1 The essence and importance of security

This book compares and contrasts American and English approaches towards the recognition and enforcement of security interests in personal property. United States law is found almost exclusively in the Uniform Commercial Code (UCC), whereas English law is derived from a variety of sources, both statutory and non-statutory. If one could compare the two systems in a word, one might say that the US approach is functional whereas the English approach is pragmatic though the overall tendency is to be facilitative and enabling. There are almost no limits on the category of assets that may be used as security, and the procedures for the creation of security interests are quite flexible and informal. The law is pragmatic rather than functional, as transactions that serve the same economic ends are often visited with different legal consequences. The latter state of affairs has attracted criticism but so far the legislature has resisted efforts to recast English law along the lines of Article 9 of the US UCC. Article 9 attempts to apply similar rules to all transactions that in economic terms are intended to serve as security. Moreover, Article 9 embodies a near-comprehensive registration obligation, i.e. public notice of security interests must be given. Under English law, by contrast, certain transactions that in economic terms might be regarded as creating a security interest are not subject to any public registration or filing requirements that might alert other potential creditors – or, indeed, the world at large – to the existence of the security interest.

The definition of security interests

The contrasting approaches between England and the US are even manifest when one considers a necessary starting-point for any analysis: the definition of security. The term ‘security interest’ is defined in Article 1(37) of the UCC as meaning an interest in personal property that secures either payment of money or the performance of an obligation and also the interest of a buyer of accounts. By contrast, there is no statutory definition of ‘security interest’ in England and so one must
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fall back on judicial interpretations that, necessarily, are conditioned and qualified by the circumstances of a particular case.\(^1\) A notable example is provided in the judgment of Browne-Wilkinson V-C in Re Paramount Airways Ltd,\(^2\) where the following definition of security was accepted: ‘Security is created where a person (the creditor) obtains rights exercisable against some property in which the debtor has an interest in order to enforce the discharge of the debtor’s obligation to the creditor.’

Clearly this is not a comprehensive definition, for it does not recognise the fact that security may be granted to secure the obligations of somebody other than the grantee. Professor Sir Roy Goode, acknowledging the ‘third party’ issue, has defined a security interest as a right given to one party in the asset(s) of another party to secure payment or performance by that other party or by a third party.\(^3\) On his analysis a security interest:\(^4\)

(1) arises from a transaction intended as security;
(2) is a right in rem;
(3) is created by a grant or declaration, not by reservation;
(4) if fixed, or specific, implies a restriction on the debtor's dominion over the asset;
(5) cannot be taken by the creditor over his own obligation to the debtor.

These characteristics ascribed to a security interest cannot be accepted in their entirety – in particular point 5, which suggests that it is a conceptual impossibility for a bank to be granted a charge over its own indebtedness to a customer.\(^5\) There is a strong contrary view that a debt is simply an item of property and, like any other item of property, it may be charged to anybody that the creditor wishes.\(^6\) This pragmatic approach appealed to Lord Hoffmann in Re BCCI (No. 8),\(^7\) who spoke for a unanimous House of Lords in categorically rejecting the doctrine that it was conceptually

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\(^1\) See the statement in P. Ali The Law of Secured Finance (Oxford University Press, 2002) at p. 15: ‘Despite the obvious importance of the concept of “security interest” to the law of secured transactions, the concept continues to evade precise definition.’

\(^2\) [1990] BCC 130 at 149. See also the comments of Lord Scott in Smith v. Bridgend County Borough Council [2002] 1 AC 336 at 355 that ‘a contractual right enabling a creditor to sell his debtor’s goods and apply the proceeds in or towards satisfaction of the debt is a right of a security character’.


\(^4\) Goode Legal Problems at pp. 1–2.

\(^5\) As was held by Millett J in Re Charge Card Services Ltd [1987] 1 Ch 150.


\(^7\) [1998] AC 214.
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impossible for a security interest to be taken by a creditor over his own obligations to the debtor. In Lord Hoffmann’s view, the law should be slow to declare a practice of the commercial community to be conceptually impossible given the fact that the law was fashioned to suit the practicalities of life. He added that legal concepts such as ‘proprietary interest’ and ‘charge’ were no more than labels given to clusters of related and self-consistent rules of law. Such concepts did not have a life of their own from which the rules were inexorably derived. In fact, English law has long taken a non-doctrinaire view towards the recognition and enforcement of security interests in property. Lord Hoffmann highlighted the example of the charge which, as he pointed out, is a security interest created without any transfer of title or possession to the beneficiary. An equitable charge could be created by an informal transaction for value and over any kind of property. 8 ‘The workhorse of the secured credit industry in England has traditionally been the charge, particularly the floating charge, 9 but there are many different types of security right recognised under English law. The law on both sides of the Atlantic is similar in generally granting secured creditors priority over unsecured creditors. Priority over other creditors in the event of debtor insolvency is commonly identified as the most important reason behind the taking of security, but there are other important reasons why a creditor might wish to take security. The rest of the chapter will look at these reasons and also ask why the law permits the taking of security as well as whether the recognition of security is economically efficient. 10

8 See also the definition of security in Edwards v. Flightline Ltd [2003] 1 WLR at 1200, where the Court of Appeal accepted the proposition that

an agreement between a debtor and a creditor that the debt owing shall be paid out of a specific fund coming to the debtor, or an order given by a debtor to his creditor upon a person owing money or holding funds belonging to the giver or the order, directing such person to pay such funds to the creditor, will create a valid equitable charge upon such fund, in other words, will operate as an equitable assignment of the debts or fund to which the order refers. An agreement for valuable consideration that a fund shall be applied in a particular way may found an injunction to restrain its application in another way. But if there is nothing more, such a stipulation will not amount to an equitable assignment. It is necessary to find, further, that an obligation has been imposed in favour of the creditor to pay the debt out of the fund. This proposition is derived from the judgment of the Privy Council in Palmer v. Carey [1926] AC 703 at 706–7, and was also approved by the House of Lords in Swiss Bank Corporation v. Lloyds Bank Ltd [1982] AC 584 at 613.

9 A floating charge is a charge which permits the grantor to carry on business in the normal way until some event occurs which causes this management freedom to terminate.

10 The ‘efficiency of secured credit’ debate has become something of a veritable cottage industry in the US. The literature is truly enormous and a lot of contributions seem to consist of assertions or attempts to demonstrate that most previous contributions to the debate have been flawed: see J. White ‘The Politics of Article 9: Work and Play
Finally the chapter will consider the fate of proposals, in both England and the United States, to limit the full priority of secured credit.

**Reasons for the taking of security**

An important point to note in this connection is that security is pervasive. The law does not require the taking of security but nevertheless as one American commentator puts it, banks pursue the taking of security with apostolic zeal. Commonly banks argue for stronger, broader and more effective security rights but not for narrower and weaker ones. The controversy over security rights in deposit accounts provides a good example. In both England and the US courts recognised banks as having rights of set-off in situations of mutual indebtedness, i.e. a bank could set off a


**11** See White ‘Work and Play’ at 2091. White says:

Unless these secured creditors can be convinced that it is in their interest to have Article 9 abolished, Article 9 will continue and the debates about its efficiency will be limited to academics. At most, we academics might snatch a small morsel off the table while the banks’ attention is diverted; we will not be seated at the main course.
The essence and importance of security customer’s deficit on its loan account with credit balances on other accounts the customer might have with the bank. Nevertheless, because of possible weaknesses in set-off rights vis-à-vis third parties banks in both countries pressed for legislative or judicial recognition of full-blown security interests in deposit accounts and their wishes were realised with the decision in Re BCCI (No. 8) and the revision of Article 9. It seems that the appetite of banks for secured credit has expanded over the years. One leading US commentator has spoken of a dramatic increase in the number and size of firms that rely on secured credit as their principal means of financing both ongoing operations and growth opportunities. Previously, with a few exceptions, secured financing principally had served second-class markets as the ‘poor man’s’ means of obtaining credit. Now, it has become the linchpin of private financing, prompting even large firms to employ leveraged buyouts as a means of fleeing public equity markets for the safe harbors of Article 9.

Put simply, the taking of security maximises the creditor’s prospects of recovery in the event of the debtor’s insolvency. This is commonly identified as the first, and most important, reason for the taking of security. When a company or other debtor declines into insolvency there is, by definition, insufficient money in the corporate kitty to satisfy everybody. The basic principle of insolvency law is one of ‘equality of misery’ or equality of treatment of creditors, i.e. pari passu distribution of available assets amongst creditors. This hallowed principle of insolvency law is, however, in fact somewhat hollow. Amongst other things, the law of insolvency in some jurisdictions – England included – privileges certain categories of claims by according them preferential status. The categories of preferential debt are set out in Schedule 6 to the Insolvency Act 1986 and, until the reforms introduced by the Enterprise Act 2002, 12

12 Re Charge Card Services Ltd [1987] Ch 150; on which see Goode Legal Problems at pp 124–9. For the position in the United States see the detailed report Use of Deposit Accounts as Original Collateral by the UCC Permanent Editorial Study Board (1992).
14 The revised Article 9 in so far as deposit accounts as original collateral is concerned departs fairly radically from traditional perfection and priority rules with the only permissible method of perfecting such a security interest being by ‘control’ rather than by ‘filing’; see generally on this area G. McCormack ‘Security Interests in Deposit Accounts: An Anglo-American Perspective’ (2002) Insolvency Lawyer 7.
16 Section 107 Insolvency Act 1986 which applies to voluntary liquidations and rule 4.181(1) Insolvency Rules 1986 applicable to compulsory liquidations.
17 See generally Mokal ‘Priority as Pathology’, who argues that the pari passu principle is rather less important than it is sometimes made out to be, and does not fulfil any of the functions often attributed to it.
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have basically comprised certain tax and employee claims. A variety of arguments have been advanced for recognising claims by particular categories of creditors to preferential status. As far as claims by governmental entities are concerned, such creditors are said to be involuntary and not consciously to have assumed the risk of the debtor's insolvency. It is also arguable that they are not in a position effectively to monitor the debtor's behaviour and to assess the risk of default or insolvency. The main justification for according employees preferential status centres on inequality of bargaining power and rests on the fact that employees lack the economic strength to bargain for security rights and, consequently, may lose out in their employer's insolvency. The Enterprise Act 2002 abolishes Crown preference (but not employee preference) as part of an 'integrated package of measures' whereby in return secured creditors lose some of their existing entitlements.

Preferential creditors are paid ahead of general creditors and also one type of secured creditor – the floating-charge holder – but not other secured creditors. Financially distressed firms commonly use the Revenue as effectively an additional source of credit and an expansion in the volume of preferential debts has led secured lenders to push forward the frontiers of the fixed-charge security into territory that has traditionally been occupied by the floating charge. These efforts may have been

18 Section 251 Enterprise Act 2002 removes paras. 1 and 2 (debts due to Inland Revenue), paras. 3–5C (debts due to Customs and Excise) and paras. 6 and 7 (social security contributions) from Schedule 6 to the Insolvency Act 1986 and thereby puts into effect the abolition of Crown preference.


21 The philosophy underlying the Enterprise Act is explained in the White Paper Insolvency: A Second Chance (2001) Cm 5234 (London, TSO, 2001) though as the legislation was in the process of gestation the banks won some significant concessions from the government.

22 For a succinct statement of the position see the White Paper Insolvency: A Second Chance at para. 2.20: ‘The preferential status of certain claims by employees in insolvency proceedings, such as wages and holiday pay within certain limits, will remain, as will the rights of those subrogated to them.’

23 Holders of existing floating charges, however, enjoy significant short-term benefits from the Enterprise Act, for they benefit from the immediate abolition of Crown preference but are not subject to any requirement to set aside a proportion of floating-charge recoveries for the benefit of unsecured creditors. The latter requirement applies only with respect to floating charges created after certain prescribed dates.

24 See the comments of Lord Millett in the Brumark case [2001] 2 AC 710 at para. 17: ‘By the 1970s, however, the banks had become disillusioned with the floating charge. The
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stymied by the decision of the Privy Council in the *Brumark* case. Be that as it may, the failure on the part of a bank to take security will not only reduce the bank to the category of unsecured creditor but also means that its claim will rank after preferential creditors.

The taking of security maximises a creditor’s possibilities of recovery, whereas placement in the ranks of the ordinary unsecured creditor may leave a person with little hope of recovering anything. Judicial utterances to this effect are well borne out by the empirical evidence. According to data from the Society of Practitioners of Insolvency, on average 75 per cent of cases return nothing to unsecured creditors and in only 2 per cent of cases can they expect to receive 100 per cent returns. More recent findings suggest recovery rates for banks in the order of 77 per cent, and this compares with 27 per cent for preference creditors and negligible returns for unsecured trade creditors.

Security serves a raft of other functions as well as maximising the prospect of recovery in a debtor’s insolvency. The second reason for taking security focuses on control. If a lender takes security over a specific asset of the borrower then the borrower relinquishes exclusive control over that asset. The borrower may be more likely to pay the lender than general creditors because failure to pay may result in the loss of an asset that is essential to the conduct of the borrower’s business. In certain circumstances this factor may be the primary reason behind the taking of security by the lender. In the American legal literature this point has been highlighted in the setting of equipment financing. As Professor Baird puts the matter:

In other contexts, the primary purpose of a security interest may be to give a secured creditor a priority over a firm’s other creditors in the event that the firm encounters financial distress and cannot meet its fixed obligations. In the case


See DTI Company Rescue and Business Reconstruction Mechanisms at para. 57. The information is drawn from research carried out by Professor Julian Franks and Dr Oren Sussman ‘The Cycle of Corporate Distress, Rescue and Dissolution: A Study of Small and Medium Sized UK Companies’ (April 2000).

See generally Scott ‘Relational Theory’; Schwartz ‘Theory of Loan Priorities’.

of the equipment financier, however, the security interest may serve a different purpose. A lender may lend because it is confident that the procedures available to it in the event of default will allow it to realise much of the amount of the loan in the event of default. Thus, the lender may take a security interest in large part because its rights upon default against the debtor are greater than they would be if it did not take security.

Thirdly, security over specific assets may enable the lender to sell off or take possession of the assets without having to seek judicial or other official intervention. This basically remains the position under the Enterprise Act 2002. Under existing law before the reforms introduced by the Enterprise Act 2002 take effect, the holder of a floating charge over the whole or substantially the whole of a company's assets may appoint an administrative receiver who may carry on the running of the business of the company with a view to optimal realisation of assets. 30 Although designated by statute as an agent of the company, 31 the basic function of the receiver is to realise the assets of the company for the benefit of the secured lender who made the appointment. The Enterprise Act abolishes administrative receivership in the generality of cases 32 but still allows a floating-charge holder to make an out-of-court appointment of an administrator. 33 An administrator has somewhat wider duties than an old-style administrative receiver, including a duty to rescue the business of the company if at all viable. 34 Nevertheless, the essential point remains that even under the new regime a secured lender will retain a substantial 30 Section 29(2) Insolvency Act 1986. For a defence of receivership as traditionally understood see J. Armour and S. Frisby ‘Rethinking Receivership’ (2001) 21 OJLS 73. They examine two proposals for the reform of insolvency law: firstly, the idea of a debtor-in-possession reorganisation regime; and secondly, the imposition of more expansive duties of care and/or loyalty on administrative receivers and suggest that the case for reform is not made out.
31 Section 44 Insolvency Act 1986.
32 Section 250 and Schedule 16 of the Enterprise Act; but nevertheless, there are a substantial number of cases where the holder of a qualifying floating charge may still appoint an administrative receiver. Moreover, holders of existing floating charges continue to enjoy the right to appoint administrative receivers. The legislative restriction on the appointment of administrative receivers only applies with respect to floating charges created after 15 September 2003.
33 Section 248 and Schedule 16 of the Enterprise Act.
34 According to Schedule 16 para. 3(1) of the Enterprise Act, the administrator of a company must perform his functions – (a) with the objective of rescuing the company, or (b) where it is not reasonably practicable to rescue the company or achieve the result mentioned in paragraph (b), with the objective of realising property in order to make a distribution to one or more secured or preferential creditors. Furthermore, even in cases where rescue is not reasonably practicable, an administrator must not unnecessarily harm the interests of the creditors of the company as a whole.
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measure of control over realising the assets of financially distressed firms. Timing the sale of secured assets is important from the point of view of increasing recoveries and it also avoids giving the appearance of a ‘forced sale’. If the lender can control the time and manner of realisation of secured assets, then this strengthens his hand greatly both from a negotiating position vis-à-vis the borrower and in terms of optimising value from the security. As one US observer has noted aptly: ‘Security is desirable because it makes available summary legal procedures that bypass the slowness with which the mills of justice sometimes grind.’ ‘Self-help’ and other extra-judicial remedies remain controversial in many jurisdictions, however, and England appears to be something of an exception, up to now, in allowing out-of-court enforcement of security by a secured lender.

Fourthly, there is an argument that the taking of security obviates the need to conduct a possibly detailed and expensive investigation into the financial circumstances of the borrower. In theory, all that the lender need do is to check the value of the secured property so as to ensure that it serves as adequate security for the loan. Of course, the prudent lender will allow for a certain excess in the value of the security over the amount of the loan to cover for legal and practical obstacles to enforcement as well as unfavourable enforcement timing and conditions. In the words of one commentator, secured lending substitutes information about the secured property offered by the borrower for information about the borrower himself:36

At its extreme, secured lending makes a nearly total substitution: a pawnshop, for example, asks no more information about the borrower than is necessary to identify the borrower in the event that the borrower has stolen the pawned good. Rather, the pawnshop operator must know the value of the collateral and the price than can be realised from selling that collateral. The history of the borrower and the purpose of the loan are immaterial.

During the government review of company rescue and business reconstruction mechanisms that preceded the Enterprise Act, banks, however,

36 Heywood Fleisig ‘Economic Functions of Security in a Market Economy’ in J. Norton and M. Andreias eds. Emerging Financial Markets and Secured Transactions (Kluwer, 1998) p. 15, at 19. Fleisig examines legal deficiencies in the framework governing secured transactions over movable property in Argentina. Theoretical and empirical perspectives are presented and the author concludes that ‘three-quarters of the problem of high interest rates facing borrowers who do not use real estate as collateral is a problem that arises from the laws and legal procedures that govern lending against immovable property’. According to the author (at p. 34): ‘In most transitional and developing economies, instituting a modern system of secured transactions would probably reduce the cost of financing movable equipment to a few hundred basis points over the government dollar borrowing rate.’
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were concerned to emphasise that they advanced funds based on an assessment of the viability of the borrower’s business plans rather than on a simple calculation of the value of the property offered as collateral. The British Bankers’ Association (BBA) said:37 ‘There is a perception . . . that banks are effectively pawnbrokers, lending only against security; or collateral. The truth is that banks principally lend against viability and cashflow. Collateral is taken as a contingency if things do not work out as planned.’ Numerous respondents to the DTI consultation exercise stressed that the real worth of security rights, and in particular the floating charge, was the control rights it gave the holder in the event of a default by the borrower.

While the achievement of priority over other creditors in the event of the debtor’s insolvency is often identified as the single driving force behind the taking of security, it certainly seems that the focus on force and liquidation outcomes is to present too simplistic a picture. An important empirical study that highlights the cycle of corporate distress with a concentration on small and medium-sized UK companies suggests a more complex pattern of lender behaviour.38 In short, the variety of security devices available to a bank lender place it in a powerful position from where it can exert pressure over the company in financial distress, both within formal insolvency procedures, and in informal rescue contexts. This study demonstrates the existence, even in the case of small and medium-sized companies, of an elaborate rescue process outside formal procedures:

About 75% of firms emerge from rescue and avoid formal insolvency procedures altogether (after 7.5 months, on average). Either they are turned-around or they repay their debt by finding alternative banking sources. . . . Turnarounds are often accompanied by management changes, asset sales, and new finance or directors’ guarantees. There is evidence that these changes significantly influence the bank’s response and the likelihood of a successful outcome.39

Banks, it appears, use their control rights to encourage or force financially distressed firms to undergo restructuring that would include downsizing and management replacement.

As far as larger quoted companies in the UK are concerned, a well-established but informal rescue procedure exists: the so-called ‘London

37 See the quotation at p. 50 of DTI Company Rescue and Business Reconstruction Mechanisms.