

Secured Transactions Law Reform Project
Working Group A**Case for reform paper series****Methods of perfection****Introduction**

1. This paper has been produced by the Working Group A (WGA) of the Secured Transactions Law Reform Project. Its purpose is to consider how the current state of law concerning perfection of security interests in England might be improved. It summarises the work done by the WGA since February 2012. Views presented in this paper are provisional and open to further discussion. In addition, they are expressed in members' private capacities and should not be attributed to any institution or organization where members work.
2. Security interests in property enable financiers to look to security to obtain payment in priority to other creditors, which is particularly important in the event of the debtor's liquidation or bankruptcy. This advantageous status of secured creditors can be perceived as prejudicial to the interests of other creditors. Rather than banning security, it is better that a legal system bestows upon third parties, particularly other creditors, an opportunity to discover security before dealing with the debtor. Discoverability of security should therefore be safeguarded. A transparent system is likely to help prevent fraud. It is also important that the cost of discoverability of security is as low as possible. This is likely to help reduce the cost of credit.
3. We think that as a general rule security should not be effective against other creditors, trustee in bankruptcy, company liquidators or administrators unless it is discoverable. We refer to the steps needed to ensure effectiveness of security against other creditors, trustee in bankruptcy, company liquidators or administrators as "perfection". Whether or not security has been perfected is also relevant to priority but perfection does not guarantee priority, this being governed by priority rules.
4. In our view, registration and control should be the main methods of perfection. Control would be used as a means of perfecting security interests in financial collateral, which raises distinctive considerations examined by a specialist group of the Project and therefore not discussed in this paper. Registration would be used for almost all other types of security.
5. In our view, perfection of security by possession creates unnecessary costs and problems. Where a financier takes security by possession, the cost of discovery of such security is unduly high to creditors looking to take further security in the same asset. There is also an increased risk of fraud on such creditors. These risks and costs are not

negligible in the modern world of finance. Therefore, we think that possession should not constitute a method of perfection in relation to goods or money (coins and banknotes). In the interests of transparency and in order to keep the costs of discoverability of security low, security interests in these assets should be taken by registration. This should not prevent the creditors from taking possession of such assets but taking possession would no longer be sufficient to ensure effectiveness of security against other creditors, trustee in bankruptcy, company liquidators or administrators. Possession should, however, continue to be a method of perfection in relation to documents of title, negotiable instruments and securities (financial collateral aside).

6. The paper considers in outline the current developments in the registration of security, discusses perfection by possession and suggests improvements in both areas.

Registration

7. The most recent reform of the registration of charges granted by companies took place under the Companies Act 2006 (Amendment of Part 25) Regulations 2013, which came into force on 6th April 2013. Although there is still considerable scope for improvement of the system of registration of security, a number of aspects of the reform are welcome. In some areas of its mandate WGA made provisional recommendations that appear to have been fully met by the 2013 reform whilst in relation to other parts the developments either have not gone far enough or have not been made.
8. The following changes have previously been endorsed by the WGA and are to be particularly welcomed. First, registration is no longer mandatory. The criminal sanction for failure to register has been removed. Second, registration has become a wholly electronic process. The registrar is no longer responsible for examining the particulars against the security agreement. The original of the security agreement no longer needs to be filed.
9. It is a welcome, albeit an insufficient, development that registration extends to almost all charges, with exceptions provided either for public policy reasons (i.e. charge in favour of a landlord on a cash deposit or created by a member of Lloyd's) or due to exclusion under a statute (such as the financial collateral under the Financial Collateral Arrangements (No 2) Regulations 2003, reg 4). In our view registration should extend to interests that perform the function of security and to certain other interests, where it would be commercially useful to have registration. We elaborate on this in a separate paper.
10. In our view, registration of security should provide more transparency than currently. Registration should function both as a method of perfection and as a means of determining priority of security. It means that a register of security should enable the creditor to protect its priority position, including the ability to register during negotiations, i.e. in advance of a security agreement.
11. If registration were a priority point, not merely a method of perfection, it would be unnecessary to prescribe a fixed time for filing with the consequent need to obtain court approval for late filing. A secured party who did not register promptly would risk subordination to a subsequent secured creditor and, as now, invalidation of the security

interest against a liquidator or administrator or execution creditors. A creditor seeking to perfect security would have every incentive to register early.

12. The register would provide reliable information to anyone interested, in particular those who wish to deal with the debtor, whether the debtor's assets at any given time are subject to security. This would, in addition, enable the debtor to provide an assurance to the prospective lender that the asset it is offering is free of security. It would also make the task of the receiver or liquidator easier by helping to ascertain not only the validity but also the priority of security.
13. In separate papers we consider in more detail the improvements that can be made in relation to:
 - a) what interests should be registrable;
 - b) who should be subject to the registration;
 - c) the operation of the register, including (i) the issue of the extent to which information entered on the register of security against the debtor's name should be linked with, and reflected in, specialist asset registers (land, aircraft, ships, trade mark, patent registers); (ii) the issue of what the register should be a notice of and to whom.

We also recognise that the existing rules governing priority between security interests are unduly complex. These are examined by a specialist group of the Project, Working Group B.

Possession

14. In our view perfection by taking possession should be an exception to the general principle that security interests are perfected by registration. It should not be an alternative to registration. Possession, whether actual or constructive, should only be a method of perfection in relation to specifically listed asset classes, with respect to which it is common commercial practice to take possessory security. These specific asset classes are negotiable instruments, documents of title and negotiable securities. Security interests in other assets, including goods and money (in the sense of coins and banknotes) could be perfected only by registration, not by possession. We are open to further discussion of the issue of perfection by possession in relation to other asset classes should that be appropriate.
15. Under the current law when creating possessory security (pledge or contractual lien) the creditor may take possession in an asset in one of the following ways:
 - a) by taking the physical control of the asset (actual possession);
 - b) by taking the means of control of the asset, for example the key to a warehouse where asset is kept (this can be seen as either constructive possession or actual possession with symbolic delivery);
 - c) by obtaining the assent of another party with actual possession (the attornment by bailee) to hold the assets for the creditor (constructive possession);
 - d) by obtaining the assent of the debtor himself or the debtor's agent (the attornment by the debtor or the debtor's agent) to hold the assets in his possession for the creditor (constructive possession).

For clarity, it is worth adding that taking possession of the document of title is tantamount to taking constructive possession of goods. This gives rise to certain concerns, which we consider separately (see para 21 below).

16. Of these methods of taking possession, attornment by the debtor in possession has often (and rightly) been criticised as a method of taking security. The rationale for perfection by possession is that the secured creditor can resort to the asset in discharge of the debt. It is questionable whether this rationale is preserved in the case of attornment by the debtor (or the debtor's agent) as the creditor cannot be sure that he can resort to the asset in priority to the trustee in bankruptcy, liquidator, administrator or other creditors should the borrower default. Attornment by the debtor does not give the creditor any control over the assets that remain in the factual control of the debtor. The creditor is left at the mercy of the debtor. The creditor should not need to constantly check whether the assets are still in the hands of the borrower or not. This problem does not exist if the creditor takes possession using the alternative methods, which provide him with sufficient control over the assets. Were it possible to perfect security by possession, attornment by the debtor in possession (or the debtor's agent) should not count as a method of perfection.

17. Furthermore, we note that actual possession of an asset by the creditor can be seen as performing the function of public notice as those dealing with the debtor do not see the asset in the hands of the debtor and therefore might not be misled as to which assets are debtor's to deal with freely. It is doubtful to what extent this actually happens nowadays. Consider the following. The function of possession of public notice is based on two assumptions. One is that possession of an asset by the debtor implies (at least to a certain extent) debtor's ability to deal with the asset unencumbered. In response to this, it has often been raised that in modern credit economies, in which non-possessory security is common, the opposite is true: a prospective lender assumes that the asset in debtor's possession is subject to some form of encumbrance. The second assumption is that those dealing with the debtor, in particular prospective creditors, conduct due diligence to inspect if an asset is in debtor's hands or not. We are not suggesting that creditors should not check whether in fact debtors have the asset they say they have. We are questioning whether conducting such diligence should be a condition of effectiveness of security against third parties, in particular whether it should be a condition of priority of creditor's security. We have reservations whether in a modern world of finance relying on conducting checks is a more efficient solution than registration.

18. Our view is that taking possession, whatever the form, should not constitute a method perfection (with some exceptions, discussed below at paras 20-22). Perfecting security by possession can be seen as an advantage to the creditor who gains the ability to resort to the possessed asset, irrespective of how possession is taken. The transfer of possession evidences the debtor's implicit consent to the security interest and the scope of the assets subject to security. However, perfection by possession can be seen as disadvantageous from the perspective of the subsequent prospective creditor because the transfer of possession increases the cost of discoverability of the existing security. The subsequent creditor must bear the cost of due diligence to ensure it will be protected in the way bargained for. The problem can be illustrated as follows: creditor 1 takes security and perfects it by possession whilst creditor 2 perfects another security interest in the same asset by registration at a later point in time. Under the general rule of priority the creditor first to perfect takes priority. Thus, creditor 2 takes security subject to the prior interest of creditor 1. Perfection by possession by creditor 1 may not be easily (or cheaply) discoverable by creditor 2 and creates a problem of "costly hidden security" (or the problem of "costly transparency"). In order to verify whether or not the asset is subject to security, any prospective secured creditor is faced with a costly alternative. He must either conduct due diligence, which inflates transaction

costs of creating security, or take the risk of lower priority, which increases credit risk. These costs would be lower if the prospective secured creditor could rely on a search of an online register to conclude whether the relevant asset is encumbered. It may, therefore, be said that allowing perfection by possession as an alternative to registration increases the cost of credit to any prospective creditor seeking to create security in a tangible asset.

19. Apart from inflating the cost of credit, treating possession as an alternative to registration has the following other disadvantages. It undermines the reliability of the register as a comprehensive source of information about the potential existence of security rights in the debtor's assets. The subsequent creditors cannot rely on the register to conclude whether the debtor had already created a security in the asset or not. In response to this argument it could be said that the prospective creditor will usually want to verify whether the relevant assets actually exist. Except for some specific asset classes in relation to which specialist registers record title checking whether debtor is in possession is the only way of ascertaining whether the debtor has title to the asset and the power to create security in the asset. Naturally, verifying possession of the asset in debtor's hands is commercially sensible: a prudent lender is likely to want to check the asset exists before making a loan. Under the proposed rule of excluding perfection by possession as alternative to registration the lender would be free to verify the existence of the asset even if the lender had to perfect by registration. Yet, the proposed rule has the advantage of bringing certainty and clarity to determining priority. Perfection by possession generates evidential difficulties in ascertaining when possession was delivered, which in turn might make it harder to determine priority. These difficulties are easier to overcome if the time of perfection can be ascertained objectively and quickly by reference to the register. The ability to determine priority with reference to the register, without having to consider the time of delivery of possession, is likely to bring more clarity in relation to priority of a wide range of registrable non-security interests such as commercial consignments (assuming that our proposal that they be registrable is accepted; for details see the WGA paper on "What interests should be registrable"). The key advantage of registration is that it reveals existence of a particular interest and that it is discoverable in a quick and simple way.
20. Perfection by possession should remain possible, alongside registration, for negotiable documents, negotiable instruments and negotiable securities in order to preserve their negotiability and the associated priority. In relation to these assets there exists established commercial practice to take possessory security. This includes perfection of security in documents of title (e.g. bills of lading), used in commodity finance. Such documentary intangibles are common in short-time financing, where the problem of the "costly hidden security" does not appear. Even if it were to arise, it would likely be outweighed by the certainty and usefulness of the rules established in practice. For the same reasons perfection by possession should also be possible in relation to security in negotiable instruments or securities insofar as they fall outside Financial Collateral Arrangements (No 2) 2002 Regulations. However, this paper does not examine to what extent security in negotiable instruments or securities falls outside financial collateral.
21. If perfection by possession were possible in relation to documents of title, negotiable instruments and negotiable securities, it would be necessary to provide that possession in these assets cannot be given by attornment by the debtor or the debtor's agent for reasons already mentioned (see para 16 above). It is worth noting that endorsement and delivery of actual possession of a negotiable document of title, for example a bill of

lading obliging the carrier to deliver the assets covered by the document to whoever has the document, would pass constructive possession in the goods covered by the document. Thus, security perfected by actual possession of a negotiable document of title would necessarily mean that security extends to goods, as the lender would hold goods in constructive possession. This would be an exception to the general rule that security in goods must be perfected by registration, not by taking possession. The exception would operate in defined circumstances, that is perfection of security by taking actual possession of a negotiable document. This effectively limits the scope of security perfected by possession to documents of title at common law (bills of lading). Thus, a creditor seeking to take security in goods stored at a warehouse would have to register its security in order to be perfected; taking possession of a warehouse receipt would not perfect security in the goods because a warehouse receipt is not considered under English law to be a negotiable document of title (even though it is a document of title under Factors Act 1889, s1(4)). Similarly, security could not be perfected by possession of a non-negotiable document such as a straight (non-negotiable) bill of lading or a sea waybill.

22. Provision would also need to be made in relation to priority between the creditor taking security in assets that are subsequently subject to a negotiable document embodying right to that asset. This is rare in practice but a good example of practical relevance involves security in goods that are subsequently subject to a negotiable bill of lading and shipped. A creditor taking security in the negotiable bill of lading should take priority over a creditor with a registered security interest in the goods, irrespective of the time of perfection. A negotiable bill of lading is a document of title: whoever holds the document has a right to take possession of the goods and he is also the owner (title-bearer) of the goods. So long as the bill of lading is negotiable, the bill of lading can be transferred and the bona fide transferee¹ obtains good title to the goods. At the heart of negotiability is the rule that the transferor of the bill of lading can pass a better title to the goods than he himself has (this is one of the exceptions to the *nemo dat* rule). When goods are in transit the holder of the bill of lading may, for example, pledge it by transferring the document in pledge to the financier. This is very common in taking short-term security by banks acting as confirming banks in letter of credit arrangements. In a confirmed letter of credit arrangement, the confirming bank has an obligation to pay under its own undertaking upon the presentation of documents, including a bill of lading. The confirming bank must pay even before it is itself paid by the issuing bank. Until then the confirming bank bears the risk of non-payment. This risk is secured by taking the possession of the bill of lading (by becoming the holder of the bill of lading the confirming bank becomes entitled to take possession of the goods). Under UCP600, relating to international payment undertakings, confirming bank cannot engage in a letter of credit arrangement unless a *negotiable* bill of lading is involved. If the bill of lading transferred to the confirming bank transferred a title subject to prior proprietary interests (e.g. security) it would lose its negotiability. For this reason where there are two secured creditors, one with security perfected by possession of a bill of lading, and one with a registered security, the creditor with possession of a bill of lading must win. In practice such security interests do not last long and are only meant to secure short-term credit.
23. Perfection by possession, especially constructive possession in the form of attornment by the debtor to the creditor (example d) in para 15 above) has been seen as

¹ This includes a “pledgee”, see e.g. *London Joint Stock Bank v Simmons* [1892] AC 201 (concerning a negotiable bearer bond).

problematic across the world. This is reflected in UNCITRAL Legislative Guide on Secured Transactions (the Guide). It is noted in the Guide that some countries opted for registration as exclusive method of perfection, thus excluding perfection by possession (the Guide, page 114, para 48). The solution we recommend is similar but less drastic: it excludes certain assets, as discussed above. Whilst the Guide itself does not make recommendations identical to ours, it is useful to observe that it mentions (page 115, para 51) that in countries where perfection can be achieved by both registration and possession “the vast majority of secured creditors tend to prefer registration” except short-term financing that uses negotiable instruments and negotiable documents. Our recommendations are consistent with the practice of perfection by possession in relation to these forms of short-term trade finance.

24. It is worth adding that if our proposal of perfection by both possession and registration is accepted in relation to negotiable documents and negotiable instruments, it will be necessary to include a priority rule resolving conflict between security interests perfected by these two different methods. The Guide recommends that security perfected by possession in negotiable instruments takes priority over security perfected in these instruments by any other method (Recommendations 101). The same rule applies in relation to negotiable documents with some modifications in relation to assets other than inventory (recommendation 109). The consideration of priority rules, if appropriate, remains with a specialist group of the Project, Working Group B.

Conclusion

25. This paper presented reasons for reform and proposed solutions in relation to methods of perfection. It develops the points made more generally in the Case for Reform document available on the Project website:
<http://securedtransactionslawreformproject.org/the-case-for-reform/>
26. We recommend that registration and control should be the main methods of perfection. Possession should not constitute a method of perfection except in the case of specifically listed asset classes in order to preserve their negotiability, namely negotiable instruments, negotiable documents of title and negotiable securities (financial collateral aside). We recognise that this would be a significant change and one that requires careful consideration. However, we think that the risk of fraud and unduly high costs of discoverability of security are problems that cannot be ignored in the modern and increasingly more complex world of finance. We would welcome views on our proposed solutions to these problems.