendor of land has received part payment or taken security for the payment in some other way, the lien may not be available.[298] In a similar fashion to other equitable remedies, the equitable lien will be extinguished by delay and laches.[299]

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[286] *In re Welsh Irish Ferries Ltd* [1986] Ch. 471.
[287] *Ibid*; *In re Kent & Sussex Sawmills Ltd* [1947] Ch. 177.
[288] *Bowles v Rogers* (1800) 31 ER 957; *Re Stucley* [1906] 1 Ch 67.
[289] Para 11-70 *et seq*.
[290] Not in relation to sales of goods, where a statutory lien applies: Sale of Goods Act 1979, s.41.
[291] *Re Bernstein* [1925] Ch 12 at 17; *Re Bond Worth Ltd* [1980] Ch 228 at 251.
[292] See *Snell's Equity* (Sweet & Maxwell, 2005), para 42-05.
[293] Trustee Act 1925, s.30(2); *Re Beddoe* [1893] 1 Ch 547.
[294] *Mackreth v Symmons* (1808) 15 Ves 329 at 340, 33 ER 778 at 782; *Rose v Watson* (1864) 10 HL Cas 672 at 684.
[295] *Re Basham* [1986] 1 WLR 1498; Hudson, *Equity & Trusts* (4th ed, Cavendish, 2005) ch 13 "Equitable Estoppel".
[296] Although in a number of cases the plaintiff has acquired only a personal equitable right to compensate her detriment: *Baker v Baker* (1993) 25 HLR 408, CA; *Sledmore v Dalby* [1996] 72 P&CR 196; *Gillett v Holt* [2001] Ch 210, CA; *Campbell v Griffin* [2001] EWCA Civ 990, [2001] WTLR 981; *Jennings v Rice* [2002] EWCA Civ 159.
[297] *Mackreth v Symmons* (1808) 15 Ves 329.
[298] See *Parrott v Sweetland* (1835) 3 My & K 655.
[299] See *Snell's Equity*, op cit., para 42-05 *et seq*.

GUARANTEES AND INDEMNITIES

The distinction between guarantees and indemnities

The formalities required for a guarantee

11-95 A guarantee is a promise made by a guarantor to a creditor to honour the performance of the obligations of some other person, the primary debtor, to that creditor. An important distinction must be made between a guarantee and an indemnity. A guarantee is a form of secondary liability in that the guarantor is only liable to make payment if the primary debtor would have been liable to make payment. In such a circumstance, the guarantor is assuming the obligation of the primary debtor where that primary debtor defaults in the performance of its obligations. By contrast, an indemnity is a promise to make good any loss which the creditor suffers under a transaction whether or not the primary debtor would have been liable to make payment. In this latter instance, it is the creditor's loss which is being compensated in general terms and not the primary debtor's failure to perform some obligation which it was at law and in equity obliged to perform. The distinction, considered below, is a matter of construction of the terms of a contract.[300]

The distinction is significant because a guarantee is required to be made in writing[301] whereas an indemnity has no such formality in its creation.[302] Under statute,[303] 'No action shall be brought … whereby to charge the defendant upon any special promise to answer for the debt, default or miscarriage of another person …' unless there is evidence of that promise in writing.[304] Therefore, the contract of guarantee may be created orally provided that it is evidenced in writing subsequently. The type of evidence required is a signed note or memorandum although it is more usual in financial markets to include all of the terms of the guarantee in one contract signed by all of the relevant parties.

As such a guarantee will create a contract between the guarantor and the creditor, provided that it is properly structured. Where a guarantor agrees to guarantee the performance of a party to a derivatives contract by paying any shortfall in their contractual obligations, that guarantor is obliged to make payment without receiving any payment or other obligation in return. In consequence, there is a risk that there would be no consideration moving between the promisee and the promisor such that guarantees are created by deed, so removing the need for consideration.[305] Where consideration is required because no deed is executed, it is common to express such consideration as taking effect by means of a forbearance on the part of the creditor

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[300] *Yeoman Credit Ltd v. Latter* [1961] 1 W.L.R. 828; *Heald v. O'Connor* [1971] 1 W.L.R. 497; *General Produce Co. v. United Bank Ltd* [1979] 2 Lloyd's Rep. 255.
[301] Statute of Frauds 1677, s.4.
[302] *Birkmyr v. Darnell* (1704) 1 Salk. 27; *Argo Caribbean Group v. Lewis* [1976] 2 Lloyd's Rep. 289.
[303] *Ibid*.
[304] That is so whether the promise arises in contract or in tort: *Kirkham v. Marter* (1819) 2 B. & Ald. 613.
[305] *Hall v. Palmer* (1844) 3 Hare 532; *Macedo v. Stroud* [1922] 2 A.C. 330.

from suing the primary debtor in the event that the guarantor performs the primary debtor's obligations.[306]

11-96 The distinction between a guarantee and an indemnity is a narrow one despite its importance.[307] It has been suggested by some commentators that the development of a different principle at common law in relation to indemnities is, in part, an attempt to circumvent the Statute of Frauds 1677.[308] What is clearly required for a guarantee is that there be some person who is liable as primary debtor and that the guarantor is liable only if that primary debtor defaults in the performance of some obligation owed to the creditor. However, in the event that a guarantor agrees to compensate the creditor for any loss suffered by the creditor from the transaction, whether or not it was owed by the primary debtor, there will be only an indemnity. There are authorities on which the guarantor's promise to "put the creditor in funds in the event of the primary debtor's failure to perform", rather than to assume all of the obligations of the primary debtor, have been interpreted to constituted a mere indemnity and not a guarantee because that provision indicates a mere duty to compensate the creditor's loss and not necessarily to assume enforceable liabilities which the primary debtor has repudiated.[309] Similarly, if a parent company were to agree to assume all of the liabilities of one of its subsidiaries such that the subsidiary maintained no further obligation to the creditor, then there would be no guarantee because the parent would either be taking an assignment of the transaction or it would be offering an indemnity to the creditor.[310]

11-97 Obtaining a performance bond from a third party in the event that a counterparty to an agreement fails to perform some delivery obligation may nevertheless be a guarantee where it supplements the obligation of that counterparty and does not merely compensate the creditor for general loss.[311] Such a structure has similarities to a letter of credit.[312] Furthermore, the creditor will be obliged to account for any surplus recovered from the guarantor under such a performance obligation as well as entitled to recover any shortfall in the primary debtor's obligation from the guarantor.[313]

Guarantees forming part of a larger transaction

11-98 The foregoing formalities apply to guarantees which stand alone and not to guarantees which form part of a larger transaction. The credit support documentation in financial derivatives transactions is intended to constitute one single agreement together with the master agreement, its schedule and all attendant confirmations.[314] In consequence, a guarantee executed as part of a master agreement would potentially be

[306] *Crears v. Hunter* (1887) 19 Q.B.D. 341.
[307] *Yeoman Credit Ltd v. Latter* [1961] 1 W.L.R. 828.
[308] Treitel, *The Law of Contract* (Sweet & Maxwell, 10th edn., 1999), 166.
[309] *Guild & Co. v. Conrad* [1894] 2 Q.B. 885, 892. Also see *Thomas v. Cook* (1828) 8 B. & C. 728; *Wilkes v. Dudlow* (1874) L.R. 19 Eq. 198; *Re Hoyle* [1893] 1 Ch. 84.
[310] *Goodman v. Chase* (1818) 1 B & Ald. 297.
[311] *Trafalgar House Construction (Regions) Ltd v. General Security and Guarantee Co. Ltd.* [1996] A.C. 199.
[312] Smith, "Security", in *Private Law*, ed. Birks (Oxford University Press, 2000), 455.
[313] *Ibid*.; *Cargill International SA v. Bangladesh Sugar and Food Industries Corp* [1998] 1 W.L.R. 461.
[314] ISDA, *ISDA Multi-currency Master Agreement* (ISDA, 1992), s.1(c).

part of a larger transaction. In circumstances in which an intermediary introduced clients to a stockbroker on condition that the intermediary would receive half the profits or bear half the losses, as applicable, it has been held that such a guarantee to meet those losses payable by the stockbroker constituted part of a larger transaction.[315]

Therefore, a guarantee to make payment under a range of derivatives transactions connected together with the guarantee by a master agreement might constitute such an agreement which is part of a larger agreement. However, typically the guarantor will not perform any part under the derivatives master agreement other than extending a guarantee and therefore, it is suggested, merely providing a guarantee ought not in substance to constitute that guarantee part of a larger transaction because the guarantor receives no other benefit nor bears no other burden under that master agreement to constitute it in truth part of a larger agreement. To make a guarantee appear to be more likely part of such a larger agreement it is suggested that it be expressed in that agreement that the guarantor's participation alters the funding of the transaction by, *inter alia*, reducing the credit risk component and thereby the cost to the primary debtor of the transaction.

11-99 One further category of guarantee which does not attract the foregoing formalities requirements is a guarantee provided by a *del credere* agent, that is a guarantor who guarantees the solvency of the counterparty and nothing more.[316] It may be that a guarantee is given by a parent company that its subsidiary will not go into insolvency during the life of the master agreement. Such a guarantee would be different from a guarantee from that holding company that it would meet directly all of the obligations of the subsidiary in relation to individual derivatives transactions.

Guarantees in variable amounts; notice

11-100 It is usual for guarantees in derivatives transactions to be guarantees to pay variable amounts, depending on the obligations of the primary debtor at the time of its failure to pay or perform. The master agreement usually provides that notice must be given of any obligation to make payment whether in activating an event of default[317] or in claiming default interest.[318] Such provisions create difficulties in relation to the legal treatment of guarantees. Where a requirement of notice is contained in the contract before payment under such a guarantee is required, if such notice is not given within a period identified in the contract then the guarantor's obligation to pay will expire.[319] Where there is no expiry date on that obligation then the obligation will not expire,[320] other than under the Limitation Act in the ordinary course of events. Similarly, if the expiry period operates only to calculate the size of the guarantor's obligation and not to decide whether or not it is liable at all, then such an expiry will

[315] *Sutton & Co. v. Grey* [1894] 1 Q.B. 285.
[316] *Couturier v. Hastie* (1852) 8 Ex. 40.
[317] ISDA, *ISDA Multi-currency Master Agreement* (ISDA, 1992), s.5(a)(i).
[318] ISDA, *ISDA Multi-currency Master Agreement* (ISDA, 1992), s.2(e).
[319] *National Westminster Bank plc v. Hardman* [1988] F.L.R. 302.
[320] *Re Crace* [1902] 1 Ch. 733, *infra.*

not affect the guarantor's obligation to make payment under the contract of guarantee.[321]

Enforceability of guarantee

Informal guarantee unenforceable, not void

11-101 Where the foregoing formalities[322] in relation to the creation of a guarantee are not performed, the contract is not automatically void but rather is not capable of enforcement.[323] Therefore, where the guarantee is itself secured by some pledged or deposited asset by the guarantor, that security will not in itself be void simply because the guarantee is not enforceable.[324] It would be possible that a guarantor would be estopped from reneging on a contract for want of formality where that contract had been partly performed in reliance on, for example, an assurance that some item of property would be available to the creditor to secure its transaction.[325] A contract of guarantee may, in certain circumstances relating to obligations beyond simply payment of money but perhaps relating to the provision of an annuity, be specifically enforceable.[326]

Other contexts in which a guarantee will be unenforceable

11-102 Under the general law of contract, a guarantee will not be enforceable in the following contexts, each category of which is considered elsewhere in this book. Where a guarantee has been procured by means of fraud,[327] misrepresentation[328] or undue influence,[329] it will not be enforceable.[330] Similarly, guarantees entered into on the basis of mistake will be unenforceable where such mistake goes to the heart of the contract.[331]

When the obligations of the primary debtor are discharged, the obligations of the guarantor are similarly discharged.[332] This position may be different under an indemnity where the contract of indemnity identifies some loss outwith the obligations of the primary debtor to pay for which the party providing the indemnity is nevertheless entitled to pay.

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[321] *Bank of Credit and Commerce International SA v. Simjee* (unreported, 3rd July, 1996).
[322] Para 11-95.
[323] *Leroux v. Brown* (1852) 12 C.B. 801; *Elias v. George Sahely & Co. (Barbados) Ltd* [1983] 1 A.C. 646, 650.
[324] *Thomas v. Brown* (1876) 1 Q.B.D. 714; *Low v. Fry* (1935) 152 L.T. 585.
[325] *Yaxley v. Gotts* [2000] 1 All ER 711.
[326] *Beswick v. Beswick* [1968] A.C. 58; *Treitel, op cit*., 170, n.12.
[327] *Barton v. County Natwest Ltd* [1999] Lloyd's Rep. 408.
[328] *Lloyds Bank v. Bundy* [1975] Q.B. 326; *Lloyds Bank v. Waterhouse* [1993] 2 F.L.R. 97; *Barclay's Bank v. O'Brien* [1994] 1 AC 180.
[329] *Barclay's Bank v. O'Brien* [1994] 1 AC 180.
[330] See the discussions in chapters 7 and 9 generally in relation to these heads of liability.
[331] *Ibid*.; *Associated Japanese Bank (International) Ltd v. Credit du Nord SA* [1989] 1 W.L.R. 255.
[332] *Western Credit v. Alberry* [1964] 1 W.L.R. 945.

Rescission for non-disclosure

11-103 The common law on guarantees has developed a limited obligation to make disclosure to the guarantor. Principally this obligation requires that disclosure be made in relation to any aspect of the transaction which would cause the guarantor to bear a greater obligation or risk than it would otherwise have anticipated.[333] However, this obligation will not relate simply to questions of the credit risk arising from the transaction and will relate only to the intrinsic commercial aspects of the contract.[334] In relation to derivatives contracts this is clearly an important limit on the enforceability of a guarantee where it can be shown that the guarantor had not understood all of the risks which it was guaranteeing. The question of the enforceability of derivatives contracts in this sense was considered in detail in chapter 7 *Liability in selling financial derivatives*.[335] In many transactions the ordinary process of identifying the competence of the buyer of such a product will determine the level of information as to the risks of the transaction which will be required to remove the seller's liability for, *inter alia*, undue influence.[336] Failure to ensure that the risks are adequately communicated to the guarantor will entitle the guarantor to rescind the contract of guarantee.

Alteration in the nature of the guarantor's obligation

11-104 In the previous paragraph it was suggested that there is a limited duty of disclosure to the guarantor of its obligations under the contract of guarantee. One context in which changing circumstances will be important and entitle the guarantor to rescind the contract of guarantee is where the circumstances of the transaction change such that guarantor is found to bear substantially different liabilities from those originally undertaken in relation to the contract of guarantee as originally envisaged by it. Therefore, if the creditor and the primary debtor were to vary their contract in some material way, then there would be an entitlement in the guarantor to rescind its guarantee.[337] In relation to a derivatives contract this would seem to include a transaction which is altered such that the risks associated with its failure are greatly enhanced.

11-105 Two difficult questions arise outwith these authorities. First, in what circumstances will an alteration in the market on which a derivatives transaction is based be such that the contract of guarantee can be taken to have been rescinded on this basis? For example, if there were an unexpectedly sharp movement in interest rates, would a guarantee over an interest rate swap be unenforceable on the basis that such a movement in market rates was outwith the volatility which the parties could have expected? It is suggested that the discussion of the doctrine of frustration would apply in this circumstance[338] whereby the parties would have to demonstrate that there

[333] *Levett v. Barclays Bank plc* [1995] 1 W.L.R. 1260; *Credit Lyonnais Bank Nederland v. Export Credit Guarantee Department* [1996] 1 Lloyd's Rep 200.
[334] *Ibid*.
[335] Para 7-08, 7-27.
[336] *Bankers Trust v. Dharmala* [1996] C.L.C. 18.
[337] *Holme v. Brunskill* (1878) 3 Q.B.D. 495; and also to recover any relevant security transferred under the guarantee *Bolton v. Saloman* [1891] 2 Ch. 48; *Smith v. Wood* [1929] 1 Ch. 14.
[338] Para 8-10.

was some clearly expressed understanding of the risks which would and which would not be borne by each of them in their contract. It is suggested that the courts will look to the expertise of the parties in relation to such financial instruments when deciding whether or not those parties ought to have understood that interest rate swaps are subject to movements in interest rates of whatever magnitude; where such a party is considered sufficiently expert to understand the risk, it will be considered bound to perform its contract whatever those market movements.[339]

11-106 Second, it is not clear how brittle the parties intentions would need to be. By that is meant the following. When the creditor and primary debtor enter into a derivatives contract they do so for a number of reasons,[340] ranging from hedging a risk to generating some speculative profit. If the profitability of the transaction changes, do the parties intentions change if they choose to maintain the transaction? It should be remembered that guarantees are frequently used to cover all of the transactions entered into under a master agreement and therefore there will be a range of intentions applicable to that range of transactions such that it would be difficult to know whether or not the parties' change of purpose in relation to one group of transactions would affect the enforceability of a guarantee executed in relation to all of their transactions.

11-107 Furthermore, the creditor will owe duties of good faith to the guarantor in relation to the realisation of any security; for example, where land has been provided by way of mortgage as part of the guarantee and that land is sold at an unreasonably low price by the mortgagee to one of its associates.[341]

Commercial issues with the drafting of guarantees

11-108 This work is not large enough to encompass all of the law on guarantees, particularly given that the details of any contract of guarantee turn on the precise circumstances and requirements of the parties. There is no particular aspect of derivatives which requires a different legal or guarantee treatment. The complications tend to relate commercial difficulties which require the lawyer to interpret them into documentation. The credit aspects of finding a company of sufficient credit worth to give the guarantee are not specifically legal problems. The solutions lie either in conducting transactions with the highly credit-rated entity or ensuring that the guarantee forms a credit support agreement under the master agreement. The commercial risk that is taken with a guarantee is that the surety or guarantor fails to perform under that agreement. The partial advantage of the collateral arrangement is that some asset is provided in advance of the contractual date of performance of the transaction. Therefore, provided that the collateral agreement is effective under the laws of all relevant jurisdictions, the seller is able to recover the fraction of its loss bargained for when creating the collateral arrangement. Typically, it is advantageous for the creditor to seek a guarantee which is "irrevocable and unconditional" as opposed to one which is couched in exclusion clauses and which is capable of being revoked by the guarantor in a large number of circumstances.

[339] *Bankers Trust v. Dharmala* [1996] C.L.C. 18, *infra*.
[340] Para 2-11.
[341] *China and South Sea Bank v. Tan Soon Gin* [1990] 1 A.C. 536.

Chapter 12

Collateral and standard credit support agreements

UNDERSTANDING COLLATERALISATION

Introduction

12-01 Collateralisation is a blanket term used to describe the different means of taking security which are commonly used in financial derivatives transactions. The various forms of collateralisation incorporate a number of the different legal techniques considered in Chapter 11. The discussion in this chapter is therefore predicated on the general discussion in the last chapter, and so the reader should consult that chapter before considering this one. The growing market practice of using collateral has created the need to deal with this subject separately from the general discussion of taking security. The different methods of effecting collateralisation are hybrids of those general legal models tailored for use in the derivatives markets. The market has begun to favour collateral and margining techniques over other techniques for reasons which are developed in the "commercial issues" section of this chapter.[342]

Otherwise, in this chapter we will consider, first, the commercial issues underpinning collateral structures;[343] secondly, we will consider the EC Directives on collateral;[344] thirdly, ISDA's personal collateral structure (the Credit Support Annex);[345] fourthly, ISDA's proprietary collateral structure (the Credit Support Deed);[346] and fifthly legal issues which arise from these structures.[347]

The two principal forms of collateral

[342] Para 12-05.
[343] Para 12-05.
[344] Para 12-18.
[345] Para 12-26.
[346] Para 12-43.
[347] Para 12-55.

12-02 While "collateralisation" may in fact be any one of a number of legal techniques for taking security, or any combination of such legal techniques, there are broadly two species of collateral structure which will be dubbed for present purposes "personal collateral" and "proprietary collateral". These are not market usages although, as will emerge, they are terms best understood by even undergraduate law students. The term "personal collateral" refers to the situation in which a secured party receives an outright transfer of assets from its counterparty with only a personal obligation to re-transfer assets of a like kind or of an equivalent value to that counterparty if the counterparty performs its obligations under the derivatives transaction.[348] This form of collateral is dubbed "personal collateral" because the secured party owes only personal, contractual obligations to re-transfer property to the counterparty,[349] as opposed to any proprietary obligations (such as holding assets on trust[350] or subject to a charge or subject to a possessory obligation such as a pledge[351]). By contrast, "proprietary collateral" refers to the situation in which a counterparty transfers assets to the secured party such that the secured party owes obligations to the counterparty to preserve those very assets which were transferred to it by holding them on trust,[352] or subject to a fixed charge[353] or a mortgage,[354] or subject to a possessory obligation such as a pledge,[355] or subject to some retention of title in favour of the counterparty.[356] Thus, if the secured party were to go into insolvency or if it were to fail to perform its obligations to retransfer those assets under the derivative contract, the counterparty would have proprietary rights in the collateral assets so as to secure its position.

There is therefore a simple distinction in any collateral structure: either the counterparty posting collateral assets has purely personal rights against the secured party in contract law, or the counterparty has proprietary rights against segregated assets held by the secured party. Similarly, the secured party will either take absolute title in the collateral assets under a personal collateral structure, or else it will be obliged to hold the collateral assets to the account of its counterparty (unless and until the counterparty fails to perform its obligations under the derivative contract) under a proprietary collateral structure. The mechanics of these various structures are considered in detail below. There are a number of commercial complexities as to which form of structure is used, how it is priced and so forth (as considered in the next section of this chapter); nevertheless, the legal questions resolve themselves to this simple distinction between having purely personal or proprietary rights in the collateral assets.

It is important to understand, therefore, that for a lawyer there is no particular magic in collateralisation. Rather "collateralisation" is the process by which ISDA standard market documents – principally the ISDA Credit Support Deed and the ISDA Credit Support Annex – provide a menu of structures from which participants in financial derivatives transactions may choose when seeking to take security in their transactions. The detail of the items on that menu under the general law were considered in detail in the last chapter; whereas the precise ISDA language is

[348] For a detailed discussion of the general on this topic see para 11-08 *et seq*.
[349] For a detailed discussion of the general on this topic see para 11-08 *et seq*.
[350] For a detailed discussion of the general on this topic see para 11-12 *et seq*.
[351] For a detailed discussion of the general on this topic see para 11-85 *et seq*.
[352] For a detailed discussion of the general on this topic see para 11-12 *et seq*.
[353] For a detailed discussion of the general on this topic see para 11-51 *et seq*.
[354] For a detailed discussion of the general on this topic see para 11-51 *et seq*.
[355] For a detailed discussion of the general on this topic see para 11-85 *et seq*.
[356] For a detailed discussion of the general on this topic see para 11-42.

considered in detail in this chapter. What is important to note at this stage is that the structures on those menus are simply stylised methods of taking security which are already well-known to all commercial lawyers. Lawyers are familiar with express trusts, fixed charges, mortgages, floating charges, liens, pledges, retention of title clauses, *Quistclose* trusts, guarantees and indemnities, and ordinary obligations to make payment: collateralisation is simply a collective term for a range of subtly different formulations of these techniques.

The purpose of collateral arrangements

12-03 The purpose of collateral arrangements is to secure the obligations of the parties to a financial derivative to an extent which matches one party's credit concerns and the counterparty's willingness to extend collateral. Simply put, collateral is property of some sort which is given by one party to its counterparty during the lifetime of a derivatives transaction to assuage that counterparty's concerns about the other party's credit worth. That much is not unique to financial derivatives. Many forms of financial and commercial transactions are secured by means of a provision of assets to another person's use in some way, either on a personal or a proprietary basis. The question for analysis – or, rather, for careful structuring – is whether the collateral structure is in truth a pledge of assets, a trust over assets, a charge over assets (all three of which are proprietary structures, for present purposes), or an outright transfer of assets with a purely contractual obligation to account in the future (which is a personal structure). These subtly different analyses are compared below.[357]

The question then is which technique is used in any given commercial circumstance. It is a principally a credit issue whether or not collateral is taken at all and a commercial issue which form of collateral any given counterparty will be prepared to advance. With the growth of the derivatives markets and the introduction of lower credit quality participants into those markets, the appetite for risk has altered. Indeed, the development of credit derivatives has even begun to manipulate this appetite for risk. Consequently, the use of collateral has grown. The large financial institutions will often require collateral to be provided. Clearly this is, primarily, a credit issue rather than peculiarly a legal one; ensuring that a viable collateral structure is created is, however, a legal issue.

The utility of two-way collateral

12-04 It is important to decide whether collateral arrangements need to be in the form of "two-way" or only "one-way" agreements: that is, whether both parties may be required to make payment in the event of some default or to post collateral ("two-way agreements") or whether only the defaulting party will be required to make payment in the event of some default or to post collateral ("a one-way agreement"). In the early days of the derivatives markets, financial institutions of high credit worth would insist that collateral be posted with them by their counterparties but generally refused to account reciprocally in that fashion. These were therefore one-way agreements in that only the customer was required to post collateral. The decision as to whether to take one-way or two-way collateral would usually turn on the comparative credit worth of

[357] Para 12-15.

the two parties; that is, the more secure party would typically be able to demand performance from its counterparty. Financial institutions would often seek one-way collateral arrangements from non-financial institutions or corporate counterparties (of materially weaker credit worth than themselves).

Financial institutions of equivalent standing[358] now frequently agree to use two-way collateral arrangements, particularly in the light of the support given to such collateral arrangements in the EC Collateral Directive[359] in allowing market counterparties to reduce the regulatory capital cost of their derivatives business where those transactions are covered by collateral agreements. Before the passage of the first collateral directive it was more common for market counterparties to agree to dispense with the expense and complexity of providing collateral and to concentrate instead on the credit enhancement provisions in any master agreement in place between them.[360] It is more common for all parties to require collateral from each other in the modern marketplace in the context of the Collateral Directive. The advantage of taking collateral "two ways" in this fashion is that both parties are able to treat their derivatives transactions as secured both to the extent that collateral has been posted with them and therefore to the extent that it is possible to reduce the amount of regulatory capital required to be posted by the secured financial institution. Therefore, two–way collateral structures mean that parties are able to set off the collateral they are entitled to receive from their counterparties against the collateral which they are obliged to post with them. Consequently, the amount of collateral actually posted by any one party to the other is reduced to a net amount. By agreeing to post two-way collateral in relation to all derivatives transactions there will be very little exposure which is not covered by collateral. It is only that exposure not covered by collateral which would require posting of regulatory capital as required by the financial institution's regulator. In effect, therefore, a collateral structure manages to reduce the regulatory capital cost of derivatives transactions, to reduce the amount of collateral to be posted by any party to small net amounts, and accordingly to increase the liquidity of all market participants.[361]

COMMERCIAL ISSUES WITH COLLATERAL STRUCTURES

The requirement for collateral

12-05 There are a number of questions, from a commercial point of view, which arise when considering collateralisation. Before considering the detail of the applicable legal issues, it is important to place the need for collateral in its commercial context. The first issue is the commercial decision whether or not collateral is required at all. Where once collateral was only taken from parties about whom there was concern as to their credit worth, it is commonly the case that even established market counterparties take collateral from one another at the time of writing, as considered in the previous section. This change in approach began initially at a time of greater nervousness among the financial

[358] That is, general investment banks of equivalent credit worth, and not hedge funds and other financial institutions of lower credit worth.
[359] 2002/47/EC ("Collateral Directive 2002").
[360] Para 3-131.
[361] See para 12-15.

community about the exposure of even the largest market players to turbulence in emerging markets. That market counterparties take collateral from each other – rather than one party seeking to take collateral solely from the weaker party in all circumstances – results in both parties being able to set off the amounts which the parties owe to each other across their portfolio of derivatives contracts. By generating a purely net amount across all those transactions for which the calculation of such a net exposure is feasible for the parties' operations systems to perform, it is possible to reduce the parties' total exposure for regulatory capital purposes either to a single net sum (if their operations systems allow) or to a series of smaller net sums.[362]

As a result of measurement of the credit risk profile of the product, market movements and the counterparty's anticipated ability to perform, the level and type of collateral required is fixed by the institutions. It is usual for the parties to use government bonds or corporate bonds as collateral – as considered below. The level of collateral posted in then as result of negotiation between the parties calculated as a proportion of the parties' total exposure to each other in relation to their derivatives contracts.

The type of asset taken as collateral

12-06 The second issue is then as to the type of asset that is required to be provided as collateral. (Market usage in this context is to refer to whatever property is taken to secure a transaction as being itself "collateral".) The principal commercial question when considering the use of collateral in any given transaction is to identify the exposure each party has in relation to the outstanding derivatives transactions, and then to identify the value of the assets needed by way of collateral to assuage each party's concerns about the credit risk involved in those transactions. Necessarily, there is a concern that, in securing the performance of a counterparty, the assets posted as collateral do not themselves prove to be worthless in time. Therefore, the question as to the type of asset that is put up as collateral is important. There is a preference for liquid assets such as cash and government securities on the part of the party benefiting from the provision of the collateral. Often buyers will not wish to provide cash, of whatever currency, because that is considered to be an expensive form of security. Furthermore, the publicly issued debt of sovereign entities is generally of high credit-worth and considered to be unlikely to fail. Cascading down the list of available possibilities are bonds and commercial paper issued by non-governmental entities with a credit rating from a recognised credit ratings agency. The next tier of desirable assets are equities issued by recognised entities on recognised exchanges. Outside these categories, it is a matter for the risk appetite of the seller as to the form of asset which will be accepted as collateral. Under general legal principles, of course, there is no limit on the type of property which may be used to secure a transaction, but the types of security considered thus far are the preferences of most participants in the derivatives market.

The amount of collateral provided will depend, in some circumstances, on the form of the collateral itself. The more volatile the value of the collateral, the greater the risk of the collateral itself decreasing in value. Therefore, there is a likelihood that a greater proportion of exposure coverage will be required where the collateral itself is of lower intrinsic value. A similar consideration arises where cash is pledged as collateral in

[362] Collateral Directive 2002, considered at para 15-39.

one currency to secure an obligation in another currency. There is a risk of foreign exchange movement, leading to the devaluation of the comparative value of the collateral. These are not legal questions *per se*, but rather form part of the credit decision as to the manner in which a collateral structure is to be put in place. The only legal questions might revolve around the difficulties of taking delivery over certain types of property in jurisdictions where there are formalities required to seize given types of property, for example currency subject to exchange controls preventing movement of that money out of a given jurisdiction, as considered next.

12-07 The further question which arises from the type of collateral extended by the buyer is the enforceability of the collateral agreement over that security. This issue is pursued below in greater detail in *Certainty of subject matter in collateral agreements*[363] but the central questions can be briefly stated. The core problem relates to the conflict of laws. If the parties are dealing across different jurisdictions, it is important for the parties to know whether or not their agreement will be enforceable by any system of law or in any jurisdiction which is called upon to adjudicate on ownership of the collateral assets or the enforceability of any right to receive payment: these issues are considered in Chapter 10 *Conflict of Laws*.[364] Therefore, the applicable governing law of the derivative contract is important. It may be that the governing law of the collateral agreement recognises a different system of law as governing title to any collateral asset. In the case of immovable assets put up as security, the system of law applicable to the jurisdiction which encompasses the situs[365] of those immovables will typically be applied.[366] Alternatively, the jurisdiction where the party providing the collateral is resident might seek to assert its own competence to hear any issue as to title. Similarly, where an English court, given jurisdiction to apply English law by express provision in the collateral agreement, seeks to enforce a judgement over assets in another jurisdiction, issues will arise as to the appropriate mechanism for enforcement of the security. Under English law there are further issues as to the segregation and identification of the assets to be held under a collateral structure using trusts.[367] Furthermore, there will be questions as to the performance of appropriate formalities in asserting title to assets.[368] Therefore, the parties must consider both questions of governing law and jurisdiction in relation to their contract, and the enforceability of their credit support arrangements under those systems of law.

12-08 There are two general points, therefore, to be made with reference to the taking of collateral. Security will need to be recognised on enforcement by the jurisdiction in which the relevant asset is located and its appropriate system of law.[369] Therefore, the security holder is normally advised to do everything necessary to perfect the security under the laws of the place where the security is held. This may involve documentary formalities and local filings and may also involve making the security documentation subject to the laws of the relevant jurisdiction. For example, where a legal charge is sought over Japanese registered shares it is usually advisable that the charging

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[363] Para 12-19.
[364] See para 10-14.
[365] *Nelson v. Bridport* (1846) 8 Beav. 547.
[366] *Johnstone v. Baker* (1817) 4 Madd. 474; *Re Hoyles* [1910] 2 Ch. 333, 341; *Macdonald v. Macdonald* 1932 S.C. (HL) 79.
[367] *Re Goldcorp* [1995] 1 A.C. 74.
[368] See for example *Milroy v. Lord* (1862) 4 De. G.F. & J. 264; *Richards v. Delbridge* (1874) L.R. 18 Eq. 11.
[369] On the distinction between jurisdiction and system of law see para 10-14.

documentation be governed by Japanese law. Under English law where a charge is taken against an English incorporated company that charge may require registration to be formally valid.[370] Secondly, there is the issue of the appropriate insolvency laws which may apply should either party go into insolvency. The result may be that it is impossible for the collateral or charging agreement to be performed, depending on which system of law is appropriate to deal with that insolvency. Therefore, in cases where insolvency is a particular concern, it is vital that the appropriate insolvency code is investigated.

Measurement of exposure and of the level of collateral

12-09 The third question is the measurement of the collateral that is required compared to the amount of collateral which the counterparty is required to acquire and to render up as collateral, without causing itself enormous liquidity problems. Two separate questions arise. The first question is the measurement of the obligation which is to be secured. The second is the measurement of the value of the assets which are put up as collateral. The use of margining techniques ensures that, rather than require a fixed amount of collateral to be provided to secure the transaction, a fluctuating value of collateral assets is provided in accordance with the contractual agreement of the parties. In measuring the size of the applicable obligation there are difficulties in valuing a derivatives transaction which is only partly performed. Where it is a ten-year swap which is to be secured, after four years it is impossible to know the value of that swap on its expiry. Instead one takes a present market value of that future cash flow. It is similarly impossible to know the exact size of the obligations that are owed on each payment date. As such it is not certain which obligation is to be secured.

The approach taken by derivatives practitioners is to construct a mark-to-market model which values the replacement cost of that derivatives transaction at any appropriate valuation date. However, there are also a number of different approaches to that measurement process. First, measurement might be based on the price of acquiring a new transaction to commence on the mark-to-market valuation date which is to run for the remainder of the existing transaction's time to expiry and which will meet that underlying transaction's commercial objectives. That value will fluctuate according to market movements and yield curve adjustments. Second, measurement might include the cost of replacing the existing asset by factoring in an amount for the loss associated with unwinding a hedge and acquiring the identical asset in identical commercial circumstances. Third, the mark-to-market model itself will be based on subtly different expectations and pricing mechanisms according to policies of the institution which is charged with calculating the appropriate levels on each valuation date. What is clear is that the value of the underlying derivative will fluctuate over time thus requiring a flexible margining strategy to maintain an appropriate level of collateral.

12-10 There is a question as to the form of structure which is to be used. The assets could be transferred to the counterparty[371] such that the counterparty is entitled to take absolute title to them and sell them, or, alternatively, by means of a pledge with a right to possession but not with a right to dispose of those assets otherwise than on default of the

[370] Companies Act 1985, s.395.
[371] The doctrine of pledge was considered in chapter 11, at para. 11-16.

counterparty of one of its performance obligations under the derivatives contract.[372] Another alternative would be to have the collateral posted held on trust by some third party custodian such that either party is entitled to a vested equitable interest in the collateral – entitling them to call for delivery of absolute title in that property from the trustee – depending on the performance of its counterparty of its obligations under the relevant derivatives transactions. The trust structure has become less commonly used with the growing market practice, as evidenced by the ISDA Credit Support Annex, of both parties accounting for collateral to its counterparty such that each party is able to use such collateral as though absolutely entitled to it, subject only to a contractual obligation to return assets of like kind or to pay a sum of money equal to the value of that collateral. The ability to turn the assets to account in this way has the advantage of rendering the property capable of being used by the parties rather than remaining frozen in a trust account, as under a proprietary collateral structure.

12-11 The further issue is as to the value of the collateral posted with the trustee (under a proprietary collateral structure), or whichever party is to receive its counterparty's posted collateral (under a personal collateral structure). The assets making up the collateral will fluctuate in value themselves. Therefore, it is necessary to isolate the market value of the existing collateral which is required on any valuation date. Given the fluctuating value of the assets put up as security, it is important for the seller to allocate discounts to the market price of those assets to account for the assets' own credit worth and volatility.[373] Consequently, the collateral assets themselves will require assessment on valuation dates, possibly requiring additions to the collateral held, even though there has been no increase in the exposure constituted by the derivatives transaction. However, it is also the case that margining agreements will provide for the return of collateral assets where the exposure under the derivative falls.

12-12 On the subject of measurement the role of the calculation agent requires mention, albeit briefly at this stage. Given the importance of valuation to the margining process and the many possible approaches to the construction of a mark-to-market model, the calculation agent occupies a powerful role in assessing the exposure existing between the parties.[374] Market practice is for the seller to operate as calculation agent in the creation of derivatives transactions. However, as between dealers it is usual for both parties to wish to be calculation agent. In relation to collateral structures under the ISDA code it is more common for the party requiring that collateral be posted with it to issue a demand that that be done.[375] This situation usually results in a formula whereby the parties undertake to agree a measurement, or appoint an independent third party where they are unable to do that. Alternatively, it may be the case that a counterparty requires an independent calculation agent to be appointed in any event, subject to an informal "appeal" mechanism consisting of a series of market quotations which are averaged out to reach the market value of the exposure on any applicable valuation date.

Formalities and regulatory requirements

[372] Para. 11-18.
[373] Usually referred to as "haircuts".
[374] The mechanism for calculation under the ISDA arrangements is considered below at para 12-30.
[375] *Ibid*.

12-13 The fourth question then concerns the formal and regulatory requirements that govern the manner in which that property is to be provided. Depending on the form of asset that is provided as collateral, there may be pre-requisites to its effective transfer to the custodian or counterparty for the purposes of securing the derivatives transaction. If a trust structure is used then, in relation to bonds and shares, it will be necessary to re-register non-bearer securities such that legal title passes to the custodian-trustee. The use of the trust structure favoured in the market is for a custodian to hold the assets as trustee on the terms set out in the collateral agreement. Necessarily, the trustee must have the legal title in the trust fund vested in it before any trust will be effective.[376] The particularly important issue for the use of margining arrangements in respect of financial derivatives is the transfer of legal title with reference to bonds issued under a global note, which remains the preferred form of security for most market dealers, held under a system of law or in a jurisdiction other than that of England and Wales. As considered below, there are a number of significant legal issues surrounding the widespread use of global notes as security. The second EU directive on collateral contains a range of formalities, such as the need for the arrangement to be put into writing, which are considered below.[377]

Title in the collateral assets

12-14 The fifth question concerns the rights that the seller has in respect of that property including the basis on which the seller is entitled to take absolute possession of the property, what further action a party can take if the property does not equal the size of the exposure to its counterparty if something does go wrong, and what rights attach to the seller in respect of the property while it is being held under the collateral arrangement. In current market practice financial institutions insist that collateral is lodged directly with it rather than with a third party as trustee. While a form of trust structure is still sometimes used, it is the trustee (frequently the seller financial institution when dealing with a hedge fund or similar counterparty) which is subject to the fiduciary obligations set out in the collateral agreement. Hence the distinction made later in this chapter between proprietary collateral structures, such as trusts, and purely personal collateral structures.

12-15 Whether it is acting as trustee itself or not, the secured party will seek permission under the collateral agreement to use the assets on its own account during the life of the agreement. Thus the collateral arrangement becomes a form of pre-payment or, where the buyer does not default, an interest-free loan for the life of the transaction, rather than a trust at all. The obligation on the secured party, as set out in the collateral agreement, would be to return the assets in like kind either after any valuation date requiring repayment or at the end of the transaction. If this is so, then the trustee does not bear the ordinary obligations of a trustee to obey the terms of the trust,[378] and to avoid all conflicts between its personal interests to turn the collateral to its own account and its fiduciary

[376] *Milroy v. Lord* (1862) 4 De G.F. & J. 264; *Richards v. Delbridge* (1874) L.R. 18 Eq. 11. See also for example *Westdeutsche Landesbank v. Islington* [1996] 1 A.C. 669 *infra* whereby there will not automatically be a trust over property without some prior cause, and *Re Goldcorp* [1995] 1 A.C. 74 whereby there cannot be a valid trust unless the trust fund is segregated from other property so as to be identifiable with certainty.
[377] Para 12-59.
[378] *Clough v Bond* (1838) 40 ER 1016.

obligations to the beneficiary.[379] The only means of validating the trustee's use of the property is expressly to give the trustee a power to advance the trust property to itself *qua* beneficiary: the complexity remains how to analyze the obligation to account for the value of that property subsequently because if the entire trust property can be applied to the use of one party then the trust itself would terminate for want of subject matter.[380] Under the general law of trusts such a use of the trust property for personal purposes by a trustee would constitute a breach of trust requiring the trustee to restore the trust fund[381] and to hold any profits made from the misuse of that property on constructive trust for the beneficiaries.[382] Thus, if the parties' intention is that the recipient of the collateral be able to use that collateral as though absolutely entitled to it, then the better structure would be to avoid the use of a trust and instead to employ a transfer of title structure, as considered below in relation to personal collateral structures under the ISDA Credit Support Annex.[383]

12-16 The remaining issue between the parties is as to allocation and title to any dividends, interest payments or other sums derived from title to the collateral assets during the life of the agreement. Evidently, where the collateral assets can be sold or re-hypothecated by the trustee-seller, there will be no issue as to title to such payments after the assets have been sold. However, the issue remains before the sale of any such assets or in circumstances where the trustee-seller is precluded from transferring the assets away. Again, the ISDA methodology for dealing with this issue is considered below.[384]

Role of the custodian

12-17 Following on from the previous section, the sixth question is as to the person who will have possession or custody of the property during the life of the derivatives transaction, in the event that a trust structure or a fixed charge is used. Where a third party custodian is to be used, the issue is as to the selection of that custodian and ascertaining the manner in which the assets will be held so that they can be obtained without complication in the event of a default under any applicable derivatives transaction. In this context it would be important to ensure that a trust structure would be enforceable against the custodian under any applicable system of law. Collateralisation structures which are personal under the ISDA Credit Support Annex do not need a custodian but instead transfer title outright in the pledged assets as discussed above.

In this context there is a very important distinction to be made between pledge structures,[385] retention of title structures[386] and trusts structures.[387] These various legal categories were considered in detail in chapter 11 *Taking security.* They are considered in outline in the discussion to follow.

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[379] *Boardman v Phipps* [1967] 2 AC 46.
[380] See *Target Holdings v Redferns* [1996] 1 AC 421. See Hudson, *Equity & Trusts* (4th ed., Cavendish, 2005) 667 on the difficulties surrounding the termination of trusts.
[381] *Target Holdings v Redferns* [1996] 1 AC 421: either by means of specific restitution or in cash: see Hudson, *Equity & Trusts* (4th ed., Cavendish, 2005) 656.
[382] *Boardman v Phipps* [1967] 2 AC 46.
[383] Para 12-26.
[384] Para 12-26 *et seq*.
[385] Para 11-85.
[386] Para 11-42.
[387] Para 11-12.

THE EC COLLATERAL DIRECTIVE 2002

The enforceability of collateral arrangements

The Directive in outline

12-18 The Collateral Directive 2002[388] deals with the enforceability of collateral arrangements in the EU, provided that they are "evidenced in writing or in a legally equivalent manner"[389] and takes effect over such arrangements "once [financial collateral] has been provided".[390] Such collateral arrangements must take effect between parties which can be one of any of the following categories of person: public authorities, central banks, credit institutions, investment firms, financial institutions, insurance undertakings, collective investment schemes or management companies.[391] The directive deals with cash collateral and securities collateral of two kinds: *title transfer collateral arrangements* and *security financial collateral arrangements.*

"Title transfer" arrangements

12-19 The term "a title transfer financial collateral arrangement", as used in the Collateral Directive, is defined to mean "an arrangement, including repurchase agreements, under which a collateral provider transfers full ownership of financial collateral to a collateral taker for the purpose of securing or otherwise covering the performance of relevant financial obligations".[392] This form of arrangement is considered below in relation to the ISDA Credit Support Annex in which parties transfer title absolutely in the collateral property by means of personal collateral structures.

"Security financial collateral" arrangements

12-20 A "security financial collateral arrangement" , as used in the Collateral Directive, is defined to mean "an arrangement under which a collateral provider provides financial collateral by way of security in favour of, or to, a collateral taker, and where the full ownership of the financial collateral remains with the collateral provider when the security right is established".[393] The reference here to "full ownership" is problematic. Taken literally, this term would not include a trust nor would it include a mortgage because in those instances there are two distinct forms of proprietary right over the same property – legal title and equitable interests in relation to the trust, the several rights of mortgagor and of mortgagee in relation to the mortgage – such that the collateral provider would not retain full ownership. Rather,

[388] 2002/47/EC ("Collateral Directive 2002").
[389] Collateral Directive 2002, art 1(5).
[390] Collateral Directive 2002, art 1(5).
[391] Collateral Directive 2002, art 1(2).
[392] Collateral Directive 2002, art 2.
[393] Collateral Directive 2002, art 2.

this literal interpretation would seem to include retention of title clauses. If the credit provider retains "full ownership" then the only other form of security which the secured party could acquire would be by way of a charge under which the chargee acquires no title in the charged property until the chargor fails to perform the underlying obligation and the charge then entitles the chargee to seize the charged property. Alternatively, if "full ownership" were taken to mean "full beneficial ownership", then it would include a bare trust in favour of the secured party because the secured party would be an absolutely entitled beneficiary. That would not however cover a trust in which both the secured party and the party posting collateral were beneficiaries under the same trust with their rights being contingent on the performance by each of the performance of their obligations in relation to the underlying transaction. In relation to a charge or mortgage, "full ownership" would only possibly be satisfied if there was no other charge or mortgage in effect over that property.

12-21 Collateral arrangements will be effective and top-up arrangements to add collateral to the fund will be enforceable in all member states when mark-to-market measurements suggest that such additions are necessary to meet the agreed collateral exposure levels between the parties.[394] This chapter is drafted on the basis that such provisions are effective in English law in any event, provided that the parties construct their collateralisation arrangements properly.

Certainty of subject matter in collateral arrangements

12-22 The Collateral Directive 2002 addresses the issue of certainty of subject matter, albeit in two different provisions. First, it is provided that the "evidencing of the provision of financial collateral must allow for the identification of the financial collateral to which it applies".[395] In this regard book entries recording a credit, in relation to securities or to cash collateral, are sufficient to identify the collateral. More specifically, it is sufficient if "book entry securities collateral has been credited to, *or forms a credit in*, the relevant account and that the cash collateral has been credited to, *or forms a credit in*, a designated account".[396] The italicised portions of this provision (in which that emphasis was added) suggest that the securities or the cash do not need to be held in an account segregated from all other securities or cash. Consequently, this provision appears to be broader than the principle in English trusts law as to certainty of subject matter. In relation to cash, it is a requirement of English trusts law that that cash be held in a separate account from all other cash.[397] There is later Court of Appeal authority which suggests that there is no need to segregate ordinary shares in a company from other shares of the same class in the same company.[398] In that case, however, the principal concern of Dillon LJ was to prevent an employer from unconscionably denying his obligation to transfer 50 ordinary shares to an employee as required by that employee's contract of employment.[399] It was in a later decision of

[394] Para 15-44.
[395] Collateral Directive 2002, art 1(5).
[396] Collateral Directive 2002, art 1(5). Italics added.
[397] *MacJordan Construction Ltd v Brookmount Erostin Ltd* [1992] BCLC 350, CA.
[398] *Hunter v Moss* [1993] 1 WLR 934, Rimer QC, Deputy Judge of the High Court; [1994] 1 WLR 452, CA.
[399] See, doubting this decision, Hayton, (1994) 110 LQR 335.

the High Court that it was suggested for the first time that there was no need to segregate intangible property such as securities from other property for there to be a valid trust created as part of that fund.[400] However, this latter approach has been doubted by most trust law commentators[401] and is contrary to subsequent Privy Council[402] and House of Lords[403] authority, as well as being in contravention of earlier Court of Appeal authority.[404] This issue was considered in detail at paragraphs 11-19 *et seq*.

Enforceability of set-off and netting

12-23 The laws of each member state are required to ensure that parties to a transaction are able to set off the collateral property against amounts owed under the relevant transactions, or to be able to set off cash collateral, "by sale or appropriation" of that collateral property.[405] It is suggested, however, that the parties may wish to turn the assets to account more generally than by necessarily selling them: as such "appropriation", which is undefined for this purpose even though it has a number of meanings in English law,[406] would be the preferable mechanism often in practice in that it gives the secured party greater flexibility in the use of the collateral property. The proviso governing this power to set off is that the parties must have provided for such a set-off if it has been "agreed by the parties in the security financial collateral agreement" – including, it is suggested, an executed ISDA Credit Support Annex or Credit Support Deed – and that the parties have agreed on the valuation of the collateral in that same agreement.[407] Appropriation of securities provided as collateral property must be permitted by the terms of the collateral agreement, unless any system of law in a member state did not permit such appropriation at the time the directive came into effect.[408]

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[400] *Re Harvard Securities, Holland v Newbury* [1997] 2 BCLC 369.
[401] See *Underhill and Hayton on Trusts and Trustees* (Butterworths, 2002), 79, where *Hunter v Moss* is clearly disapproved; *Lewin on Trusts* (Sweet & Maxwell, 2000), 32, doubting this decision; Hudson, *Equity & Trusts* (Cavendish: 2005), 87 *et seq*, especially 90, where this case is again disapproved; Thomas and Hudson, *The Law of Trusts* (OUP: 2004), para 3.25 *et seq.*. The only commentator giving houseroom to the contrary view is *Hanbury and Martin Modern Equity* (Sweet & Maxwell, 2005), 101.
[402] *Re Goldcorp* [1995] 1 AC 74.
[403] *Westdeutsche Landesbank v Islington* [1996] AC 669. See also the position in Australia in *Herdegen v Federal Commissioner of Taxation* (1988) 84 ALR 271 which is in accordance with the English senior courts.
[404] *MacJordan Construction Ltd v Brookmount Erostin Ltd* [1992] BCLC 350, CA. Thus the doctrine of precedent ought to have compelled the Court of Appeal in *Hunter v Moss* to have decided differently.
[405] Collateral Directive 2002, art 4.
[406] In English equity, "appropriation" refers inter alia to the recourse of a secured party to assets which were set aside to secure an obligation (*ex p Waring* (1815) 19 Ves 345) or the taking of an identified asset to satisfy a legacy (e.g. *Re Lepine* [1892] 1 Ch 210). At common law it is inter alia a reference to goods being set aside to satisfy delivery obligations under a contract for the sale of goods (Sale of Goods Act 1979, s.18): as to the difficulty of achieving a satisfactory definition of the term "appropriation" at common law see *Benjamin's Sale of Goods* (6th ed., Sweet & Maxwell, 2002) para 5-069.
[407] Collateral Directive 2002, art 4(2).
[408] Collateral Directive 2002, art 4(2).

12-24 In relation to set-off in insolvency proceedings, a close-out netting provision will be effective in relation to winding up proceedings or any other judicial attachment of property in insolvency proceedings.[409]

ISDA COLLATERALISATION DOCUMENTATION

The two principal types of collateralisation

12-25 For many readers of this discussion of collateralisation, it is an analysis of the ISDA credit support documentation which will be of greatest significance to their day-to-day legal practice. However, all readers are advised to consider the general legal issues discussed in Chapter 11 *Taking security in financial derivatives* before considering this material because the ISDA credit support documents are merely bundles of well-understood techniques being applied for a specific purpose and in the light of certain market practices which are peculiar to financial derivatives. For example, there is a nervousness in the derivatives markets about taking charges over their counterparties' assets in case such charges require registration and would therefore impose on market participants the costs and administrative burdens of maintaining those registrations. Therefore, the ISDA credit support documentation falls into two types: the first, the Credit Support Annex, is intended to create no registrable charge at all and thus effects "personal collateral",[410] whereas the second, the Credit Support Deed, purports to create a "security interest" which may take the form of a charge and so effects "proprietary collateral".[411] It is worth noting that, in spite of the provision in the ISDA Master Agreement to the effect that all documents, including any credit support agreement, constitutes a single agreement, it has nevertheless been held that a collateral agreement was separate from the two option contracts which it secured for tax purposes.[412] The commercial issues which attend the parties' decisions as to taking collateral and the attitude of EU law to collateral structures have been referred to in the foregoing discussion. The forms of ISDA document considered in this discussion are the "bilateral forms" (as created for the purposes of English law[413]) whereby both parties owe "two way" collateral obligations to each other, rather than only "one way" duties in which a single party would owe obligations to deliver collateral to their counterparty. Each is considered in turn in the sections to follow.

Personal collateralisation – the ISDA Credit Support Annex

The structure of personal collateral arrangements

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[409] Collateral Directive 2002, art 7.

[410] The issue with charges is that they may require to be registered in many circumstances so as to be valid and participants in financial markets do not want the expense or risk of failure associated with maintaining such registrations. This question was considered in the preceding chapter: see para 11-29.

[411] Whether or not it does create such a charge is doubted in the discussion below.

[412] *Inland Revenue Commissioners v Scottish Provident Institution* [2003] STC 1035.

[413] Whereas previous editions of this book have included references to the New York law version and to the Credit Support Deed.

12-26 Personal collateralisation refers to the structure in which no proprietary rights in the form of a trust, mortgage or charge are created over any collateral property: rather, whichever party owes the surplus on a net basis across all of the parties' relevant[414] outstanding transactions is obliged to transfer collateral property equal in value to that surplus to the other party to cover that exposure. The aim of the ISDA Credit Support Annex ("the Annex") is that the party who has a net exposure to its counterparty across their derivatives transactions is entitled to take an outright transfer of assets from that counterparty: by "outright transfer" is meant that the secured party becomes absolute owner of those assets.[415] Once there has been proper performance of the underlying derivative transactions, the party who owed that surplus under the collateral transaction is entitled to recover an amount of collateral property of like kind and like value from the secured party. That is, once the surplus owed between the parties falls in part or falls to zero when the underlying derivatives obligations have been properly performed, then the party who owes that surplus is entitled to recover the amount of that reduction in the exposure between the parties from the secured party.

A worked example of a personal collateral arrangement

12-27 Thus, if A has a net exposure on its interest rate swap business to B of US$50,000, A may demand collateral property of a kind defined in their credit support annex in a net[416] amount equal to US$50,000. A becomes the absolute owner of those assets and is able to use, sell or otherwise deal with them as their absolute owner. Meanwhile, A and B will be performing their interest rate swaps business in the ordinary way and making payments are required under those swaps contracts irrespective of the collateral arrangements in place between them. If, subsequently, A's net exposure to B falls to US$40,000 (because B has performed its interest rate swap obligations to that extent), then B may demand a transfer from A to B of assets of a kind specified in the credit support annex in the value of US$10,000 (being the amount by which the exposure has fallen). These assets which are transferred from A to B are not required to be made up of the original assets which B transferred to A at the outset. Consequently, we can say that A owes merely contractual obligations to B (to effect a transfer of assets back on demand) but that A owes no proprietary obligations to B (because A is entitled to take the collateral assets as their absolute owner). B's risk, therefore, is that A might go into insolvency or be otherwise unable to perform any duties of transfer of collateral assets to B. A's risk was that B would not perform its obligations under the interest rate swap contracts: that risk was assuaged when B transferred an amount of collateral to A equal to the net exposure between the parties at that time. The manner in which the ISDA Credit Support Annex conceives of these transactions is considered in the next section.

[414] By "relevant" here is meant whichever derivatives transactions are intended to be covered by the collateral agreement at issue.
[415] ISDA Credit Support Annex, para 2 and 3.
[416] That is, taking into account any haircuts and established by reference to a mark-to-market method.

The ISDA terminology for this structure

12-28 Under the terms of the ISDA Credit Support Annex the terminology works in the following fashion, where all capitalised terms are defined terms in the ISDA Credit Support Annex. At the commencement of the Credit Support Annex, when there is a net exposure ("the Credit Support Amount") between the parties under their relevant derivatives transactions on any given Valuation Date,[417] the party which owes the surplus on that net basis ("the Transferor") is obliged to effect an outright transfer[418] of Eligible Credit Support to its counterparty ("the Transferee") of the Delivery Amount.[419] From that time, the parties maintain an account between themselves of the Credit Support Amount from time-to-time and the amount of Eligible Credit Support held on account at that time: such that the size of the obligation to maintain the Credit Support Amount varies at each Valuation Date.[420] All obligations under the Annex are to be made "in good faith and in a commercially reasonable manner".[421]

12-29 Two important further points arise. First, the obligation to make a transfer only arises once the Transferee makes a demand for such a transfer.[422] There is no obligation to make a transfer simply because an amount is due under the collateral agreement, unless and until a demand has been made to transfer those collateral assets. Secondly, the transfer is to be made to the Transferee (or, the "secured party", as discussed in this chapter) personally, as opposed to being made to some third party trustee to hold on trust for the Transferee.[423] As considered below,[424] the Transferee is then entitled to treat the collateral assets as though the Transferee is absolutely entitled to them.[425] This is the feature which makes the ISDA Credit Support Annex a purely personal obligation, as opposed to a proprietary obligation, because "all right, title and interest in" the collateral assets are vested in the Transferee.[426]

12-30 The periodic Valuation Dates are identified in the schedule to the ISDA Credit Support Annex.[427] On each Valuation Date the party who is appointed as the Valuation Agent is required to calculate the net exposure over the relevant derivative transactions so as to carry out the calculations at the Valuation Time identified, as in the schedule, and then to notify the parties at the Notification Time, as identified in the schedule.[428] The precise mechanism by which the Valuation Agent is obliged to carry out these calculations is not specified in the transaction. Rather it is left to the Valuation Agent to carry out a valuation of the exposure owed by each party to the other on all derivatives intended to be covered by the Credit Support Annex, subject to the dispute resolution procedures considered below.[429] Instead there is a rough

[417] ISDA Credit Support Annex, para 2(a).
[418] ISDA Credit Support Annex, para 3.
[419] ISDA Credit Support Annex, para 2(a).
[420] ISDA Credit Support Annex, para 2(a), *infra.*
[421] ISDA Credit Support Annex, para 9(b).
[422] ISDA Credit Support Annex, para 2(a).
[423] ISDA Credit Support Annex, para 2(a).
[424] Para 12-38.
[425] ISDA Credit Support Annex, para 5(a).
[426] ISDA Credit Support Annex, para 5(a).
[427] ISDA Credit Support Annex, para 3(b).
[428] ISDA Credit Support Annex, para 3(b).
[429] Para …

equation provided in the Annex which provides that the Transferor is obliged to transfer

> 'the amount [of Eligible Credit Support] by which
> (i) "the Credit Support Amount"
> exceeds
> (ii) the Value as of that Valuation Date of the Transferor's Credit Support Balance (adjusted to include any prior Delivery Amount and to exclude any prior Return Amount, the transfer of which, in either case, has not yet been completed and for which the relevant Settlement Day falls on or after such Valuation Date)'[430]

The Credit Support Amount is thus the exposure which the Transferor is obliged to match with Eligible Credit Support on each delivery date. The reference to "the Transferor's Credit Support Balance" in this equation is the amount in the Transferor's account at the Valuation Date: if the new amount of collateral required at that time is greater than the balance, then the Transferor must add more assets to the account; contrariwise, if the new amount of collateral required is less than that held in the account, then the Transferor is entitled to receive a repayment (a Return Amount) from that account, as considered below.

12-31 The "Eligible Credit Support" which is to be transferred is a collective term for the types of asset which the parties are prepared to accept as part of their collateral arrangements.[431] The forms of Eligible Credit Support are selected by the parties in the schedule to the Credit Support Annex from a pro forma list including cash (in whatever currency), government bonds, corporate bonds and other securities.[432]

12-32 So, if on a Valuation Date, there is a reduction in the amount of collateral which is needed to meet the net exposure between the parties at that time, then the Transferor is entitled to a Return Amount.[433] The Transferor will, however, only be entitled to such a re-transfer if the amount to be retransferred is sufficiently large (as identified in the schedule to the Credit Support Annex) to merit the effort of such a re-transfer: this threshold amount is defined as the Transferor Equivalent Credit Support.[434]

The manner in which this structure provides security

12-33 It is useful to think of derivatives transactions secured by collateral as being comprised of two layers. On the underneath is the underlying derivative contracts (whether option, forward or swap) which the parties are obliged to perform under the terms of their confirmations and master agreement as though no credit support agreement existed. On the upper layer is the credit support agreement which provides the obligation to post collateral whenever there is a net exposure between the parties on their underlying derivative contracts: the obligation to post collateral exists

[430] ISDA Credit Support Annex, para 2(a).
[431] ISDA Credit Support Annex, para 9 "Eligible credit support".
[432] ISDA Credit Support Annex, para 11(b)(ii).
[433] ISDA Credit Support Annex, para 2(b).
[434] ISDA Credit Support Annex, para 11(b)(i).

separately from any obligation to make payment in relation to the underlying derivative contracts. The two layers therefore operate in parallel but never meet, except that a breach of the collateral agreement will ordinarily constitute an event of default under the master agreement. The method by which this structure affords security is by means of the party who is owed the surplus receiving a transfer of assets equal in value to the amount of its net exposure to the counterparty before any payment is owed under the underlying transaction, although the payment and delivery obligations on the underlying derivative transaction must still be made. The secured party thus receives payments equal to its net exposure in advance and is obliged to return a value equivalent to the collateral property subsequently if the counterparty performs its obligations in relation to the underlying derivatives contracts properly. Failure to perform under the credit support agreement would constitute an event of default under the master agreement and thus would start the appropriate termination procedures under that master agreement.

12-34 Many of the issues surrounding personal transactions were considered at the outset of this chapter in relation to the commercial issues surrounding collateralisation; in this section reference will be made specifically to the ISDA Credit Support Annex. In outline, the party supplying collateral property transfers that property outright to the counterparty. The counterparty's obligations are obligations to transfer property of like kind and like value back to the supplier on satisfaction of the underlying obligations. Therefore, this is a purely personal, contractual obligation which creates no rights in property by way of trust, charge or mortgage when returning value to the supplier.

Credit support obligations

12-35 The purpose of the Credit Support Annex is to enable whichever party has a net exposure to its counterparty to demand a transfer to it an amount of collateral property equal to that net exposure in each valuation period.[435] If the amount of collateral property posted with either party exceeds the net exposure from time-to-time, then the counterparty is entitled to recoup assets of the same kind as the collateral property equal in value to the surplus of posted collateral over the then net exposure. Thus, the parties maintain accounts with one another containing collateral property equal in value to the net exposure between the parties from time-to-time. Consequently, the parties have no rights to any specific property but rather have only personal rights to demand collateral property or to demand a return of property equal to a reduction in the exposure. The securing effect of this structure is to secure what is effectively a prepayment of the net exposure, such that any failure to deliver constitutes an event of default under the master agreement, as opposed to establishing any rights in property or any rights by way of guarantee.

Transfers

12-36 All transfers are to be made "in accordance with the instructions of the Transferee or Transferor, as applicable": thus Delivery Amounts and Return Amounts

[435] ISDA Credit Support Annex, para 2.

must be made to the accounts ordered by the recipient, or by means of a book entry in the appropriate form so as to effect transfer to the recipient where appropriate, or by re-registration with the depositary in relation to securities issued under a global note.[436] Transfer must take effect before the Settlement Time[437] on the Settlement Day once a demand for transfer has been received: in relation to cash the Settlement Day is the next local business day, whereas in relation to securities the next local business day after settlement of trades in such securities may be effected.[438]

Calculations and dispute resolution

12-37 All calculations are to be made by the Valuation Agent by reference to the Valuation Time. The Valuation Agent will ordinarily be the person "making the demand" and so the Valuation Agent is ordinarily the recipient of the transferred property: unless the parties specify some other person to act as Valuation Agent.[439] Valuation Time means the close of business on the appropriate date in the market for the property at issue.[440]

12-38 Either party may dispute "reasonably" any calculation made by the Valuation Agent or the valuation given for any Eligible Credit Support.[441] If the dispute is made otherwise than reasonably, for example so as to delay any obligation to make a transfer but not on the basis of a genuine error in any valuation, then it is to be assumed (because the Annex is silent on this point) that the dispute resolution procedure need not be activated and that the party obliged to make a transfer is obliged to make that same transfer in the same amount in good time: the parties are well-advised to make this clear in their Annex. The dispute resolution procedure requires the Disputing Party to give notice to the other party before the close of business on the date on which the transfer is to have been made.[442] To the extent that there is no dispute between the parties, the transferor is obliged to effect that transfer to the extent of the "undisputed amount".[443] As to the amount that is in dispute the parties are required to consult with a view to resolving their differences,[444] but if the issue remains outstanding then the parties should take up to four quotations for that valuation by means of Market Quotation[445] (as considered in relation to the master agreement).[446] Failure to make a transfer which is in dispute between the parties will not constitute an event of default under the Annex or under the master agreement.[447] As considered above, it must be assumed (although the Annex is silent on this point) that an unreasonable dispute will not prevent a failure to pay or deliver from being defined as being an event of default.

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[436] ISDA Credit Support Annex, para 3(a).
[437] As defined by the parties.
[438] ISDA Credit Support Annex, para 3(a).
[439] ISDA Credit Support Annex, para 11(c)(i).
[440] ISDA Credit Support Annex, para 11(c)(iii).
[441] ISDA Credit Support Annex, para 4(a).
[442] ISDA Credit Support Annex, para 4(a)(1).
[443] ISDA Credit Support Annex, para 4(a)(2).
[444] ISDA Credit Support Annex, para 4(a)(3).
[445] ISDA Credit Support Annex, para 4(a)(4).
[446] See para 3-115.
[447] ISDA Credit Support Annex, para 4(b).

Title in transferred property

12-39 Significantly there is an outright "transfer of title" from the Transferor to the Transferee.[448] It is provided that:

> 'Each party agrees that all right, title and interest in and to any Eligible Credit Support, Equivalent Credit Support, Equivalent Distributions or Interest Amount which it transfers to the other party under the terms of this Annex shall vest in the recipient free and clear of any liens, claims, charges or encumbrances or any other interest of the transferring party or of any third person (other than a lien routinely imposed on all securities in a relevant clearance system).'[449]

All assets transferred under the Annex thus become absolutely the property of the Transferee.[450] The ISDA Credit Support Annex therefore creates a purely personal obligation to transfer a Return Amount to the Transferor in the future if the net exposure between the parties falls.[451] The Return Amount is in the form of assets which are also in the form of Eligible Credit Support but those assets are not the very same assets which were originally transferred to it but are instead "Equivalent Credit Support", which must be "Eligible Credit Support of the same type, nominal value, description and amount as that Eligible Credit Support".[452] Thus the obligation is a personal obligation to make repayment by way of a Return Amount comprising assets of like kind and value, whereas if the obligation were an obligation to effect a re-transfer of the original assets posted as collateral by the Transferor then the obligation would be a proprietary obligation. That it is not a proprietary obligation but rather a purely personal obligation is further evidenced by the provision that "all right, title and interest in" the collateral assets are vested in the Transferee.[453] The effect of this structure is that the Transferor is taking the risk that, once the collateral assets have been posted under the Credit Support Annex, the Transferee will go into insolvency (or become otherwise incapable of performing its obligations under the Annex) because there is no property held to its account.

Representation as to title in collateral property

12-40 Each party represents that there are no prior claims to the collateral property which the party delivers to the other party.[454] As a matter of property law this does not mean that there will not be any prior claims at law or in equity to that collateral property, simply that if there if that party does not have good title to that property then that party will have committed a breach of its obligations under the credit support agreement.

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[448] ISDA Credit Support Annex, para 5(a).
[449] ISDA Credit Support Annex, para 5(a).
[450] ISDA Credit Support Annex, para 5(a).
[451] ISDA Credit Support Annex, para 2.
[452] ISDA Credit Support Annex, para 10.
[453] ISDA Credit Support Annex, para 5(a).
[454] ISDA Credit Support Annex, para 7.

Default

12-41 The default provision in paragraph 6 of the Annex is ambiguously drafted. If there is an event of default caused under the master agreement generally, and any amount remains unpaid or undelivered under the credit support agreement, that amount unpaid under the credit support agreement is an Unpaid Amount which falls to be taken into account in the termination of the master agreement or any terminated transactions under that master agreement. What is unclear here is how this avoids double-counting: if the collateral structure requires the pre-payment of the net exposure between the parties then set-off between the terminated transactions would identify that net exposure in the same amount as the net exposure payable under the credit support agreement. It is suggested that this would be a double payment. An alternative analysis of paragraph 6, which does not repay close attention to the words of the provision, would be that an event of default under the Annex requires payment of that Unpaid Amount under the Annex. The only sensible structure in this context would be to waive the secured party's obligations to make any re-transfer of a Return Amount.

12-42 If a payment or delivery is not made by the time it is supposed to be made under the terms of the Annex, then Default Interest is payable.[455] The amount of interest payable is an amount calculated by reference to the amount which should have been paid at that time at the Default Rate as defined in the parties' contract.[456]

Proprietary collateralisation – the ISDA Credit Support Deed

Taking a right secured over property

12-43 Typically a commercial lawyer would be more comfortable with a form of security which permits recourse to some identified property in the event that the counterparty fails to perform its obligations, as opposed to having some purely contractual right from that counterparty. It is proprietary collateralisation which provides this form of protection, unlike the personal collateralisation considered in the preceding section. Proprietary collateralisation is embodied by the ISDA Credit Support Deed ("the Deed") whereby the contracting parties seek to take proprietary rights in the collateral property advanced. What remains at issue, however, is the precise form of the property right which is acquired by the secured party. The Deed is intended to form a single agreement with an ISDA master agreement, as discussed in chapter 3.[457] The ordinary form of this agreement anticipates that both parties will provide such collateral property as is required to off-set any surplus which they owe to their counterparty across all of the relevant derivatives transactions outstanding between them.

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[455] ISDA Credit Support Annex, para 9(a).
[456] ISDA Credit Support Annex, para 9(a). This term is, oddly, not defined in the Annex. It therefore falls to the parties to define it.
[457] Para 3-11.

The problem in identifying the nature of the property right in the standard contractual language

12-44 The nature of the proprietary right in this context is, however, very problematic. Paragraph 2(b) of the deed provides that:[458]

> 'Each party as the Chargor, as security for the performance of the Obligations: (i) mortgages, charges and pledges and agrees to mortgage, charge and pledge, with full title guarantee, in favour of the Secured Party by way of first fixed legal mortgage all Posted Collateral (other than Posted Collateral in the form of cash), (ii) to the fullest extent permitted by law, charges and agrees to charge, with full title guarantee, in favour of the Secured Party by way of first fixed charge all Posted Collateral in the form of cash; and (iii) assigns and agrees to assign, with full title guarantee, the Assigned Rights to the Secured Party absolutely.'

The principal point to make on the basis of paragraph 2(b) is this: it is impossible to know from this provision what the nature of the secured party's right is. In subparagraph (i) the provision that the relevant party "mortgages, charges and pledges" is simply doctrinally impossible. As was considered chapter 11, a mortgage grants a property right (but not absolute title) in the mortgaged property subject to an equity of redemption, whereas a charge effects no transfer of title but rather suggests an appropriation of property contingent on the satisfaction of underlying payment obligations, whereas a pledge connotes a mere possessory right, or in the ISDA sense of that term[459] connotes a transfer of absolute title. Clearly, a person has one or other of these rights but it is not possible to have all three simultaneously. Matters are further complicated in (ii) where a charge is described and then in (iii) where an "assignment", which ordinarily would mean a transfer of absolute title, is described: a chargee does not take a full transfer of title of the charged property. Therefore, any person intending to use the Credit Support Deed should amend this provision to make it plain exactly which form of right is intended: whether mortgage, charge, transfer of absolute title or mere pledge. As drafted and without more, the right in paragraph 2(b) is so poorly described that it possibly creates no single right at all. At best it would be for a court to decide what form of right is created under the governing law of the contract: it is therefore suggested that the parties to a Deed should specify more precisely the nature of the right which is intended to be created between them.

12-45 The purpose underlying this provision would seem to be that the secured party becomes a chargee of the collateral property such that there is no other charge in existence over that property (whether at all or in such a way as to be able to claim a priority over the rights of the chargee). This is not a mortgage nor is it a pledge. The issue raised is as to whether or not the charge granted would require registration under the Companies Act 1985, as was discussed in chapter 11. If, alternatively, the parties' intention is that the chargee have a proprietary right in the collateral property, then a legal[460] mortgage or even a trust would be more appropriate.

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[458] ISDA Credit Support Deed, para 2(b).

[459] It was discussed in chapter 11 that the ISDA sense of the term "pledge" is not the manner in which this term is ordinarily understood by commercial lawyers.

[460] That is, a legal mortgage as opposed to an equitable mortgage.

The release of the security

12-46 The security will be released in accordance with the following provision:[461]

> 'Upon the transfer by the Secured Party to the Chargor of Posted Collateral, the security interest granted under this Deed on that Posted Collateral will be released immediately, and the Assigned Rights relating to that Posted Collateral will be re-assigned to the Chargor, in each case without any further action by either party. The Chargor agrees, in relation to any securities comprised in Posted Collateral released by the Secured Party under this Deed, that it will accept securities of the same type, nominal value, description and amount as those securities.'

This provision suggests that the charge is released by means of an outright transfer of the collateral property to the secured party. The result would be that absolute title is passed to the secured party: a result which could not obtain if a mortgage were intended, as considered in the previous section. The second sentence of this provision ostensibly obliges the chargee merely to return property of like kind to the charged property. Therefore, this is not really a charge relationship at all; rather, the secured party receives an outright transfer of the property and is able to turn that property to its own account with a purely personal obligation subsequently merely to transfer property of like kind back to the chargor. Ordinarily a fixed charge would entitle the chargee to take possession of the property only if the chargor's payment obligations were not performed. It is unclear, therefore, how there could be said to be a charge in existence here at all when in truth there has been an outright transfer of property.

The preservation of the security

12-47 The deed provides that there will be "preservation of security" such that the "security constituted by this Deed shall be a continuing security".[462] The term "continuing security" is not defined in the documentation. It should be taken to mean that the security is not intended to cease while there are transactions outstanding between the parties. This term is problematic for two reasons. First, the identity of the collateral property will change from time-to-time because the agreement necessarily anticipates that new collateral property will be posted or removed from the fund as the exposure between the parties waxes and wanes: thus, there cannot be a continuing security over all of the property if some of the property can be redeemed during the life of the transaction. Secondly, the term "continuing security" is not a term of art, even though we can guess at what is intended. This issue develops with the following provision of the Deed. We are told that this continuing security "shall not be satisfied by any intermediate payment or satisfaction of the whole or any part of the Obligations but shall secure the ultimate balance of the Obligations".[463] The "Obligations" referred to are "all present and future obligations of that party under the Agreement and this Deed and any additional obligations specified [by the parties in

[461] ISDA Credit Support Deed, para 2(c).
[462] ISDA Credit Support Deed, para 2(d).
[463] ISDA Credit Support Deed, para 2(d).

the schedule to the Deed]".[464] Thus the obligations which are to be secured do not include the *past* obligations of the parties, and this raises issues as to the provision that no "intermediate payment" can discharge the charging obligation. Consequently, we are left with the definition of the "ultimate balance" for which the security must be preserved. This term "ultimate balance" is not defined. It could be taken to refer to satisfaction of all of the outstanding transactions in existence between the parties under the master agreement: however, in relation to many market counterparties there may never be a time at which there are no obligations at issue between the parties. Therefore, if the parties did structure their deed as a mortgage, this might be held to be void as a mortgage on the basis that there would not redemption of the mortgage over the collateral property and thus that there would be no valid equity of redemption.[465]

12-48 The better understanding of this provision would be that, until the outstanding exposure between the party has been satisfied by the party obliged to make payment under the master agreement, the secured party retains a charge over that property; whereas once the outstanding exposure has been satisfied, then the collateral property can be recovered by the other party and the charge therefore ceases over that property.

Custody of the collateral property

12-49 Paragraph 6 of the credit support deed deals with the obligations of secured party in relation to the collateral property. The main obligation is to "exercise reasonable care to assure the safe custody of all Posted Collateral to the extent required by the applicable law".[466] This obligation is made up of two conflicting parts. First, the secured party must take reasonable care to ensure the property's safe custody; secondly, it is required to do so only to the extent required by the applicable law (in the case of this deed, English law) when that applicable law has no general *requirement* that any particular thing be done or not done. To ensure safe custody might involve placement in a segregated account operated by the secured party or it might involve deposit of the property with a third party custodian as trustee: but there is no single thing required by the general law, instead we must look to the Deed for the precise nature of that obligation. Under the terms of the Deed, the secured party is entitled either to retain the property itself or to appoint a custodian.[467] The second obligation is then defined by the deed to be that the secured party or its custodian (if one is used) "shall … open and/or maintain one or more segregated accounts … in which to hold Posted Collateral".[468] Significantly, then, the secured party and the custodian (as appropriate)

> "shall each hold, record and/or identify in the relevant Segregated Accounts all Posted Collateral (other than Posted Collateral in the form of cash) held in relation to the Chargor, and, except as provided otherwise herein, such Collateral *shall at all times be and remain the property of the Chargor* [emphasis added] and segregated from the property of the Secured Party or the

[464] ISDA Credit Support Deed, para 12.
[465] See para 11-52.
[466] ISDA Credit Support Deed, para 6(a).
[467] ISDA Credit Support Deed, para 6(b)(i).
[468] ISDA Credit Support Deed, para 6(c).

relevant Custodian, as the case may be, and shall at no time constitute the property of, or be commingled with the property of, the Secured Party or such Custodian".[469]

The italicised portion of this provision ensures that the collateral property is owned by the chargor throughout the transaction. Given that the property has been paid into an account in the name of the secured party or the custodian, this property must be owned at common law by that secured party or custodian and in turn the chargor can only have equitable ownership of that property. Therefore, the effect of this provision is most likely to create a trust over the collateral property. This would be made more evident if the provision simply read that "the Posted Collateral shall be held on trust by the [secured party] or the custodian (as appropriate) for the Chargor". As drafted the trust is required to be inferred from the circumstances, which is unfortunate if a trust is intended or doubly unfortunate if a trust is not intended.

12-50 As considered above, this provision appears, *prima facie*, to establish a trust over the collateral property. And yet, as discussed above, paragraph 2(b) provided that the parties agreed to mortgage, charge and pledge the collateral property. If the effect of paragraph 6(c) is intended to be to impose an equitable charge over the collateral property as opposed to a trust, then that intention should be made plain in the drafting. More confusingly yet, paragraph 2(c) provides that the obligation to post collateral property is discharged by delivery of collateral property of like kind (where paragraph 2(c) provides that the "Chargor agrees [and thus binds itself] … that it will accept securities of the same type") as opposed only to being capable of discharge by transfer back of the very property which was originally supplied by the chargor. Holding this collateral property in segregated accounts could be analysed as creating a beneficial interest under a trust in specific property, rather than merely a right to receive a transfer back of property of a like kind. There is therefore, across paragraphs 2 and 6, the possibility that the secured party bears on the one hand purely personal rights and on the other hand proprietary rights of indeterminate kind. In either event the deed provides that the secured party has no right to use the property.[470]

12-51 Thus the drafting of the Credit Support Deed is potentially self-contradictory because it contains mention of so many proprietary concepts and permits analysis of further forms. It is advised that users of these structures prepare their own documentation, based perhaps on the ISDA standard, which makes plain which type of proprietary right the secured party is intended to receive.

12-52 It is suggested that the only structure which will meet both objectives in this context is the trust. To avoid the need to register a charge, a trust should be used. To ensure that the secured party is required to segregate the collateral property from all other property, a trust whereby the secured party holds the collateral property on trust for the benefit of the chargor would be advisable. The additional advantages of the trust structure are that any distributions attaching to the underlying property will also

[469] ISDA Credit Support Deed, para 6(c).
[470] ISDA Credit Support Deed, para 6(d). This raises the question why the secured party may return property other than the original property to the chargor.

form part of the trust fund in turn[471] and the secured party as trustee will owe fiduciary obligations to the chargor.[472] The issues in relation to trust structures, as to certainty of subject matter, were considered in chapter 11.[473]

Rights of enforcement

12-53 The secured party, in spite of the fiduciary obligations which he may owe in relation to the collateral property, may take beneficial title in some or all of the collateral property in any one of three occasions: a Relevant Event (being an event of default within the terms of the deed), an Early Termination Date pursuant to an event of default or termination event under the master agreement, or a Specified Condition which is stipulated specifically by the parties in the schedule to the deed. The three forms of Relevant Event stipulated in the Deed:[474] first, an event of default under the master agreement; secondly, a failure to make any transfer of collateral property under the Deed; or thirdly, failure to perform any other obligation which continues for 30 days after notice of that failure has been given to the defaulting party. In the event of any of these three occasions, the secured party is able to deal with the collateral property as though its absolute owner. In relation to property other than money, the secured party is empowered to sell the property and to use the proceeds to set off against its exposure to the counterparty. In relation to money, the secured party is able to use that money to set off against its exposure to the counterparty, including making any necessary currency conversions. The secured party is purportedly granted a power of attorney on behalf of the chargor in relation to any rights of the chargor to deal with the collateral property.[475] A purchaser of the collateral property in good faith is stipulated to take good title in the property.[476] However, whether or not the purchaser can take good title may depend on the validity of the chargor's title, although in equity a bona fide purchaser for value without notice of any other person's rights will take good title in the purchased property.[477]

12-54 [*this section is not reproduced here because it is not on the course.*]

LEGAL ISSUES IN COLLATERAL STRUCTURES

Distinguishing between transfer of title, pledge, and trust over collateral

12-55 The foregoing discussion demonstrates that there is no single structure used for collateral agreements. Rather, any combination of the techniques considered in chapter

[471] Otherwise under the deed, the secured party has no obligation to collect distributions in relation to the collateral property (ISDA Credit Support Deed, para 6(e)) although any distributions collected must be transferred to the chargor (ISDA Credit Support Deed, para 6(f)).
[472] See Thomas and Hudson, *The Law of Trusts* (OUP, 2004) 307 *et seq*.
[473] Para 11-12.
[474] ISDA Credit Support Deed, para 7.
[475] ISDA Credit Support Deed, para 8(b).
[476] ISDA Credit Support Deed, para 8(c).
[477] *Westdeutsche Landesbank v Islington* [1996] AC 669.

11 *Taking security in financial derivatives* may be used. A summary of the distinctions between them are considered in this section. In a pledge structure the party merely transfers possession of the collateral to the recipient, whereas in a transfer of title arrangement the party posting collateral transfers title outright to the assured party. The secured party, on receiving the collateral, in a transfer of title arrangement is entitled to treat that property entirely as its own and therefore to sell it, mortgage it or deal with it in any way that an absolute owner would be entitled to behave with it. The only obligation which the assured party bears is to return property of a like kind if its exposure to the counterparty under the transaction falls. That obligation to return property of a like kind means that the original property posted as collateral does not have to be returned; rather, it is only similar property or even its equivalent value in cash which is to be returned.

12-56 In a retention of title structure, the assets would be "lent" only – in the market argot, where that actually connotes a transfer of possession without any necessary transfer of title – by the party posting collateral. Therefore, the party posting collateral does not surrender title in those assets to the assured party. Rather the assured party will acquire possession of those assets and only a lien over those assets. That means that the assured party has possession of the assets but no rights of ownership whether to sell that property, mortgage it or deal with it in any other way. A lien may crystallise into a proprietary right if the contract between the parties containing the lien entitles the assured party to convert those assets once the counterparty has failed to perform the relevant obligations under the derivatives agreement, or where it has committed some event of default under the master agreement: the means for so doing were considered in Chapter 11. However, in the absence of any breach of the agreement or in the absence of the commission of any event of default, the party posting collateral retains ownership rights in the property.

12-57 In a trusts structure a trustee would hold the posted collateral on trust such that both parties had some contingent beneficial right in the property. The assured party's beneficial right would be contingent on the performance of the counterparty such that the assured party's right would not vest in it (or, crystallise) until there was some default committed by the counterparty. Similarly, the counterparty's right would vest at the time its obligations to the assured party were satisfied. The principal difficulty with this structure is considered below in relation to those question of taking property rights over bonds issued under a global note.[478]

12-58 Which of these analyses is applicable to any set of factual circumstances is dependent on the choice which the parties make in structuring their credit support documentation. For example, the ISDA Credit Support Annex pre-supposes that the parties will make such an express selection in their documentation. Clearly, some of these issues are general commercial issues and some of them are purely legal issues. On the whole though, they are issues which a lawyer must consider and deal with in framing collateral documentation. This section will first consider the commercial issues covering the provision and taking of collateral. Then it will consider the legal issues surrounding collateral. Finally, it will examine some of the regulatory and inter-party alternatives to *ad hoc* collateralisation, as practised in the market currently, which produce the same credit amelioration effect.

[478] Para 12-19.

Proprietary rights under global notes

12-59 There is an issue surrounding the use of bonds and other commercial paper as collateral. The dematerialisation of such financial obligations has had the effect that the question of asserting title over those securities becomes counter-intuitive. The problem, at root, is as follows.[479] The publicly-issued debt market has developed a pragmatic response to the dangers of physical bearer securities being misappropriated from their rightful owners. Much in the same way that cash can be stolen and spent (usually) anonymously, bearer securities can be sold or lost and then misapplied. The market developed the use of global notes which represent rights in the bearer securities by means of a title registration system. The bearer securities themselves are held physically in secure vaults so that no subscriber actually receives their physical security. The global note and the debt issue typically express the securities to be bearer securities. Each subscriber to the issue is required to register their title with the custodian. The commercial risks associated with physical custody are thus removed.

12-60 The legal conundrum that is created surrounds the creation of other rights in the global-note-bearer-securities. If the registered title-holder in that security declares itself a trustee of the security for another person under English law, that other person will acquire the rights of a beneficiary under English trusts law against the title-holder. What is not clear is what rights will that other person have to enforce rights in the security which is expressed to exist in the jurisdiction where the bearer notes are physically deposited, if the system of law applicable in the situs of the deposit does not recognise the rights of a beneficiary under an English trust but only the property rights of the registered title-holder. Such unenforceability of the trust structure would render ineffective any collateral agreement based on a trust over the bearer notes.[480]

12-61 The further problem of English trusts law which arises is the following. To create a valid express trust under English law the property comprising the trust fund must be separately identifiable.[481] Therefore, where a beneficiary attempts to assert rights under the law of trusts over a trust fund comprising a portion of a total holding of intangible securities, that trust will not be found valid unless the specific securities at issue are identified.[482] Therefore, any proprietary rights asserted over the trust fund would similarly fail.[483] This issue was considered at paragraph 11-19 *et seq*. There is authority, however, that with reference to a trust declared over a portion of a total holding of ordinary shares, there is no need to segregate those shares which are to be

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[479] For an extended discussion of this issue of global custody see Benjamin, *The Law on Global Custody* (Butterworths, 1996).
[480] See, for a general commercial analysis of this issue Duffett, "Using trusts in international finance and commercial transactions" [1992] *Journal of International Planning* 23.
[481] *Re Goldcorp* [1995] 1 A.C. 74; *Re London Wine (Shippers) Ltd* [1986] P.C.C. 121; cf.: Goode "Ownership and Obligation in Commercial Transactions", (1987) 103 L.Q.R. 433; Ryan, "Taking Security Over Investment Portfolios held in Global Custody", [1990] 10 J.I.B.L. 404 .
[482] [1995] 1 A.C. 74.
[483] As Benjamin sets out, there is no obligation typically on the depositary to segregate the assets in the manner which English trusts law would appear to require: Benjamin, *The Law on Global Custody* (Butterworths, 1996), 131. See also Prime, *International Bonds and Certificates of Deposit* (Butterworths, 1990), 4 *et seq.* on the role of euro-currencies in this context.

held on that trust.[484] It is suggested that this latter approach will only be effective where there is, for example, no issue of insolvency and a number of creditors seeking to claim rights in the shares which is greater than the number of shares available to be distributed among them.[485] In relation specifically to money, which might be thought to be the most obvious example of property which is inter-changeable, there is a requirement that the fund be segregated within a bank account before any trust can be imposed equal to a liquidated sum held with other moneys in a bank account.[486]

12-62 There is one final issue as to the role of the custodian of the global note as a trustee in itself. A trustee may or may not be appointed in respect of the global note. Further, the custodian may not be expressed to be a trustee and yet appear to have the trappings of a trustee in a jurisdiction where the trust concept is not recognised. The issue as to the enforceability of trustee obligations is therefore a vexed one. This issue arises generally with reference to bond issues and in particular in respect of depositary receipts.[487]

Shortcomings in standard market documentation for collateral

12-63 The discussion of the ISDA Credit Support Deed identified a number of deficiencies in the description of the nature of the rights which the secured party acquires: see in particular in paragraphs 12-44, 12-45, 12-47 and 12-49. There are other problems, however. The impact of the decision in *Westdeutsche Landesbank v Islington*[488] is that – even though it was accepted that the parties would have expected to receive compound interest on their money in ordinary circumstances and that they had entered into the standard form contracts – parties to financial contracts will not be entitled to proprietary remedies where those agreements are held to be void. Furthermore, it appears from the decisions that any contractual provision which sought to preserve such proprietary rights would itself be void, making the retention of title in such agreements impossible.

Therefore, the key problem with the decision in *Westdeutsche Landesbank v Islington* and all of the other local authority swaps cases is that the courts intentionally overlook the fact that the parties had allocated the risks of their transactions. Leggatt LJ considers that there is no substantive issue to consider on the facts of *Westdeutsche Landesbank v Islington* when he held that:-

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[484] *Hunter v. Moss* [1994] 1 W.L.R. 452, [1994] 3 All E.R. 215; see also (1994) 110 L.Q.R. 335. Also possibly *Re Stapylton Fletcher Ltd* [1944] 1 W.L.R. 1181 would be of some support as to the lack of need for segregation, although the case relates only to legal interests in the chattels at issue.

[485] See *Westdeutsche Landesbank v. Islington LBC* [1996] A.C. 669, [1996] 2 All E.R. 961 *per* Lord Browne-Wilkinson approving the decision in *Re Goldcorp, op cit.*.

[486] *Mac-Jordan Construction Ltd v. Brookmount Erostin Ltd* [1992] B.C.L.C. 350; *Re Jartray Development Ltd* (1982) 22 B.L.R. 134; *Rayack Construction v. Lampeter Meat Constructions Co Ltd* (1979) 12 B.L.R. 30; *Nestle Oy v. Lloyds Bank plc* [1983] 2 Lloyds Rep. 658; *Concorde Constructions Co Ltd v. Colgan Ltd* (1984) 29 B.L.R. 120. Cf.: *Swiss Bank v. Lloyds Bank* [1979] 2 All E.R. 853, affirmed [1981] 2 All E.R. 449, whereby a claim to an unsegregated fund might nevertheless give rise to a charge.

[487] See Benjamin, *The Law on Global Custody* (Butterworths, 1996), 41 *et seq.*.

[488] [1996] A.C. 669.

> "The parties believed that they were making an interest rate swaps contract. They were not, because such a contract was ultra vires the local authority. So that they made no contract at all.'[489]

Therefore, the courts made no reference at all to any of the contractual terms agreed between them. The result of this refusal to consider the standard market contracts will include those terms dealing with credit risk management, as well as terms dealing with the creation of commercial interest rate swap obligations.[490] Therefore, the further question arises: would a guarantee or collateral agreement be valid if it were annexed to that contract? That is, would the banks have been able to enforce the terms of any guarantee extended to them by the local authorities? It would follow from the courts' insistence that the contracts are to be ignored, that any credit support document attached to the interest rate swap agreement would be similarly void. Therefore, if the local authorities had ring-fenced a particular bank account with an amount of money in it, held on trust for the banks contingent on the authorities' failure to perform under the main agreement, the banks would have had no recourse to that money because the agreement creating the trust would be unenforceable as being void *ab initio.* Therefore, a collateral agreement would be unenforceable unless it was created at arm's length from the master agreement and any confirmation to enable it to survive as a free-standing arrangement.

Given the decision of the House of Lords (which was unanimous on this point) that there was no ground for the banks having a proprietary interest in any property held by the local authorities, the logical conclusion of their reasoning is that there would have been no way in which the banks could have reserved to themselves any proprietary interest in the money paid to the local authorities by means of either the master agreement or any other document incorporated into it in the standard market format.

12-64 [*this section is not reproduced here because it is not on the course.*]

12-65 The salutary lesson for those attempting to create collateral arrangements is therefore to attempt to achieve their goal in a context which permits the collateral structure to be free-standing and not bound into the void master agreement and confirmations. This is a direct abnegation of the principle of achieving single agreements through a credit support annex which is propounded by ISDA.[491] However, it is contended that the contracting party must choose between an attempt to manage the risk of counterparty insolvency by achieving broad close-out netting under a single, all-enveloping master agreement, and a viable collateral structure which will manage credit risk by retaining proprietary rights in some specified category of assets even though the master agreement is held to be void.[492]

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[489] [1994] 4 All E.R. 890, 967.
[490] On this, see para 9-03.
[491] Para 3-11.
[492] See Hudson, "Proprietary rights in financial transactions", *Amicus Curiae*, Issue 4, February 1998, 9.