



Secured Transactions Law Reform Project

Working Group A

**Case for reform paper series**

**Registrable interests and the issue of their recharacterisation**

**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 could be improved in relation to the range of registrable interests and consequences of registration. The paper 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. At present, financiers may hold various interests in the property of the company but only charges and mortgages are registrable. Other interests, which may function as security but take a different form than charge, such as retention of title under conditional sale agreements and hire-purchase agreements or finance leases are not registrable. As a result, financiers looking to an asset for security have no way of knowing whether an unregistered interest has been created ahead of them. This may lead to the financiers unexpectedly finding their interest subject to another interest. In some cases they can rely on searches with certain non-statutory bodies such as HPI or Experian. However, their records are confined to motor vehicles with failure to register having no legal sanction and registration having an uncertain effect.
3. To deal with this problem, in our view, registration should be available not only in relation to charges (and mortgages) but also retention of title clauses, hire-purchase agreements and leases for the purpose of securing payment or performance (finance leases). We note that the distinction between finance and operating leases is seen as problematic by the accounting bodies and we remain mindful of any changing standards. Throughout the paper we use the term "*title-based interests*" as shorthand for conditional sales, hire-purchase agreements and finance leases.
4. In our view title-based interests should be governed by the same rules on attachment, perfection and priorities as security interests (charges and mortgages) but different rules in relation to rights and remedies on default by the borrower. This means that title-based interests should fall outside the rules on surplus, so that even if the re-possessed asset were worth more than the outstanding debt, the financier would not have to pay any surplus to the debtor.

5. In our view registration should also extend to other interests, which do not normally function as security. These include: operating lease for more than one year, sale of receivables, promissory notes and commercial consignments. Similarly to title-based interests, these transactions ought to be governed by the same rules on attachment, perfection and priority as security interests but fall outside the rules relating to right of surplus and remedies concerning charges and mortgages.
6. The paper begins by identifying the distinction between finance and operating leases. It proceeds to discuss the issues of registration and right to surplus in relation to title-based interests. The bulk of the paper is devoted to this issue as we see it as potentially more controversial than others. Finally, we briefly address reasons for registration of sale of receivables, promissory notes, operating leases and commercial consignments.

### **Finance and operating leases – where to draw the line?**

7. At present, the difference between finance leases and operating leases stems from their treatment for accounting purposes. They are recorded differently on the balance sheet of the lessor and lessee. Finance leases are treated as the lessee's asset whilst operating leases are treated as the lessor's asset. If substantially all the risks and rewards of ownership are transferred to the lessee the lease is a finance lease (Statements of Standard Accounting Practice, SSAP 21, para 15). This is determined by considering whether the minimum lease payments amount to at least 90% of the fair value of the leased asset. In accounting, therefore, finance leases and loans secured on an asset are treated identically.
8. We note that there are proposals of accounting bodies to treat finance and operating leases in the same way by reference to use value. The lessee would record in the accounts the value of the rights and obligations transferred by the lease. Significant value would correspond to what is now called a finance lease; small value would relate to what is now an operating lease. If this proposal were adopted, it would be necessary to define which leases are to be registered by reference to their substance and not form.
9. There are also some suggestions made by accounting bodies to allow a simplified accounting procedure for leases for less than a year. If followed, it would be possible to draw a line between registrable and non-registrable leases by introducing the requirement of registration only in relation to leases for a period of at least year. In any case, we think that short-term operating leases, such as car rentals, should be excluded from registration as impractical and unnecessary.
10. Until the accounting standards change, we adopt the distinction between finance and operating leases, which translates into a proposal to register all finance leases and only those operating leases that are for over one year.

### **Why register title-based interests?**

#### **General points**

11. Retention of title clauses, hire-purchase agreements and leases share a common need for publicity with charges and mortgages. As non-possessory interests, they carry the risk of giving an impression of 'false wealth'. When a lessor puts a lessee in possession of goods, the lessee's possession may be seen as creating the appearance of ownership (also known as 'ostensible ownership'), which may mislead third party creditors,

purchasers and secured creditors. Since the lessor generates this problem, it is the lessor who should be required to cure it by registration of its interest. If charges and mortgages are registrable, in relation to which the problem of ‘false wealth’ also arises, title-based interests should also be registrable.

12. Registration reduces opportunities for fraud and collusion. It ensures the veracity of timing of perfection by eliminating the possibility that the debtor and a supplier of goods might conspire to claim that the title was retained or a lease created when in fact it was not.
13. Further, introduction of registration of title-based interests brings benefits that outweigh its costs. We address different costs in turn.

#### **Risks to third parties under current law and how to diminish them**

14. Bringing title-based interests within the scope of registration would decrease the costs of finance to financiers looking to take a charge or mortgage. At present, financiers making decisions whether or not to take security in borrower’s assets have to conduct checks in relation to the existing encumbrance of assets that might take priority. This usually involves checking any available records and inquiring with the prospective debtor. It takes less effort and time to obtain reliable information from one source than from multiple sources. The current law carries, therefore, greater costs of financing, which are ultimately borne by the borrowers. If both title-based interests and security interests (charges and mortgages) were registrable, financiers would be able to check for any already existing interests in a quicker and more reliable way than is currently possible. The public notice would also be very likely to lower the cost of preliminary checks and therefore lower the cost of finance.

#### **Addressing the problem of the limited scope of current existing records**

15. At present, information on financing is available in relation to motor vehicles via a number of non-statutory bodies. These include HPI (HPICheck.com), Experian (autocheck.co.uk), RAC (rac.co.uk), CarStatusCheck.co.uk or MotorDataCheck.com. Their records are, however, limited in scope to a particular type of asset (motor vehicle) and have an uncertain legal effect. The registration we recommend would extend to all assets and therefore ensure transparency of finance interests more widely.

#### **Addressing the problem of uncertain effect and uncertain reliability of current existing records**

16. The risk of inaccurate information provided by these non-statutory bodies is borne by the person conducting the search, not the person who retained the title and left another in possession. Some of these information providers hold guarantee schemes providing reimbursement of financial loss suffered from inaccurate or incomplete information. However, the amount of reimbursement is at the option of the data provider, so it may not put the person relying on the information in a position they would have been in if the information had been accurate (i.e. compensation is likely to be smaller than expected). In addition, guarantees are capped (typically at £10,000-£30,000) and limited in scope. For example, reimbursement is only available where the loss was *caused* by inaccurate information. Reliance on information provided by others would presumably exclude the guarantee cover. In any case, they seem to be aimed at buyers, not chargees, because the guarantees relate to failure to “acquire” good title and

chargees cannot be said to “acquire” title. Therefore, a person proposing to take security in the car or proposing to lend money to the owner of the asset would not be covered by this guarantee and would not be able to rely on the existing records. This suggests that the existing opportunities for information checks, existing in the area of car finance, are not suited to the needs of financiers looking to take security interests or lenders considering extending credit to the asset owner.

17. The registration scheme we recommend would address this problem. Registered interests would take priority over unregistered interests pursuant to the rule that the first to register takes priority. Registration would provide reliable and easily accessible evidence of the baseline time of perfection on which the first-in-time priority rule would be applied. Determining perfection of interests and priorities based on the time of registration would reduce evidentiary costs and disputes in connection with existence of such interests. Financiers performing a search would gain certainty as to their position and would not bear the risk and related costs of a prior unregistered interest. Detailed issues of priority are considered by a specialist group, Working Group B.

#### **Addressing the problem of costs of searching for information on existing interests**

18. Moreover, searching the register for title-based interests, leases or other interests, would be likely to cost less than the current searches with the existing non-statutory bodies, which are priced between £5-£20 per single check. By comparison, a search for a security interest in the New Zealand Personal Property Securities Register costs NZ\$3 (ca. £1.50) or NZ\$1.50 (ca. £0.75) for high frequency users. At present, searches in the Companies House to check whether or not the company granted a charge are free whereas more detailed information costs £1 per charge. This suggests that introduction of registration of title-based interests would be likely to lower the costs of searches for existing finance.

#### **Possible costs and benefits to suppliers associated with introduction of registration of title-based interests**

19. There are certain risks which financiers supplying goods under title-based interests would need to be aware of. First, lack of registration would make unregistered interests ineffective against secured creditors, administrator and the liquidator. Although this is a significant risk, and constitutes a potentially high cost to the suppliers, it could be eliminated easily and cheaply by way of registration.
20. Further, suppliers would be likely to lose their legal title if their interests were not registered and the goods were further sold or leased to a third party who did not have actual knowledge of the suppliers’ title. Loss of financier’s title is also possible under the current law. For example, at present, buyers in possession may under certain circumstances pass title they do not have (Factors Act 1889, s 9; Sale of Goods Act s 25). Similarly, a conditional buyer under the conditional sale or a hirer under a hire-purchase agreement may pass good title to the goods to a third party purchaser if the third party is a private purchaser in good faith without notice (Part III of the Hire Purchase Act 1964). Under the proposed regime the supplier would be able to protect its title to a certain extent by registering the interest.
21. The law should also strike a better balance than currently between interests of the financier and an innocent third party purchaser. Provisionally, we think that a third party should take free of the financier’s interest if the conditional buyer, hirer or lessee

sells them (or leases them) in the ordinary course of business and if his business normally involves selling or leasing goods of that type. The supplier would then only lose their title to a buyer in the ordinary course of business. This rule may require some fine-tuning. For example, the scheme might provide that the supplier's interest is not lost if the buyer or lessee knows that the sale constitutes a breach of the agreement between the financier and the conditional buyer, hirer or lessee. Another example of fine-tuning might be that third party innocent purchasers would take free of the financier's interest in relation to small transactions where the buyer or lessee had no knowledge of the interest and provided value for the interest acquired.

22. Under current law there is much uncertainty in relation to retention of title clauses in proceeds or products of the goods in which the title was originally retained. An agreement between a supplier and a company which provides for retention of title to proceeds or products is likely to be recharacterised as a charge and therefore void if not registered. In the proposed new regime it would be possible to provide for a rule that would solve this problem by either allowing parties contractually to "retain" title in proceeds or products or by introducing a default rule, whereby the supplier's title would automatically extend to proceeds and products.
23. Therefore, despite the costs associated with having to register their interest for protection, suppliers' position could be strengthened. Even if this strengthening is not considered a sufficient incentive or advantage from the perspective of suppliers, we think that the benefits associated with registration of title-based interests outweigh in our view the costs of having to register interests that were previously not registrable.

### **Right to surplus**

24. In our view registration of conditional sale, hire purchase or lease should not have the effect of recharacterisation as security interests in the sense of subjecting these interests to rules governing rights and remedies available to secured creditors on borrower's default. One of the characteristics of security interests is the obligation of the creditor to account to the debtor for any surplus value in the property over and above the outstanding amount of the debt. We think that in relation to conditional sale, hire purchase and lease surplus on default should be distributed according to contractual arrangements.
25. We note that in many cases title-retention financiers are only concerned about recovering the sum owing under the agreement, including interests, charges and costs incurred. Any surplus might be seen as a windfall in which they have no interest. Further, in practice, it is not uncommon for agreements to provide for return of any surplus to the debtor and even in the absence of such an agreement, financiers might, upon request, hand over any surplus to the liquidator. We do not think, however, that this practice ought to be turned into a mandatory or default rule. In our view such a rule might detract from existing flexibility in shaping rights and duties by contract. Parties are better placed to decide the right to surplus contractually. We realize that this solution might require introduction of some safeguards against unconscionable bargains.
26. A rule that surplus belongs to the debtor would not be appropriate in relation to operating leases because the lessor relies on the residual interest in the leased goods. Moreover, the possible departure from differentiation between finance and operating

leases in accounting standards, as noted above (paras 7-10 above), suggests that the law should not be build around the differences between them. Provided that the English law of secured transactions is to continue to be consistent with the accounting approach (and we see no reason why it should not), it would not be sensible to apply different rights to surplus in relation to one type of lease but not the other.

### **Lack of tax consequences**

27. We do not see that our proposal to register both finance and operating leases would cause any changes in the formal or economic ownership and so would not trigger any tax consequences.

### **Registration of longer operating leases, sales of receivables, promissory notes and commercial consignments**

28. We think that operating leases for more than a year, sales of receivables, promissory notes and commercial consignments should be brought within the scheme of registration and within the priority rules governing other registrable interests. If not registered, they increase the cost of dealings because it takes third parties more time and effort to discover existence of such transactions. In extreme cases, they might create a risk of misleading third parties, who might not be able to find out that the property no longer belongs to the person they are dealing with. Registration would give publicity of the financier's interest in an asset to anyone seeking to buy the asset, to take security in the asset or to lend money or extend credit to the owner of the asset. In addition, registration would preserve priority over any third party seeking to create an interest in the receivable.
29. The problem with lack of registration under the current law is particularly prominent in relation to outright sales of receivables, for example, under factoring or invoice discounting. At present, where the client is not a company, absolute assignments of receivables are not registrable. Priority of interest in the receivables is established with the use of a rule in *Dearle v Hall* (1828) 3 Russ 1, according to which priority is given to the person who is first to give notice to debtor unless they know or ought to know of previous assignment or charge when they the receivables were assigned. Where no notice is given to the debtor, the first in time to have created an interest in (or to have been assigned) the receivables takes priority. This makes establishing priority an unduly complex and costly exercise with often uncertain result. Lack of registration and ensuing lack of ability to ascertain the date of assignment opens door to opportunism and risk of fraud and collusion. Where the client is not a company, general assignments of existing and future book debts (or any class thereof) must be registered in the Bills of Sale register (under Insolvency Act 1986, s 344). Registration gives actual or constructive notice to those expected to search the register but it remains unclear who is expected to search. Lack of registration means that the subsequent financier cannot discover an unregistered sale of receivable by searching the register and that the priority can only be secured by giving notice to the debtor.
30. These problems are avoided if we introduce registration of sales of receivables, alongside registration of security interest in receivables, in relation to both companies of unregistered businesses. Priority would be ascertainable by date of registration. Unregistered interests would be void in insolvency. The right to surplus would remain a

matter of contractual agreement between the parties. This would bring transparency, as all interests would be visible on the register. There would be no need to give notice to the debtor to protect priority and the priority rules would become clearer and simpler. This would reduce the costs resulting from complexity and uncertainty of the current law.

31. Discussion of these problems and proposed solutions was one of the topics at a specialist Project seminar on receivables financing on the 8<sup>th</sup> May 2014. The representatives of the receivables finance industry and lawyers involved in this type of finance supported registration of outright sales of receivables. As mentioned previously, detailed rules relating to priority issues are considered by a specialist group, Working Group B.

## **Conclusion**

32. This paper presented reasons for reform and proposed solutions in relation to the scope of registrable interests and to what extent, if at all, they should be recharacterised as security interests. The paper develops the points made more generally in the Case for Reform document available on the Project website:  
<http://securedtransactionslawreformproject.org/the-case-for-reform/>
33. In our view, registration should extend to conditional sale agreements, hire-purchase agreements, finance leases, operating leases for over a year, sales of receivables, promissory notes and sales of receivables. All registrable interests should be subject to rules on attachment, perfection and priority that are the same as those applied to security interests but would be governed by their own rules regarding rights and remedies on default. Thus, if the debtor were to default, the financier would have such remedies as provided in the agreement and even if the asset were repossessed or sold and worth more than the outstanding debt, the financier would not be required to, absent parties' agreement, to pay the surplus to the debtor purely because the interest was registered. This is by contrast to security interests in relation to which the surplus of sale proceeds on default would go to the debtor.
34. Introduction of registration requirement in relation to the mentioned interests would bring total transparency of these interests, make discoverability of these interest cheaper and provide much clearer and simpler rules on priority. This would be likely to make borrowing more efficient and cheaper.