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“Security interests in derived assets”

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To Jonathan

for whose understanding, support and patience

I am so grateful
Abstract

This thesis focuses on the extent of security interests in property. A security interest is a right of a creditor to resort to an asset with priority to at least some other creditors of the grantor of security when debtor defaults on the secured obligation. This work examines to what extent the secured creditor’s right is, or ought to be, affected when the encumbered asset undergoes changes that result in a new derived asset. Three scenarios are looked at: where new assets ("fruits") are derived from the original collateral; where the original collateral is substituted for another asset or where it is incorporated or mixed with other assets into a new product.

The question has attracted little judicial or academic attention. In the key case Buhr v Barclays Bank Plc [2001] EWCA 1223 it was held that the secured creditor had a right to sale proceeds of collateral by virtue of its property right. This was termed as a “principle of substitutions” encompassing accretions, fruits and proceeds of the original collateral. It is suggested that this “principle” does not exist in current English law. This is so whether the security is fixed or floating. If a security interest is to extend to derived assets, parties ought to bargain for it. If new assets are a result of dispositions unauthorised by the secured creditor the creditor may claim the proceeds by asserting a new right based on unjust enrichment, not by virtue of the original property right.

English law contrasts with Article 9 of the Uniform Commercial Code in the US, where the secured creditor automatically acquires right to proceeds. Law and economics analysis suggests that extending security to proceeds promotes efficiency of secured credit but only if proceeds are understood narrowly and do not include fruits.
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Preface

When I started my PhD, my plan was to write a comparative law thesis about security interests. I had received solid education as a Civil Law lawyer but my knowledge of English law was limited to the core subjects covered in the Diploma in Law course which I read for after coming to the UK. Commercial law, personal property law and restitution were not among them. It seemed natural that my doctoral research on secured credit would involve comparison of the Civil Law jurisdictions I was familiar with (mainly Polish, French and German law) with only some aspects of English law. The result surprised me. With the exception of a few footnotes, the thesis is not about Civil Law at all! English law proved to contain too many fascinating complexities and nuances to use the precious space to talk about Civil Law. The inspiration to write this thesis came to me when I read – with my Civilian mindset – a section on “Derivative Security Interests” in Goode on Legal Problems of Credit and Security edited by Professor Louise Gullifer. The question that budded in my mind was this: how can a property right, created by an owner in favour of another person in a particular asset, shift from one asset onto another? In Civil Law this is quite exceptional; in Common Law not so. The concept of a trust, which developed in Common Law, is a paradigm case of rights being asserted to traceable proceeds. Yet security interests are not the same as beneficiaries’ rights under a trust. The aim of this work is not to explore the secured creditor’s right to traceable proceeds by comparison with trusts but to look at the nature of security interests under the current English law and to ask if it could be improved. Given that the reform of secured transactions is “in the air” the timing for asking this question could not be better. Although the scope of this work may be narrow, it highlights a crucial question of how far property rights in assets should extend. Rights of owners, even beneficial owners, to traceable assets are one thing; but non-ownership property rights granted over an asset may be entirely different. This work suggests that it should not be automatically assumed that just because a right is proprietary it extends to traceable proceeds.

Magda Raczyńska
Norwich, 17 October 2012
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I am also deeply indebted to the Executive Committee of the Secured Transactions Law Reform Project for enabling me to assist the fascinating work on the reform of security interests in England. Through my assistance in the Project I gained invaluable practical insights, which helped me shape my own views about how the law of security interests functions, or should function, in the Common Law world. I am in particular very grateful to Professor Sir Roy Goode for truly inspirational conversations and to Georgia Quenby for her insights into the practice of secured transactions. Although they have not read my chapters I have learnt a lot from our discussions. I would also like to thank, in alphabetical order, Professor George Gretton, Professor Mathias Siems, Professor Lionel Smith and Dr Andrew Steven for their time and stimulating conversations about property law, secured transactions law and comparative law. Writing about law and economics without a solid economics background was no easy task, so I would like to express my thanks to Professor Morten Hvid for his very helpful explanations of aspects of economics, especially at the early stages of my thesis, to Professor John Drobak and Professor Oliver Hart for their encouraging comments on my paper and short presentation at the ESNIE Law and Economics workshop and to my husband Jonathan for his readiness to engage with me in so many wonderfully stimulating chats about economics, particularly in the least expected (and possibly least convenient!) times. My thanks also go to Professor Sjef van Erp and Dr Bram Akkermans. Their module, European Property Law, I undertook as an undergraduate Erasmus student at the University of Maastricht was run with so much passion that it sparked off my own fascination with property law. The usual caveat, of course, applies: all errors are mine.

Finally, I would also like to thank the Faculty of Social Sciences at the University of East Anglia for fully funding my PhD and to all those at the UEA Law School for providing a wonderfully warm and intellectually enriching environment to work on my thesis.

Magda Raczynska
Norwich, 17 October 2012
INTRODUCTION

This thesis investigates the extent of security interests in property. A security interest is a right in an asset conferred on a lender to resort to the asset in priority to other creditors of the borrower, should the borrower default on an obligation to pay. Security interests may be conferred by law or created on the basis of an agreement. This work sets out to examine the latter, consensual security interests. It is concerned only with real security, that is rights in assets, whether tangible or intangible, which provide the creditor with a right in rem to resort to the asset to discharge the underlying debt.\(^1\) Outside of its scope are therefore personal security rights such as demand or suretyship guarantees. Rights in rem given for security purposes can be either granted or retained. If retained, for example in retention of title devices, hire purchase agreements or finance leases, they do not create security interests in law\(^2\), even though their economic effect is indistinguishable from “true” security interests.\(^3\) Such “quasi-security” interests are not discussed as the thesis focuses only on “true” security interests. Security interests may be granted by a debtor or by a third party – the grantor of security. To simplify the analysis we will assume throughout the thesis that the debtor granted security.

Security interests are property rights in assets. What counts as a property right is controversial in English law.\(^4\) The orthodox view, accepted here, is that property rights are rights in particular assets

\(^3\) *Goode on Legal Problems of Credit and Security* (n 1) para 3-05.
exigible against third parties.\textsuperscript{5} This means that the secured creditor has a right enforceable against an indefinite number of people, including the liquidator or trustee in bankruptcy of a person against whom the right is asserted, although it does not mean that the right is enforceable against everyone in the world.\textsuperscript{6} For example, those who acquire legal title to an asset subject to an equitable security interest may take free of that security. The focus of the thesis is on subject matter of security interest (i.e. the collateral). Specificity of assets is deeply embedded in English law\textsuperscript{7} although there is some ambiguity over property understood as things and as wealth.\textsuperscript{8} A view preferred here is that security interests are in particular assets, not wealth.\textsuperscript{9}

Key to security interests is the continued existence of the encumbered asset (also referred to as the collateral\textsuperscript{10}). If the asset ceases to exist, the creditor is left only with a personal claim against the borrower to repay the loan, which may be worthless if the debtor is insolvent. A secured transaction is a continuing relationship between the parties. During that time the collateral may undergo various changes, including changes that lead to destruction of the collateral or production of a new asset. This thesis explores how some of these changes affect the secured creditor’s right to resort to the asset to discharge the secured debt. These changes can be usefully divided into the following basic scenarios, depending on the position of the creditor:

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\textsuperscript{5} See also J Penner, \textit{The Idea of Property in Law} (OUP, Oxford 1997) 30-31.
\textsuperscript{6} Beale et al, \textit{The Law of Security and Title-Based Financing} (n 2) para 4.01; Goode on \textit{Legal Problems of Credit and Security} (n 1) para 1-03.
\textsuperscript{9} This assumption is particularly controversial in relation to the floating charge, which is why in chapter IV we will discuss in more detail why it could be seen as a right to specific assets.
\textsuperscript{10} The term “collateral”, popularised in the USA, is now widely used in English legal practice.
(a) the collateral is mixed with other assets in a way that allows the creditor to follow the original asset and continue to assert a security interest in it (e.g. collateral is transferred to a donee or some ear-marked sheep subject to security mingle with other sheep);

(b) the asset subject to security has been improved, or another asset was added to it (an accretion), which enables the creditor to follow the original asset and assert security in the original asset;

(c) cases where collateral can no longer be followed and no new asset comes into being (e.g. an antique vase subject to security was shattered);

(d) collateral is joined with other assets in such a way where it is no longer possible to follow the original collateral but it may be possible to claim a product of the mixture (e.g. a loaf of bread is baked from encumbered flour), or cases where the creditor may follow the original asset but can no longer claim it because it was transferred to a third party who raises a defence (e.g. the debtor exchanged the flour subject to an equitable charge for sugar with a bona fide third party, who obtained legal title to the flour without notice of the charge\(^\text{11}\));

(e) the collateral, remaining itself in existence, generates new assets; the creditor may follow the original asset and may be able to assert a right to the new asset that comes into being (e.g. lamb is born from a sheep; income is collected from a lease).

We are not interested in scenarios (a), (b) and (c) here. The purpose of this thesis is to examine what rights, if any, a secured creditor has to new assets that arise in scenarios (d) and (e). These new assets in scenario (d) are typically referred to as substitutes, which are further divided into proceeds (if they result from clean substitutions) and

\(^{11}\text{Pilcher v Rawlins (1872) 7 Ch App 259 (CA).}\)
products (if they result from mixed substitutions). The new assets in (e) are referred to as fruits. Both substitutes and fruits are referred to as derived assets. The question has been asked before in *Legal Problems of Credit and Security*\(^\text{12}\) but it received little judicial or academic attention. Detailed discussions of claims to traceable proceeds of dispositions of assets subject to equitable ownership such as beneficiaries’ rights under trusts\(^\text{13}\) might partially explain the dearth of interest in this area. Yet rights of trust beneficiaries and rights of a secured creditor are different. The secured creditor has no beneficial ownership in the asset, merely a right to resort to an asset if the debtor does not pay. Even where the creditor has the legal or equitable title to an asset, this is only by way of security, which means that the creditor can only resort to the asset to the extent that the secured debt is discharged. This is not to say that the law of tracing is not useful in the context of security interests. The evidential rules of identifying the original asset (following) or rules identifying substitutes, which represent the value of original asset (tracing) are relevant in the context of security interests. Claims to traceable proceeds are a controversial matter and their analysis must take into account the nature of security interests. The most recent and highest authority in the area of a secured creditor’s claims to traceable proceeds is the Court of Appeal decision in *Buhr v Barclays Bank Plc*\(^\text{14}\). The Court of Appeal held that the secured creditor had, by virtue of his property right, an automatic right to any accretions (improvements and fruits alike) and substitutes (traceable proceeds) of the collateral. This rule was referred to as a “principle of substitutions and accretions”. The argument advanced in this thesis is that this “principle” does not exist. It is argued that substitutions and accretions ought to be treated differently and that the term “accretions” itself comprises two diametrically different notions (improvements and fruits), which also ought to be subject to different rules. The decision in *Buhr v Barclays Bank* reveals confusion in the

\(^{12}\) Goode on Legal Problems of Credit and Security (n 1) paras 1.57-1.69.

\(^{13}\) The seminal work in this area is Smith, *The Law of Tracing* (n 7).

area of security interests in substitutes and fruits, which needs clarification. It seems that the “principle of substitutions and accretions” was used as a “wild card” to answer the question of whether a secured creditor may assert his security interests in new assets, irrespectively of the type of asset (proceeds, products and fruits). It is argued that the “principle of substitutions and accretions” is not sufficiently supported in the current English law.

The task is approached primarily by doctrinal analysis of English law. We also use comparative law as well as law and economics. We examine rules governing security interests in derived assets under Article 9 of the Uniform Commercial Code (UCC). The pragmatic solutions adopted in Article 9 UCC are aimed at preserving efficiency of secured transactions. Although such approach may be useful for commercial parties, its success relies on our ability to evaluate what is efficient. We will question the efficiency of some rules adopted in Article 9 UCC in relation to derived assets and suggest that if English law is to emulate the American model, it should do so with proper understanding of efficiency of security interests in derived assets. Despite the very rich debate on law and economics of security interests, little attention has been paid to the specific question of efficiency of security interests in derived assets. This thesis will attempt to fill this gap with basic economic analysis. It is hoped that it will be of use in the current debate on the law reform of secured transactions in England. Although the Government decided not to implement the Law Commission proposals in 2005 in the reforms leading to Companies Act 2006, the Consultative Paper and the Draft Company Security Regulations produced by the Law Commission in 2004 continue to form the basis for a debate on law reform in this area.16

15 Law Commission, Company Security Interests (Law Com CP No 176, 2004), hereinafter referred to as LC CP. Draft Regulations contained therein are referred to as DR.
16 The state of current law and the need for and shape of future reform are being examined within the Secured Transactions Law Reform Project, http://securedtransactionsproject.wordpress.com, last accessed 21 October 2012.
It is also important to say what this work is not about. First, we are not interested in personal claims of the creditor against the debtor for dealing with collateral in an unauthorised way because they are likely to be worthless if the debtor goes insolvent. We deal only with fundamental questions of whether the secured creditor has a proprietary right to new assets, which derive from the original collateral, and, if so, on what basis. Second, the thesis concentrates on non-possessory security interests. Thus, outside of the confines of this work are specific problems arising in relation to pledges in goods. In particular, we do not ask how a possessory security interest (a pledge) would be affected if the pledged tangible asset was substituted for an intangible. Third, if the collateral has changed due to someone’s action directed at the asset, we will assume that it was the debtor’s action or an action on behalf of the debtor. We do not, therefore, consider in detail situations where a third party caused the asset to change to a new asset outside of the debtor’s control. Fourth, we do not deal with questions of multiple secured creditors. Outside of the scope are issues of priority of security in the new asset if more than one creditor may have a claim to it. Finally, outside of the scope are problems surrounding sub-security, that is cases where a security interest in an asset itself becomes subject matter of another security interest. In such situations no new asset is created; the subject matter of the original security does not change. We may also note that although the primary concern of this work is with grantors who are a corporate bodies and who grant non-possessory security interests over personal property, it will be necessary, in order to find a coherent answer to the question posed, to look at situations where the grantor is an individual, an unincorporated business, or where the asset encumbered is real property.

In order to establish the secured creditor’s rights to derived assets, we need to first set the context and define the basic notions. Thus, the first chapter explains the meaning and purpose of security interests. Security

17 Goode on Legal Problems of Credit and Security (n 1) para 1-67, especially fn 267.
interests are understood to be economically efficient devices. A question will be posed whether substitutions or accretions promote this efficiency or not. The first chapter will also set the basic background knowledge of security interests in English law and briefly under Article 9 UCC. The second chapter looks at the principles developed under Roman law to address issues of property rights in assets that become mixed or generate fruits. It will be seen that these principles, incorporated later to some extent in English law, do not provide a sufficient response to deal with security interests. A new distinction will have to be drawn between assets resulting from a disposition by the debtor and assets that arise without the intervention of any person (fruits). Chapter three discusses situations where parties in the security agreement did not provide for any changes in the collateral. The distinctions drawn between accretions and other derived assets will be useful here as it will be shown that a secured creditor has an automatic right to accretions but he does not generally have such a right in relation to other derived assets. Chapter four is devoted to a scenario where the parties included a clause in the security agreement extending security to derived assets. Such clauses are problematic because they essentially create security in assets that do not exist at the time of the agreement. Derived asset clauses may also have an impact on characterisation of the security. It is particularly controversial to what extent a fixed charge is consistent with a provision for substitute assets in the security agreement. It will be argued that fixed charges are not in principle inconsistent with substitutions and that the debtor has a power to substitute but very limited authority to do so. A theory of a fixed charge will be suggested analogous to what would be no-authority agency. Where a security agreement creates a floating charge an issue arises whether this can be interpreted to imply that the parties agree to extend the security (the floating charge) to proceeds of disposition. Such a view has been presented in the literature but it will be argued that it is flawed. Finally, chapter five will deal with situations where the debtor disposed of property in a way not authorised by the creditor. It will be argued that the secured creditor can claim proceeds of such
dispositions, not on the basis of the security interest but as a new right arising on the basis of unjust enrichment.
CHAPTER I - The concept of security interests

1 Introduction

The purpose of this chapter is twofold. First, it seeks to investigate why parties seek security and whether the same rationale that underlies taking security interest in an asset may also be said to support security interests in new assets that derive from the original asset. Of particular interest will be justifications of security interests on the basis of economic efficiency. If financing on a secured basis is more efficient than financing on an unsecured basis, a question, which we pose here as well, is whether security interests that extend to derived assets can also be said to promote this efficiency. We will consider separately security in new assets, which the debtor receives as a substitute for the original collateral (substitutes) and security in new assets, which arise without destruction of the original subject matter (fruits). If security interests in derived assets also promote efficiency, a legal system ought to contain a rule that security interest automatically extends to derived assets if the law is to promote more efficient transactions. The second purpose of this chapter is to present the basic types of security interests under English law and explain how the approach to security interests under the Uniform Commercial Code in the USA differs from English law in its present shape. The rights of the secured creditor to new assets derived form the original collateral depend on the rights the secured creditor has in the original collateral in the first place. Understanding the basic features of the law of security interests in property is necessary for the detailed analysis of security in derived assets in the chapters that follow. The chapter is divided into three parts accordingly. The first part presents the justifications for security interests. The second part is an overview of the types of security in English law, which are juxtaposed in part three with the single, functional idea of security under Article 9 UCC.
2 Rationale for security interests

A question arises as to why the law differentiates between secured and unsecured creditors by awarding the former such an advantage over the latter. The riddle, which came to be known as the “secured debt puzzle”, has generated a lot of literature, particularly in the United States. The puzzle is this: the secured creditors levy lower interest rates on loans because security reduces their risk of non-payment but unsecured creditors raise their rates because the lack of security increases that risk. From the borrower’s perspective, in a perfect market, secured financing is a “zero-sum game”: the benefits derived from secured financing are offset by the cost of higher rates of interest charged by unsecured creditors because of the increased risk that they undertake. This argument rests on the assumption that secured credit is cheaper than unsecured credit. Mokal showed, using empirical evidence, that this “rate reduction assumption” is flawed. The interest rate charged is marginally related, if at all, to the decision to finance on a secured or unsecured basis. In practice, borrowers (at least small to medium businesses) do not seem to have a choice whether to borrow


21 This debate derives from Modigliani-Miller “irrelevance theorem”, F Modigliani and M Miller, 'The Cost of Capital, Corporation Finance and the Theory of Investment' (1958) 48 Am Econ Rev 261, according to which the cost of capital is, absent taxes and bankruptcy costs, independent of the firm’s capital structure (whether it is financed with debt or equity) and the level of investment is unaffected by the type of security used to raise finance.

secured for a lower interest rate or unsecured for a higher interest rate. The lenders may simply not lend unless provided with collateral. Moreover, as Jackson and Kronman noted in the article, where they originally set the “puzzle”:

“if the law denied debtors the power to prefer some creditors over others through a system of security agreements, a similar network of priority relationships could be expected to emerge by consensual arrangement between creditors. Permitting debtors to encumber their assets achieves the same result, but in a simpler and more economic fashion”.23

The creditors have an advantage to be gained from securing priority and it is more efficient if the law recognises security interests as property rights than to multiply transaction costs.

Even if the secured debt puzzle rests on a flawed assumption, the theories advanced in response to the puzzle are useful in understanding the rationale for taking and granting collateral. The justifications are grouped in three categories: a conventional theory, a property-based theory and a group of efficiency theories.24 The third, most comprehensive, category comprises not only considerations of cost and benefit of secured transactions but also issues of fair distribution of resources. It is worthwhile to look at these theories since they shed light on the rationale of security in substitutes and fruits and help answer the question whether a legal system should promote automatic extension of security interests to such assets.

2.1 Conventional explanation of security interests

Security interests in property make both the lender and the borrower better off than they would have been without security. This is encapsulated in the Roman tenet of Corpus Iuris Civilis: a security is

23 Jackson and Kronman, (n 18) 1157.
given for the benefit of both parties: for the debtor because he can borrow money, and for the creditor since he can lend the money safely.25

A. The benefit for the debtor: facilitating finance

Some debtors are creditworthy enough to raise unsecured finance. Others may not be able to borrow at all either because of the risk they present26 or because they have no credit history.27 Security makes the credit market accessible to many debtors who, in the absence of security, would be unable to obtain finance.28 On a view drawn from practice, debtors do not grant security unless they are required to do so.29 It has also been shown that firms may not undertake certain profitable projects if only equity or unsecured debt is used to finance them, but will undertake them if they can be financed with secured debt.30 The debtors may not want to, however, to “immobilise” their assets. Selling assets free from security or using them to make new products may be essential to a debtor’s business or project. If such dealings defeat the security, the creditors may be unwilling to provide finance. A debtor’s ability to grant security in sale proceeds or new products may therefore offset the creditor’s risk of losing security and so facilitate provision of finance.

26 Mokal, (n 22) cf Oditah (n 24) 17.
B. The benefits for the secured creditor

It is often emphasised that the first and foremost purpose of security interests is the reduction of credit risk.\textsuperscript{31} According to the classic banking theory collateral reduces risk because the lender may seize collateral even if the borrower has insufficient sources to repay its debts\textsuperscript{32}, thus increasing the likelihood of obtaining performance of the contract with the debtor.\textsuperscript{33} Since the risk of non-payment materialises upon the debtor’s insolvency, it is at that stage that security is most needed.\textsuperscript{34} This is why the most considerable advantage that the secured creditor enjoys over the unsecured one is the priority position in the debtor’s insolvency.\textsuperscript{35} Furthermore, taking collateral gives the creditor a certain degree of influence over the events, which could not be achieved by personal covenants.\textsuperscript{36} Moreover, an all-embracing security may also affect the debtor’s market behaviour because in practice it may give the creditor an exclusive right to supply the debtor with credit.\textsuperscript{37} Security may deter unsecured creditors from enforcement of their claims, if these were to lead to restructuring since the would be likely to lose out in restructuring.\textsuperscript{38} We may also note that if a security interest is taken in investment securities held with a right of use,
including sale, the creditor gains the ability to raise funds itself and engage in market operations.\textsuperscript{39}

All these benefits depend on the continuing existence of the collateral. Risk of non-payment cannot be reduced if the asset no longer exists because there is no collateral to resort to discharge the underlying secured debt. Likewise, the benefits, which the creditor derives from its secured status, whether in relation to the debtor or vis-à-vis external bodies, also depend on the continuance of collateral.

\subsection*{2.2 Property-based theory of security interests}

The fact that security interests provide both parties with certain benefits explains why it may be desirable for the parties to borrow or lend secured but it does not yet justify why a legal system should allow for security interests to exist. To address this Harris and Mooney\textsuperscript{40} proposed a normative justification of security interests based on theories that justify the institution of private property. The right to own private property is part and parcel of a market economy. Inherent in the ownership are the following rights: to use an asset (\textit{usus}); to take benefits from that asset (\textit{fructus}); to change its form and substance (\textit{abusus}); and to transfer all or some of these to others.\textsuperscript{41} In a market economy resources are allocated by exercising the right to transfer. Private property promotes market efficiency by providing incentives for the allocation of assets to those who place the highest value on their use.\textsuperscript{42} Given that security interests involve the alienation or transfer of property (like sales or debt repayments), granting a security interest in

\begin{flushright}
\textsuperscript{39} Ibid. para 1-02.  \\
\textsuperscript{40} Harris and Mooney, 'A Property-Based Theory of Security Interests: Taking Debtor’s Choices Seriously' (n 28) 2047, called by Ponoroff and Knippenberg as “compelling for its simplicity”, L Ponoroff and F Knippenberg, 'The Immovable Object Versus the Irresistible Force: Rethinking the Relationship between Secured Credit and Bankruptcy Policy' (1997) 95 Mich LR 2234, 2260.  \\
\textsuperscript{41} See also Honoré, 'Ownership' (n 4) 161, 170 (arguing that power to alienate is one of the rudimentary incidents of the concept of liberal ownership).  \\
\end{flushright}
favour of a creditor is merely a way of exercising the freedom of contract aimed at transferring or alienating an interest in the property. The property-based theory was critiqued by Schwartz as not capable of justifying the rationale of security interests because it does not take into account market efficiency and costs that result from market externalities or asymmetric information.

Applying this theory to explain security in derived assets seems problematic. Derived assets are future assets. The basic premise, on which the law of property transfers is founded, is that no one can make a present transfer of something they do not presently own or otherwise have a power to dispose of. It is therefore not clear why the power to alienate (dispose of) one’s asset should include the power to make future dispositions. Another difficulty, relevant to rights in proceeds and products, is to explain why a legal system should allow one asset to be substituted for another instead of making the creditor always follow the original asset and, where that fails, extinguish his interest. These questions require considerations of economic efficiency and comparison of costs, for example arising from asymmetric information, of situations where security extends automatically to new assets and situations where it does not. Since the property-based theory of security interests does not address market efficiency, it cannot explain whether security interests should automatically extend to derived assets or not.

2.3 Efficiency of security interests

Security interests are said to make funding more efficient. There are many definitions of economic efficiency and we need not look at these here in detail. Pareto efficiency is achieved where no one can be made

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44 A Schwartz, ‘Taking the Analysis of Security Seriously’ (1994) 80 Va LR 2073, 2081ff (general) and 2086 for that particular criticism.
45 Cf Penner (n 5) 154.
better off without making someone else worse off.\textsuperscript{46} Kaldor-Hicks efficiency has less stringent criteria. Even if some persons become worse off, an outcome can still become more efficient if sufficient compensation is arranged from those that are made better off to those that are made worse off so that all would end up no worse off than before.\textsuperscript{47} We adopt the latter definition of efficiency. Although we talk about an outcome being efficient if it makes all members of society better off, it is convenient to split the analysis of efficiency of security interests into two questions: (i) whether security interests increase efficiency between the creditor and the debtor and (ii) whether security interests are an efficient outcome for all members of society, in particular other creditors of the debtor. Most of the analysis of efficiency of security interests in the literature focused on addressing the first question. A convenient way of measuring benefits to parties is to look at economic surplus parties receive.\textsuperscript{48} There is a limit to the amount that each borrower is willing to pay for a loan. The maximum price the borrower is willing to pay can be called his willingness to pay. It measures how much the borrower values the loan. Each borrower would want to obtain a loan at a price below its willingness to pay. To simplify the analysis, we assume that the price the borrower is willing to pay is the amount of interest rate charged over the duration of the loan. If the borrower can obtain the loan below the maximum amount she is willing to pay, the borrower receives a surplus.\textsuperscript{49} For example, if the borrower is willing to pay £1000 for a loan but pays only £800, the borrower receives a surplus of £20. Assuming that borrowers are rational, willingness to pay can serve as a measure of benefit to the borrower (as the debtor himself perceives it). Similarly, the benefit to lenders (lender’s surplus) can be measured by the amount the lender is paid minus the cost to the lender. If, for example, costs of lending

\textsuperscript{49} This is by analogy to buyer surplus, Ibid. 132.
amount to £700 but the lender is paid £800, the surplus to the lender is £100.\(^5\) Market equilibrium is reached at a point which indicates the price the borrower actually pays to the lender. Resource allocation (including resource use) is efficient if the total surplus received by the lender and the borrower is maximised. If surplus to the lender and the surplus to the borrower are both maximised, we say that equilibrium is efficient. The surplus is at its highest when the amount that the borrower is willing to pay for the loan is as high as possible and the costs to lender are as low as possible. If the benefit cannot be increased any more without making the lender incur more costs and thereby making the lender worse-off then the equilibrium reached is efficient. If some gains from the financing are not being realised, for example because costs to the lender can be reduced, financing is inefficient.

In order to see whether security interests make finance more efficient, we need to first understand the risks associated with an unsecured loan. The greater the risk, the greater are the costs to the lender and the greater is the price of the loan to the borrower. If the risk is too great, the lender will not lend, irrespective of price. We can think of the greatest amount of risk, which the lender is willing to take, as “safe credit”. If costs can be decreased in a system, more loans will be assessed as “safe credit”. Both lenders and borrowers are better off because lenders are able to provide more of their product whilst borrowers are able to obtain finance which otherwise would not have been available to them. Reducing costs of lending makes finance more efficient. Costs of lending depend on the assessment of risk that the creditor is willing to undertake. This assessment in turn is a function of a number of factors, which can be broadly grouped in two categories. The first group of factors relates to the creditor’s own attitude to risk-taking. These may result from individual employees’ assessments, from financiers’ own business models or from factors external to the creditor and debtor’s relationship but which may nevertheless influence the

\(^5\) This is by analogy to producer surplus, Ibid. 136-137.
creditor’s behaviour such as market conditions or legal regulations. The second group of factors that affect the creditor’s assessment of risk is the creditor’s assessment of the probability of repayment of the loan. This assessment depends on the information, which the creditor has about the debtor. Each borrower knows, or can predict, its own expected return and repayment probability. In general the greater the return the more likely the loan will be repaid. This information is, however, not observable by lenders.\textsuperscript{51} Lenders can ascertain this only partially from the conduct of the debtor, its credit history or the borrower’s previous relationship with the lender. As the debtor has better knowledge than the creditor of its own willingness and ability to pay the loan, we say that this information is asymmetrically distributed.

Once the loan has been made and priced according to the risk that the debtor poses, there is also additional risk that the debtor will subsequently undertake more risky investments or will seek to avoid payment. This is referred to as the moral hazard problem. It is through reducing the costs arising from information asymmetry and moral hazard that security interests have been primarily shown to increase efficiency of lending. Before we go on to discuss these in detail, we briefly address how security interests impact on the first category of factors: that is, the creditor’s own attitude to risk.

\textbf{A. Impact of security interests on creditor’s risk preferences}

Creditors’ risk-aversion differs, as noted by White.\textsuperscript{52} First, he observed that risk assessment is made by individual employees, whose interests may not be to maximise the employer’s profits. He argued that security interests might overcome excessive caution of particularly risk-averse employees. Scott questioned whether security is the most cost-effective

way of dealing with risk-aversion of particular employees. Superfluous risk-aversion may be balanced out by using reward and incentive systems. The second point made by White was that the institutions themselves might exhibit differential risk distribution depending on the variations of legal rules that regulate their lending activity. Regulated institutions (commercial banks) are likely to be more risk averse than those that are not (financial institutions). Taking security alleviates the risk-aversion of the regulated institutions. Scott, however, noted that this is inconsistent with the evidence that regulated commercial banks have historically bought most unsecured debt whilst financial institutions have almost exclusively dealt in asset-financing.

In response to that debate, one could observe that taking security is relevant to the risk-weighting of capital for capital adequacy purposes under the Directive on capital adequacy and the Directive on taking up and pursuit of the business of credit institutions, which are an application of Basel II. Capital adequacy rules set down the amount of capital a bank or credit institution must hold. This amount is based on risk. There are various financial instruments, which a credit institution may employ to mitigate risk. These include derivatives, corporate bonds and also asset-backed securities. The legal rules on capital adequacy make secured credit more desirable in cases where there is willingness to reduce exposure for capital adequacy purposes. Thus, the choice of taking security is made on the basis of rules external to the relationship between the lender and the borrower. If

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53 Scott, 'A Relational Theory of Secured Financing' (n 36) 906, fn 19 and literature cited there.
54 White (n 52).
55 Scott, 'A Relational Theory of Secured Financing' (n 36) 906 and 943
57 Directive 2006/48 relating to the taking up and pursuit of the business of credit institutions [2006] OJ L177/1, as amended, currently also under review, see n 56.
58 An updated set of rules set up in June 2004 by the Basel committee, a part of the Bank for International Settlements. The rules are applied in the EU via directives 2006/48/EC and 2006/49/EC.
collateral is taken, capital charges may be reduced, which may make the capital available for other users.\textsuperscript{59} Secured credit is simply more advantageous than unsecured credit for calculating risk-weighted assets for capital adequacy purposes.

\textbf{B. Overcoming problems of asymmetry of information and adverse selection}

We now turn to discussing how security interests have been shown to maximise the lender’s surplus and to make lending more efficient. We begin with addressing the issue that the market is not perfect and information is asymmetrically distributed.\textsuperscript{60} With the potential debtor seeking the lowest-cost transaction and the cost at least in part being determined by the level of default risk he presents, the debtor has an advantage to be gained from presenting himself as a lower risk. With imperfect knowledge of the debtor the creditor is faced with the challenge of determining both the overall risk level of the transaction (and therefore whether to enter into it at all) and determining an effective pricing mechanism. A simple solution would be to price credit at a level that seems the worse case scenario. However, this would not produce optimal efficiency of the credit market and would not match the priorities of debtor companies working in a competitive market to reduce prices to ensure they stay competitive. As we have seen above when discussing the market equilibrium, it is only worthwhile for a person to borrow if the return on investment exceeds the cost of borrowing. The borrower is considered to have a better knowledge than his creditor to assess the return on investment and whether or not he will be willing and able to repay the loan at all. The lender could try to assess repayment probability by looking at how much interest rate the borrower is willing to pay, the assumption being the more interest the borrower is willing to pay, the more profitable the

\textsuperscript{59} J Benjamin, \textit{Financial Law} (OUP, 2007) para 20.06.
investment and so the greater the repayment probability. Such reasoning would be flawed. The interest rate as such cannot signal the willingness and ability to pay. If a debtor accepts a higher interest rate, it could reflect either the profitability of the undertaking or that the debtor is ready to take greater risk. Higher interest rates will, however, drive more trustworthy debtors out of the market, thus the ‘selection’ of borrowers may be ‘adverse’ from the viewpoint of the lender. Adverse selection may be anticipated by the creditors and thus cause a decrease in the availability of credit. If the lender cannot compensate for the increased risk of “bad debtors” by charging a higher interest rate, the lender will not lend at all to debtors even if they are willing to pay a higher interest rate.

Security interests reduce the asymmetry of information between the creditor and the debtor by providing a known and verifiable asset. The existence of the asset enables the creditor to better inform herself of the creditworthiness of the debtor and eliminate the need of a higher interest rate, thereby overcoming the adverse selection. Moreover, taking security may reduce the costs of evaluating the financial risk that debtor poses. Instead of collecting and analysing information on the debtor’s creditworthiness, the creditor may prefer to lower the immediate costs and obtain security. Security interest itself may serve as a tool of reducing the information asymmetry by sending the creditor

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63 Bester (n 32); Y Chan and G Kanatas, 'Asymmetric Valuation and the Role of Collateral in Loan Agreements' (1985) 17 Journal of Money, Credit and Banking 84, 85; Besanko and Thakor, (n 60); H Bester, 'The Role of Collateral in Credit Markets with Imperfect Information' (1987) 31 European Economic Review 887.
65 Finch (n 19) 638.
a positive signal about the creditworthiness.\(^{66}\) Although typically lenders require collateral for loans granted to borrowers with lower credit quality (i.e. presenting a higher credit risk),\(^ {67}\) in cases of borrowers with no record of previous financial or commercial activity willingness to give collateral may signal that they are creditworthy.\(^ {68}\)

### C. Overcoming the moral hazard problem

The contract between the lender and the borrower is concluded on the basis of the lender’s assessment of the borrower’s repayment probability. After the contract has been concluded, the creditor risks that the borrower’s behaviour may be inconsistent with that assessment. If the rate was fixed, the debtor could try to reduce the real cost of loan by undertaking activity more risky than the one envisaged by the creditor. The borrower might, for instance, obtain a higher-risk loan at an interest rate commensurate with the price for a less risky activity\(^ {69}\) or by distributing corporate assets to shareholders in the form of excessive dividend payments.\(^ {70}\) Thus, the so-called “moral hazard” problem is created. It arises when one person (the agent) is performing a task on behalf of another (the principal). If the principal cannot perfectly monitor the agent’s behaviour, the agent may engage in dishonest or otherwise undesirable (“immoral”) behaviour.\(^ {71}\) Misbehaviour generates conflicts known as agency costs, which inflate the cost of

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\(^{66}\) F Buckley, 'The Bankruptcy Priority Puzzle' (1986) 72 Va LR 1393, 1426, 1464 (arguing that security interests reduce the lenders’ net screening costs in determining debtor’s creditworthiness and minimises adverse incentive costs).


\(^{68}\) Jiménez, Salas and Saurina, (n 27) 256, providing empirical evidence for a previous theory (for the theory see A Schwartz, 'Security Interests and Bankruptcy Priorities: A Review of the Current Theories' (1981) 10 J Leg Stud 1, 14-21; Bester, 'Screening vs Rationing in Credit Markets with Imperfect Information' (n 32); Chan and Kanatas (n 63); Besanko and Thakor (n 60).

\(^{69}\) Jackson and Kronman (n 18) 1149-50.

\(^{70}\) These are referred to as financial agency costs, see Mokal (n 21) 711. See also Finch (n 19) 641.

\(^{71}\) Mankiw and Taylor, *Economics* (n 48) 446.
Compensating the creditor for its portfolio risk by increasing interest rates might increase moral hazard and inflate agency costs.\(^{73}\)

**(a) Reduction of costs of monitoring**

One way to deal with moral hazard is to monitor the debtor.\(^{74}\) For instance, the debtor could be required to submit regular financial reports. This, however, could be cumbersome and costly. The creditor only has an incentive to monitor the debtor if the benefits of monitoring outweigh its costs.\(^{75}\) Security may reduce the need, as well as the cost of monitoring of the entirety of the debtor’s assets, to monitoring only a secured asset and thus overcome moral hazard problems.\(^{76}\) The presence of collateral does not eliminate the risk of the debtor’s misbehaviour but the creditor is shielded from the consequences of such misbehaviour and cost of borrowing need not be inflated by agency costs.\(^{77}\) The cost decrease would be noticeable in particular by creditors whose monitoring costs would otherwise be large because of lack of information of day-to-day business with the debtor.

In addition, security interests avoid free-riding problems as they reward the monitoring efforts of the secured creditor in a multi-creditor scenario.\(^{78}\) Where the debtor borrows from different creditors and at least one creditor monitors the debtor, the other creditors have an interest to free-ride on the monitoring efforts of that creditor. The non-

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\(^{72}\) Oditah (n 24) 16.


\(^{74}\) Other ways include obtaining price protection by trading debts where possible, spreading risks by diversifying; cutting down repayment periods and using covenants in loan contracts: see Finch (n 19) 642.

\(^{75}\) Ali (n 19) para 2.63; Finch (n 19) 643.

\(^{76}\) Jackson and Kronman (n 18); White (n 52); Kripke (n 29); Shupack (n 18) 1075ff; Boot, Thakor and Udell (n 73); but see Schwartz, ‘Security Interests and Bankruptcy Priorities: A Review of the Current Theories’ (n 68) (rejecting monitoring and signalling explanations of secured credit’s efficiency); Schwartz, ‘The Continuing Puzzle of Secured Debts’ (n 20) 1066-67; T Jackson and A Schwartz, ‘Vacuum of Fact or Vacuous Theory: A Reply to Professor Kripke’ (1985) 133 U Pa LR 987, 994 (rejecting Professor Kripke’s argument that security interests are not a zero-sum game).

\(^{77}\) Jackson and Kronman, ‘Secured Financing and Priorities among Creditors’ (n 19) 1153.

\(^{78}\) S Levmore, ‘Monitors and Free-Riders in Commercial and Corporate Setting’ (1982) 92 Yale LJ 49; see also Shupack (n 18) 1077-1078.
monitoring creditors avoid incurring costs of monitoring whilst benefitting from the fact that the risk of the borrower’s misbehaviour is reduced. Security interests compensate the efforts of the monitoring creditor by promoting its claim upon default over the claims of the non-monitoring creditors. The non-monitoring creditors no longer benefit “for free” from the fact that someone else keeps an eye on the debtor.

(b) A mutually-interested relation reducing moral hazard

Scott argued that security interests, particularly in an exclusive lending arrangement, might cause “each party [to] ... act as if it owned all the property rights in the prospect”. Scott, 'A Relational Theory of Secured Financing' (n 36) 916-919. Neither party would then act contrary to the interests of another for the fear of retaliation in either future or present transaction. It seems, however, that placing the interests of the lender and the borrower on a par is not fully justified, as the former will favour a more cautious approach than the interests of the latter would dictate. This theory, called the “relational theory”, may explain security interests in project and infrastructure finance, where the creditor-debtor relationship resembles a joint-venture, with some form of “fiduciary” duties owed by one joint-venturer to another but it does not seem to explain the efficiency of secured transactions more widely.

D. Fair distribution and efficiency in a wider context – third party issues

Efficiency is about maximising the surplus to all members of the society, not merely the lender and the borrower. Security interests, as property rights, are enforceable against third parties. In order to assess the efficiency of secured credit, it is necessary to consider whether the surplus of third parties is maximised when lending is secured.

79 Scott, 'A Relational Theory of Secured Financing' (n 36) 916-919.
80 See also W Boot and A Thakor, 'Moral Hazard and Secured Lending in an Infinitely Repeated Credit Market Game' (1994) 35 International Econ Rev 899, 904-914.
81 Mann (n 29) 656.
82 Ali (n 19) para 2.74, citing G Bean, Fiduciary Obligations and Joint Ventures: The Collaborative Fiduciary Relationship, OUP 1995.
(a) The net impact on society

Schwartz argued that it is impossible to prove that security is efficient without first understanding how it reduces the social cost. He himself, after testing several economic theories, could not show that social gains exceed social costs and declared the efficiency to be unproven. Jackson and Kronman opined that secured credit reduces the overall costs to any particular debtor and since all parties share the resulting savings, there is an incentive for all to produce these cost savings. White called this benefit to all parties the “common welfare”. Barnes, in turn, argued that secured transactions do not produce any value (there is no “net societal gain”) but merely shift it from some participants to others. If this is true, it seems that it is not possible to say whether credit market equilibrium is more efficient with or without collateral. Barnes himself suggested that security interests could nevertheless be justified on the grounds of utilitarianism.

(b) The impact of security interests on unsecured creditors

LoPucki famously and controversially stated: “security is an agreement between A and B that C take nothing”. He argued that secured creditors and debtors extract a subsidy from those who involuntarily became creditors. Consequently, security interests misallocate resources by imposing on unsecured creditors a bargain to which many, if not most, of them have given no meaningful consent. Although involuntary creditors cannot be said to take the risk of the debtor’s

84 Jackson and Kronman, ‘Secured Financing and Priorities among Creditors’ (n 18) 1153.
85 White (n 52) 475.
89 See Ibid., 1895 In 36; also E Warren, 'Bankruptcy, Policymaking in an Imperfect World' (1993) 92 Mich LR 336, 354 refers to “involuntary creditors such as tort victims and environmental cleanup funds”.
insolvency, they bear its consequences. LoPucki’s analysis is preoccupied with tort victims.\textsuperscript{91} He observed that tort claims form a substantial part of liabilities in bankruptcy proceedings,\textsuperscript{92} which lead him to argue, controversially, that secured credit is used purposely to defeat these liabilities.

Mokal critiqued this reasoning.\textsuperscript{93} First, larger companies are more likely to take security when they aim to avoid bankruptcy.\textsuperscript{94} They do not set out to defeat tort claims by granting security when the company is solvent. For smaller firms liquidation bears comparatively significant costs, which are unlikely to be outweighed by the benefits from liquidating a firm in order to externalise tort liabilities.\textsuperscript{95} Second, companies often pay the “involuntary” liabilities anyway. Secured debt does not serve to externalise costs nor does it victimise the ‘involuntary’ creditors.\textsuperscript{96} The lawmakers in a given legal system may choose to protect certain creditors above secured creditors but this is a policy decision made by considering fairness of distribution. Unlike economic efficiency, it cannot be judged on positive, objective grounds but involves normative judgments from political philosophy\textsuperscript{97} such as equality of creditors at insolvency.\textsuperscript{98}

Notwithstanding the controversies, LoPucki’s analysis is a good illustration of an important theme: the legal system ought to ensure that one creditor is not unjustly enriched at the expense of another.\textsuperscript{99} The extent to which the debtor’s assets are subject to security is crucial in

\textsuperscript{91} Point noted by S Block-Lieb, 'The Unsecured Creditor’s Bargain: A Reply' 80 Virginia LR 1989, 1993; Knippenberg (n 90) 1969-70, fn 13; Mokal (n 22) 692.
\textsuperscript{92} Point also cited by Bebchuk and Fried, (n 20) 883, fn 89; L Bebchuk and J Fried, "The Uneasy Case for Priority of Secured Claims in Bankruptcy: Further Thoughts and Reply to Critics’ (1997) 82 Cornell LR 1279, 1296-97, fn 60; Finch (n 19) 645, n 80 and in four other places as pointed by Mokal (n 22) fn 38.
\textsuperscript{93} Mokal (n 22) 695-696.
\textsuperscript{94} LoPucki (n 88) 1927 fn 153, pointed out by Mokal (n 22) 695.
\textsuperscript{95} Mokal (n 22) 699.
\textsuperscript{96} Ibid. 696.
\textsuperscript{97} See Mankiw and Taylor, Economics (n 48) 141.
\textsuperscript{98} See discussion of the pari passu rule as a contradiction of the principle of equality viewed as fairness of distribution: R Mokal, 'Priority as Pathology: The Pari Passu Myth' (2001) 60 CLJ 581.
\textsuperscript{99} The importance of this theme is also placed by R Goode, 'The Modernisation of Personal Property Security Law' (1984) 100 LQR 234, 256.
achieving the fair balance. Fairness in individual cases may be impossible to reconcile with the utilitarian principle of greatest happiness for the greatest number but a legal system should at least strive to achieve fairness in the typical case and to remove unnecessary impediments to efficiency.\textsuperscript{100}

### 2.4 Efficiency of security interests in derived assets

We said above that risks and costs associated with lending depend on the attitude to risk of the creditor and on the creditor’s assessment of the probability of repayment. We concluded that security interests increase efficiency of credit by overcoming information asymmetry and moral hazard problems. However, a problem that has only been partially addressed in the debate on efficiency of security interests is that taking security presents additional risks for the lender. If a loan is secured, the probability of repayment depends on additional factors such as the value of the collateral on the market at the time of enforcement of the security and the continuing existence of a security interest in an asset (whether the original collateral or a new asset). If the value of the asset falls, the creditor may not be paid in full. Neither the lender nor the borrower can predict with certainty the future market value of the asset and this is usually outside of their control.\textsuperscript{101} Yet, in some cases, secured lending itself may fuel moral hazard when the lender places ungrounded reliance on the value of collateral, for example where the lender counts on the collateral improving in value.\textsuperscript{102}

Key to this thesis is the risk posed by legal rules of security interests. This issue has not yet attracted the attention of law and economics scholars. The problem of potential inefficiency of security is a serious

\textsuperscript{100} Ibid. 236.

\textsuperscript{101} An exception is where the creditor has security over shares where the grantor of security has rights issue of shares. An exercise of the right would lead to the value of the creditor’s shareholding being diminished.

The increased efficiency of the credit market equilibrium, which we discussed above, depends on the continuing existence of the collateral. If a security interest may cease to exist when the debtor withdraws assets from security or when encumbered goods are mixed with other goods, this creates a new risk for the creditor: a risk of losing security. If security interest can no longer be asserted in the old asset, the problem of moral hazard is not overcome. If, after security interest has been granted, the debtor tries to withdraw the collateral from security, a new moral hazard problem arises. Without an asset subject to security the debtor will present a higher risk than the creditor originally agreed to finance. Thus, a legal system permitting withdrawal of assets from security without consent of the lender may fuel moral hazard where the debtor may, by its behaviour, cause assets to be withdrawn from security.

It is argued that a rule that automatically extends security interests to substitutes (whether clean substitutions or mixed substitutions) deals with this moral hazard problem and promotes efficiency of security interests. By contrast, it is argued, a rule that automatically extends security to fruits leads to inefficiency. The distinction between fruits and substitutes is not always clear-cut and we deal with it in chapter 2. 103

A. Promoting efficient credit market equilibrium: security in substitutes

The problem of moral hazard posed by collateral can be overcome if the creditor contracts to take security in the substitute resulting from the debtor’s disposition of the old asset to a bona fide purchaser or mixing of the old asset to create a new one. Additional contracting means additional transaction costs, which can be avoided if the security interests extend to substitutes by operation of law. A rule that security automatically extends to substitutes (“substitutes rule”) may be seen as preserving the bargain between the parties and avoid additional

103 See text to n 360.
transaction costs associated with contracting for this rule. A new asset acquired with the value represented in the old asset simply takes place of the old asset. The creditor still has a known and a verifiable asset, which preserves the reduced costs of monitoring of the debtor. It seems that whether the new asset is equivalent in value to the old asset is irrelevant at this stage because the creditor monitors a particular asset, not its value.

Where there is a risk of the creditor’s security interest being defeated by a debtor’s disposition, a substitutes rule in a legal system is likely to promote the role of security. The creditor need not include the risk of losing security in the cost of borrowing. The likelihood of repayment is greater than if the creditor were to lose its security in the original (disposed of) collateral. This is true even if it may be difficult to estimate whether the likelihood of repayment differs depending on the type of asset encumbered: the asset which constitutes proceeds or product may be a different type of asset than the original collateral, which may in turn have an influence on the creditor’s ability to resort to that asset if the debtor defaults. Even if the likelihood of repayment is smaller when security shifts to a substitute compared to security in the original collateral (for example due to the smaller value of the substitute), it is still greater than not having security at all. While the creditor is better off by having a right to resort to proceeds or products (i.e. substitutes), the debtor is not worse off: the debtor surrenders security in one asset and substitutes it for another. Indeed, if security did not extend to proceeds and products automatically the creditor would likely be worse off (if he lost security in the original collateral) whilst the debtor would be better off as his assets would no longer be subject to a right in favour of the creditor. The substitution of the original asset for proceeds or products does not, as a matter of principle, change the position of the debtor’s other creditors, who will

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104 For the role of security in reducing costs of monitoring see text to nn 74-78.
need to give priority to the secured creditor with respect to the new asset instead of the original collateral.¹⁰⁵

B. Security in fruits as an impediment to an efficient equilibrium

The rationale for extending security to fruits seems to be different than in the case of security in substitutes. Fruits are generated beside, not instead of, the original collateral. A rule automatically extending security interests to fruits (“fruits rule”) would enlarge the subject matter of security. A question to ask is whether such a rule, similarly to the substitutes rule, would work to promote efficiency of security. In the process of generating fruits, unlike with proceeds or products, there is no risk for the creditor of losing security in the original asset. Let us consider the costs and benefits to the lender and the borrower of such a rule. It is shown that the fruits rule causes oversecuritisation of the lender and a deadweight loss to the credit market.

The debtor, however, is worse off because new assets become automatically encumbered, in addition to those already subject to security. This means that the debtor receives no new value and is limited in making use of the new assets, for example when seeking new credit the debtor cannot offer to his prospective new creditor a first-ranking security in the new asset (the fruit) because a security already exists in that asset. This leads to a problem of oversecuritisation and deadweight loss.

(a) Oversecuritisation

It might be tempting to think that the creditor is better off with a right to fruits than he is without it because he has more assets to resort to (fruits as well as original collateral) in the event of debtor’s default. The value of these assets may be much greater than the amount of the loan secured. We need to remember, however, that the creditor can only

¹⁰⁵ Thus other creditors of the debtor also are not worse off. This matters if we take into account interests of third parties when discussing efficiency of secured credit. See text to nn 88-100.
resort to the assets up to the amount of the secured debt. Probability of repayment does not increase linearly with the increasing number of assets. The increase of repayment probability with extra assets being added is incremental. The benefit of having security automatically extend to fruits is therefore marginal.

Extending security to fruits makes the credit market equilibrium less efficient if one takes into account the interests of third parties. The difference between proceeds and products on one hand and fruits on the other is that the former are new assets that do not represent new wealth available to the creditor since they are substitutes of assets disposed of or mixed. Fruits are new assets that represent new wealth in the debtor’s estate. The rule carves out a greater proportion of the debtor’s assets to the secured creditor, which is difficult to reconcile with interests of other creditors, thus making it further questionable from the perspective of fairness. The creditor ends up in a position where he can resort to assets worth much more than the secured debt. The creditor is oversecuritised. Yet the creditor does not gain a benefit (or gains only a very small benefit) from the greater number of assets as collateral because the increase in the repayment probability is incremental.

(b) The deadweight loss of the fruits rule

Another argument against an automatic extension of security to fruits is that such a rule would create a deadweight loss. In economic terms the rule extending security to fruits by operation of law would impede efficiency in a way analogous to deadweight loss in market equilibrium. A deadweight loss is the fall in total surplus that results from market distortion. A typical example is tax. In a market of goods when tax is imposed the price paid by the buyers rises but the sellers do not receive a greater price. This causes the supply and

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106 For example, if Andy lends £5 to Jenny, who gives security over her watch worth £100, the likelihood of repayment will not increase substantially (if at all) just because Jenny will add security over her computer worth £500.

demand curve to shift.\textsuperscript{108} For example, if the tax is levied on sellers of widgets, the price of widgets goes up and the supply curve shifts: fewer widgets are sold at the given price. A tax on a widget causes the size of the market for the widget to shrink. It is argued that a rule that automatically extends security interests to fruits (which we continue to refer to as a “fruits rule”) generates deadweight loss in a similar way as taxation does.

We need to measure gains and losses to borrowers and lenders from the fruits rule. We already said that the benefits to the lender from the fruits rule are marginal. We can therefore assume that the lender is neither better off nor worse off with a fruits rule. The borrower, however, is worse off where the rule applies because the cost of borrowing rises for the borrowers. All assets, which the borrower can use to raise finance, present an investment opportunity to the borrower. The borrower can use the new assets to raise new finance. If the new assets are automatically subject to an interest in favour of the lender, the borrower loses that opportunity. What the borrower must give up is an opportunity cost.\textsuperscript{109} The borrower is worse off where the fruits rule applies because the cost of borrowing are enlarged by the opportunity cost. The borrower cannot offer the new assets as security to other lenders to gain fresh loans. He cannot borrow as much as he would be willing to. The market does not reach its efficient equilibrium because the surplus to both parties (i.e. the surplus of the borrower and the surplus of the creditor) is smaller.

A legal system could provide that parties can contract out of the fruits rule but this increases transaction costs, as they need to spend time and money to consider whether to exclude this rule. It is more efficient to let parties decide to “opt-in” rather than to “opt-out”. Assuming that parties are rational, there is arguably no deadweight loss in a parties’ agreement to extend security to fruits because parties would have

\textsuperscript{108} Ibid. 150-151.
\textsuperscript{109} Ibid. 151.
considered why their relationship requires extension of security to fruits. For example, parties may decide to extend security to fruits because it is foreseen that the value of the original collateral will diminish on the market and so new assets will need to become subject to security.

3 Types of security in England

Rights of the secured creditor to assert security in new assets that derive from the original collateral depend on the legal rules of security interests in general. Before we can proceed with the discussion on security interests in derived assets we need to first examine the four available types of security in English law: pledge, charge, mortgage and contractual lien.110 As mentioned in the introduction, this thesis concerns non-possessory security interests, which means charges and mortgages. Equitable liens can also be non-possessory consensual security but their nature is controversial and practical importance minimal. Although not all types of security interests are of interest in this thesis, we need to briefly outline all of them to know what types of security remain outside of the scope of this work.

3.1 Pledge

Pledge111 is a possessory security. It is created by delivery of actual or constructive possession of the asset to the creditor by way of security112 or by a third party attornment to the creditor.113 The pledgor remains

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110 Re Cossett (Contractors) Ltd [1998] Ch 495 (CA) 508 (Millett LJ); Goode on Legal Problems of Credit and Security (n 1) para 1-42.
111 See generally on pledge N Palmer and A Hudson, ‘Pledge’ in N Palmer and E McKendrick (eds), Interests in Goods (2nd edn, LLP, 1998) and Beale et al, The Law of Security and Title-Based Financing (n 2) paras 5.01-5.55. Where a pledge is used as a security for a short-term loan to an individual over tangible goods (a pawn) it is governed by Consumer Credit Act 1974, ss114-121.
112 Dublin City Distillery Ltd v Doherty [1914] AC 823 (HL); Goode on Legal Problems of Credit and Security (n 1) para 1-43.
113 Official Assignee of Madras v Mercantile Bank of India Ltd [1935] AC 35 (PC), 58 (Wright LJ). Attornment means that the third party, or even the debtor himself (Meyerstein v Barber (1866) LR 2 CP 38, 52 (Willes J), agrees to hold the goods or documents for the creditor instead of the debtor.
the owner of the asset whilst the pledgee becomes a possessor and enjoys a “special property”.\textsuperscript{114} The possession gives the creditor a legal, albeit limited, interest in the asset.\textsuperscript{115} It entitles the pledgee to exercise the proprietary and possessorial remedies against a third party wrongdoer, including (common law) damages calculated according to the full value of goods as if he were an owner. The pledgee has a right to use the asset, albeit at his own risk, as long as this will not impair it;\textsuperscript{116} a right to sell the interest as a pledgee or to assign it by way of gift; a right to sub-pledge the asset on the same conditions as he holds it and for a debt no greater than his own; a right to deliver the asset to another for safe keeping; and a right to sell the asset in the event of default in payment by the pledgor. The limited nature of the pledgee’s interest in the asset is seen first in the lack of a right to foreclosure\textsuperscript{117} and, second, in the obligation of the pledgee, following discharge of the debt, to hold any surplus on trust for the pledgor if he recovers a sum greater than the secured debt.\textsuperscript{118}

Assets that can be encumbered with a pledge must be reducible to possession. Choses in action, such as shares, cannot be pledged.\textsuperscript{119} Assets pledged in practice are goods and documentary intangibles (e.g. documents of title such as bills of lading, negotiable documents of entitlement to be paid\textsuperscript{120} and negotiable securities\textsuperscript{121}). Unlike in the US,

\begin{itemize}
\item \textsuperscript{114} E.g. Ratcliff v Davies (1610) Cro Jac 244, 245 (Fleming CJ); Coggs v Bernard 92 ER 107, 112; (1703) 2 Ld Raym 909, 916 (Holt CJ); Donald v Suckling (1866) LR 1 QB 585, 595 (Shee J), 606 (Mellor J), 614 (Blackburn J); Sewell v Burdick (The Zoe) (1884-85) LR 10 AC 74, 106 (Fitzgerald LJ).
\item \textsuperscript{116} This is different now than was at the time of Coggs (n 114) 917 (Holt CJ), where pledge had “the nature of a deposit (…) not liable to be used” unless the asset pledge required use, e.g. a horse or a cow, then a reasonable use was permitted.
\item \textsuperscript{117} Carter v Wake (1877) LR 4 Ch D 605. Unless the contract or a statute otherwise provide, the pledgee cannot become the owner of the pledged assets upon the default of the debtor.
\item \textsuperscript{118} Matthew v TM Sutton [1994] 4 All ER 793, 793 (Chadwick J); Donald (n 114) 604 (Mellor J); Chabba Corp Pte Ltd v Jag Shakti (owners), The Jag Shakti [1989] AC 337 (PC); The Odessa [1916] 1 AC 145 (PC) 159 (Mersey LJ); N Palmer, Palmer on Bailment (3rd edn Sweet & Maxwell, London 2009) para 23-034.
\item \textsuperscript{119} Harrold v Plenty [1901] 2 Ch 314.
\item \textsuperscript{120} E.g. bills of exchange, cheques, promissory notes, treasury bills.
\item \textsuperscript{121} E.g. bearer shares, share warrants, bearer bonds and debentures, negotiable certificates of deposit.
\end{itemize}
where registered securities can be pledged insofar as they are certificated, under English law registered securities cannot be pledged. In England, a certificate relating to registered shares or debentures is not negotiable. However, if the certificate has been delivered and transferred, until registration takes place, the transferee has an equitable charge or equitable mortgage.

3.2 Lien

Lien seems to be one of the most “confused” types of security interests in English law. Slade J explained in Re Bond Worth that the word “lien” is more commonly used in its narrow sense to mean a right arising by operation of law. As such it may arise by virtue of a statute, common law or equity. In a broader sense, lien may also signify a right, which arises on the basis of a contract. Contractual liens are said to take effect both by common law and equity. Common law liens connote a possessory lien, which involves a right to detain goods until the money owed to the detainee has been paid. When created by contract they are similar to a pledge: for a lien to arise there must be a (voluntary) delivery of possession to the creditor. In contrast to pledge, the goods subject to lien are usually deposited not for the purpose of security but for some other purpose such as custody or repair. Unlike a pledgee, a lienee cannot dispose of his interest and cannot generally sell the goods, which are subject to a lien.

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122 UCC §9-313(a).
123 Harrold (n 119); Goode on Legal Problems of Credit and Security (n 1) para 1-47, fn 169 and case law cited there.
125 Re Bond Worth [1980] Ch 228, 250 (Slade J); Beale et al, The Law of Security and Title-Based Financing (n 2) para 6.140.
126 Hammond v Barclay (1802) 2 East 227, 235; 102 ER 356, 359 (Grose J); Tappenden v Artes [1964] 2 QB 185 (CA); Ibid. (n 2) para 5.57.
127 Gladstone v Birley (1817) 2 Mer 401, 404; 35 ER 993 (Grant MR).
128 Cosslett (n 110) 508 (Millett LJ).
129 Goode on Legal Problems of Credit and Security (n 1) para 1-49; see e.g. in Forth v Simpson (1849) 13 QB 680; Cosslett (n 110) 508 (Millett LJ).
130 Donald (n 114) 604 (Mellor J). Exceptions may arise on the basis of a contract, trade usage or a statute (e.g. unpaid seller’s right of resale, Sale of Goods Act 1979, s48).
position has been questioned recently. As a limited property right, it is
perceived to be capable of assignment where the debt is also
assigned.\textsuperscript{131} It has been argued that a contractual power to sell will not
convert a contractual lien into pledge,\textsuperscript{132} although there are also views
to the contrary.\textsuperscript{133}

Equitable liens, unlike common law liens, elude a definition.\textsuperscript{134} They
are traditionally seen as not depending on possession.\textsuperscript{135} Consequently,
they are thought to operate similarly to charges, for example by being
enforced in the same way.\textsuperscript{136} However, a shadow of a doubt has been
cast recently on whether intangible property could be subject to a
lien.\textsuperscript{137} If the property subject to an equitable lien is disposed of to a
purchaser of a legal interest in the asset, the purchaser takes free of the
lien unless they had a notice of it. Equitable lien may be protected by
registration if the asset is land\textsuperscript{138} but not if the asset is personal
property.\textsuperscript{139} Equitable liens arise by operation of law in relation to a

\textsuperscript{131}Ibid. (n 130) 1106; Palmer and Hudson, 'Pledge' (n 111) 636.
\textsuperscript{132}Sealy and Hooley (n 130) 1108 citing Trident International Ltd v Barlow [1999] 2
BCLC 506 – a contractual lien not converted into an equitable pledge, and Marcq v
Christie Manson & Woods Ltd (t/a Christies) [2003] EWCA Civ 731, [2004] QB 286
\textsuperscript{133}Goode on Legal Problems of Credit and Security (n 1) para 1-49.
\textsuperscript{134}G McCormack, Secured Credit under English and American Law (Cambridge
Studies in Corporate Law, CUP, 2004) 45 and case law cited there. Generally on
equitable liens see I Hardingham, 'Equitable Liens for the Recovery of Purchase
Money' (1985) Melbourne ULR 65; Phillips (n 124); Beale et al, The Law of Security
and Title-Based Financing (n 2) paras 6.140-6.163.
\textsuperscript{135}McKendrick (ed), (n 115) 661.
\textsuperscript{136}Re Beirnstein [1925] Ch 12, 19.
\textsuperscript{137}Re Lehman Brothers International (Europe) [2012] EWHC 2997 (Ch) [34], [36]
(Briggs J) (the arrangement of “general lien (…) on all other property held by [the
custodian]” was characterised as a charge).
\textsuperscript{138}Class C(iii) land charge where land is unregistered under Land Charges Act 1972,
s2(4)(iii); a caution against first registration if registered land, Land Registration Act
2002, s 15; as a notice, LRA 2002, s 32, or an overriding interest if the lien-holder is in
possession, LRA 2002, s70(1)(g).
\textsuperscript{139}Equitable liens are not registrable under Companies Act 2006, s860. This does not
change under Draft Companies Act 2006 (Amendment of Part 25) Regulations 2013
(revised draft, to come into force 6 April 2013); only charges created by the company
are registrable. Liens are “created”: London and Cheshire Insurance Co Ltd v
Laplagrene Co Ltd [1971] Ch 499. The revised Draft Regulations do not, however,
expressly exclude registration of liens as the previous version of the Draft Regulation
did (previous version of s859A(6)(c)).
contract or other relationship between the parties concerning an asset. The indicative circumstances sufficient (rather than essential) for a lien to arise are: (i) existence of a debt of the owner of an asset to another (the creditor of the debt) arising from a promise to pay consideration for acquiring the asset or payment of, or a promise to pay, an expense in relation to that asset; (ii) identification and appropriation of the asset to the performance of the contract; (iii) it would be unconscionable on the part of the owner to dispose of that specific asset to a third party, without consent of the creditor or without discharging the debt owned to that creditor.\textsuperscript{140} An example of an equitable lien is a vendor’s lien, which arises where legal or equitable title in an asset is transferred to a purchaser before the full payment of the purchase price. The vendor has an equitable lien in the asset to the extent the price remains unpaid as it is considered to be unfair for the purchaser to keep the property without paying for it.\textsuperscript{141} The greatest difficulties are around unconscionability. It seems that what must be unconscionable is the lack of priority of the lienholder in the event of the lienor’s insolvency as against other creditors of the lienor.\textsuperscript{142} Beale, Bridge, Gullifer and Lomnicka suggest that the relevant factors to be taken into account in determining unconscionability are issues of justice and fairness between the lienholder and the other creditor and whether it would be unconscionable for the lienholder to be an unsecured creditor.\textsuperscript{143} Thus, in order to find out if a lien arises we need to know whether the claimant deserves proprietary protection. We examine possible arguments in favour of proprietary protection when we examine claims to proceeds of unauthorised dispositions of collateral in the final chapter.\textsuperscript{144} The equitable lien we consider in the final chapter is a proprietary remedy, which usually arises as an alternative to

\textsuperscript{140} Hewett v Court (1983) 149 CLR 639 (Aus H Ct) 668 (Deane J).
\textsuperscript{141} Beale et al, *The Law of Security and Title-Based Financing* (n 2) para 6.154; vendor’s lien does not appear to apply in the context of sale of goods, see ibid. para 6.144 but contrast Hardingham, (n 134) 75 and S Worthington, ‘Equitable Liens in Commercial Transactions’ (1994) 53 CLJ 263, 269.
\textsuperscript{142} Phillips (n 124) 991-993.
\textsuperscript{143} Beale et al, *The Law of Security and Title-Based Financing* (n 2) para 6.142.
\textsuperscript{144} See text to nn 983-997.
This is a different role of the equitable lien than the one we find in relation to, for example, vendor’s equitable lien, where the lien secures specific obligations that relates specifically to particular property which is subject matter of the contract. As we shall see, however, the need to put the claimant above unsecured creditors justifies a proprietary response but it does not automatically help us explain the type of the proprietary response: a lien or a constructive trust. The sort of arguments based on fairness and justice, which may support the imposition of, for example, vendor’s equitable lien do not suffice to explain why the proprietary remedy should be a lien rather than a constructive trust in a given scenario. In the final chapter we shall therefore examine why a lien is more suitable than a constructive trust as a remedy in the specific context of a secured creditor’s restitutionary claim to proceeds of unauthorised dispositions of collateral.146

3.3 Mortgage

Mortgage involves a transfer of ownership of the asset, or any other lesser interest held by the transferor, by way of security upon the express or implied condition that ownership will be re-transferred to the debtor upon the discharge of his obligation.146 Traditionally, the mortgagor has a right to get the mortgaged asset back on redemption and restrictions of such right are prohibited.150 A mortgagee exercising the power to sell to discharge the secured obligation is bound, similarly to a pledgee, to hold any surplus on trust for both the mortgagor and

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145 Beale et al, The Law of Security and Title-Based Financing (n 2) para 6.163.
146 See discussion below, chapter V, section 3.3.C.
147 See generally Beale et al, The Law of Security and Title-Based Financing (n 2) paras 6.01-6.16; E Cousins and I Clarke, Cousins on the Law of Mortgages (3rd edn Sweet & Maxwell, London 2010).
148 See Goode on Legal Problems of Credit and Security (n 1) para 1-50 (identifying five ways of transfer of legal of title for the purpose of creating a legal mortgage).
150 See however the criticism of the rule A Berg, 'Clogs on the Equity of Redemption—or Chaining an Unruly Dog' (2002) JBL 335; see also Beale et al, The Law of Security and Title-Based Financing (n 2) paras 6.30-6.46.
any subsequent mortgagees. Unlike in the case of a pledge or a common law lien, delivery of possession is not a condition of creating a mortgage, which means that both tangibles and intangibles can be subject to mortgage. Mortgages are traditionally divided into legal and equitable. A legal mortgage is a transfer of legal title to the mortgagee whilst an equitable mortgage involves a transfer of an equitable title or a declaration of trust in favour of the mortgagee. Requirements to effect transfer of legal title for the purposes of creation of a mortgage may differ depending on the asset or the person of the grantor. For example, a legal mortgage of a debt or other chose in action is effected by assignment in writing by the assignor accompanied by a notice of assignment to the debtor. Alternatively, a legal mortgage over such assets can be effected by novation. An equitable mortgage, as Lord Templeman explained, “is a contract which creates a charge on property but does not pass a legal estate to the creditor.” This may be because the owner of the property does some act, which is insufficient to transfer a legal estate or title in the subject matter upon the mortgagee, but it will, nevertheless, demonstrate a binding intention to create a security in favour of him. An equitable mortgage may also arise where the subject matter is a future asset; where the mortgage is of an equitable interest or where the mortgagor creates a second

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151 Law of Property Act 1925, s105; prior to legislation see Banner v Berridge (1880) LR 18 Ch D 254, 260; Beale et al, The Law of Security and Title-Based Financing (n 2) para 18.54. See also text to nn 832-844 for discussion of the extent of the duty of the mortgagee and for discussion of whether the presence of a fiduciary relationship between the mortgagee and mortgagor underlies the rationale of this rule.

152 For advantages of non-possessory security see e.g. Goode, ‘The Modernisation of Personal Property Security Law’ (n 99) 234; M Bridge, ‘Form, Substance and Innovation in Personal Property Security Law’ (1992) JBL 1 (noting that possession may be integral to the operation of the debtor’s business and hence influence his ability to repay the loan).

153 Approved in London & County Banking v Goddard [1897] 1 Ch 642.


155 Law of Property Act 1925, s136.

156 Downsview Nominees Ltd v First City Corporation Ltd [1993] AC 295 (PC) 311 (Templeman LJ).

mortgage since the legal title is with the first mortgagee and legal title can be transferred only once. 158

3.4 Charge

A charge 159 is a non-possessory security, whereby the charged property is appropriated without the transfer of possession or title. 160 A chargee, unlike a mortgagee, cannot foreclose or take possession. Whilst a mortgage involves conveyance of property subject to equity of redemption, a charge conveys nothing and merely gives the chargee certain rights over the encumbered property. 161 Yet, sometimes the chargor may also be said to have a right to redeem. 162 A mortgage does not create a right in the asset belonging to the debtor. Instead, it transfers the already existing right to the asset that the debtor has (i.e. a legal or equitable title) to the creditor. Thus, the right, which the creditor acquires, is not a new one. Thus, a mortgage creates a right in re su a (the right of redemption). By contrast, an equitable charge creates an interest in re aliena. 163 The chargor creates an interest, which previously did not exist in the asset, and grants this interest to the chargee. Despite these differences between a charge and a mortgage, the term “charge” may be regarded as an umbrella expression to cover a right of recourse to property for security purposes, in which case it also

158 Beale et al, The Law of Security and Title-Based Financing (n 2) para 6.07.
159 See generally Ibid.(n 2) paras 6.17-6.29.
161 Bond Worth (n 125) 250 (Slade J).
162 Beale et al, The Law of Security and Title-Based Financing (n 2) para 6.30.
includes the term “mortgage”.164 The two terms, “mortgage” and “charge”, are often used interchangeably.165 In this thesis we will use the term “charge” to mean either charge or mortgage unless it will be necessary to distinguish between the two.

The juridical nature of charge is unclear. In *National Provincial and Union Bank of England v Charnley*166, a charge was said to arise where:

“both parties evince an intention that property, existing or future, shall be made available as security for the payment of a debt, and that the creditor shall have a present right to have it made available (…) even though the present right which is contemplated can only be enforced at some future date, and though the creditor gets no legal right of property, either absolute or special, or any legal right to possession, but only gets a right to have the security available by an order of the Court”.167

Based on *Charnley* Professor Goode defined charge as a present right which arises upon an agreement between the parties and by which a particular asset or class of assets is appropriated168 to the satisfaction of the debt.169 When a charge is created, the creditor acquires a right of recourse against the asset belonging to the debtor.

**A. Distinction between fixed and floating charges**

Charges are fixed or floating. Broadly speaking, a fixed (specific) charge “fastens on ascertained and definite property or property capable

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164 *Shea v Moore* [1894] IR 158, 168 (Walker LC): “every charge is not an equitable mortgage, though every equitable mortgage is a charge”; *Goode on Legal Problems of Credit and Security* (n 1) para 1-52.
165 *London County and Westminster Bank, Limited v Tompkins* [1918] 1 KB 515 (CA) 528-9 (Scotton LJ); *Bond Worth* (n 125) 250 (Slade J); Companies Act 2006, s861(5): “in this Chapter “charge” includes mortgage”; under Law of Property Act 1925, s205(xvi) “mortgage” includes any charge or lien on any property for securing money or money’s worth”; see also Beale et al, *The Law of Security and Title-Based Financing* (n 2) paras 6.56-6.58.
166 [1924] KB 431 (CA) 449 (Atkin LJ).
167 *Charnley* (n 166) 449 (Atkin LJ), cited also in *Goode on Legal Problems of Credit and Security* (n 1) para 1-51.
168 A mere contractual right to take or retain possession without a right of appropriation does not constitute a charge, *Cosslett* (n 110) 507-508 (Millet LJ).
169 *Goode on Legal Problems of Credit and Security* (n 1) para 1-50.
of being ascertained and defined” whereas a floating charge is “ambulatory and shifting in nature”. An agreement that the creditor has a right to sell assets and to apply proceeds to discharge debt may not, however, be sufficient to create a fixed charge. Where assets are to be dealt with in the ordinary course of business the charge created is typically the floating charge. It is important to understand the distinction between fixed and floating charges because this has a direct bearing on security interests in derived assets under the current law because some new assets are created as a result of dealings with assets. It would be an inaccurate simplification to say that whenever assets are dealt with, the charge must be floating. This section shows that not all dealings with charged assets secured mean that the charge is floating.

(a) Hallmark of a floating charge: right to dispose free of security without consent

Finding a hallmark of a floating charge has proven highly controversial. The quest for this Holy Grail of the floating charge has returned a number of results in cases and literature. We cannot start retracing the steps in this “floating” odyssey other than by recounting the dicta of Romer LJ in the Court of Appeal in *Yorkshire Woolcombers*, who listed three characteristics of a floating charge:

“(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 the 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

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170 *Ilingworth v Houldsworth* [1904] AC 355 (HL), 358 (Macnaghten LJ).
171 *Ilingworth* (n 170) 358 (Macnaghten LJ).
172 *Smith (Administrator of Cossett (Contractors) Ltd) v Bridgend CBC* [2001] UKHL 58, [2002] 1 AC 336. This was so because the assets in question – two coal washing plants – were considered capable of being replaced during the currency of the contract (at [44]) (Hoffmann LJ). For criticism see Beale et al, *The Law of Security and Title-Based Financing* (n 2) para 6.104; P Walton, ‘Fixed Charges over Assets Other Than Book Debts - Is Possession Nine-Tenths of the Law’ (2005) 21 IL and P 5.)
ordinary way as far as concerns the particular class of assets I am
dealing with."\textsuperscript{173}

Not all three factors are our hallmark. The first one certainly is not. A
class of future assets can also be subject matter of a fixed charge.\textsuperscript{174}
Assets, which are not in existence at the moment of creation of the
fixed charge will fall within the charge as soon as the assets come into
existence.\textsuperscript{175} The description of subject matter of security as a class of
assets will also function as an after-acquired property clause, so a fixed
charge will extend to such assets with retrospective effect from the time
the charge was created.\textsuperscript{176} As the number of assets within the class
grows, there are simply increasingly more assets in the pool of assets
subject to a fixed charge.\textsuperscript{177} The second factor can also be dismissed
because assets in a fixed charge can change.\textsuperscript{178} They can, for example,
be wasted.\textsuperscript{179} Equally, a floating charge can exist over a diminishing
pool of assets where the assets are disposed but none are added.\textsuperscript{180}
There is considerable attraction to view the third characteristic as the
hallmark of a floating charge. Lord Scott in \textit{Spectrum} certainly thought
so.\textsuperscript{181} His Lordship said that the asset subject to the charge is not
appropriated as security for the payment of the debt until the
occurrence of some future event. He explained:

\begin{itemize}
  \item \textsuperscript{173} [1903] 2 Ch 284, 295 and approved sub nom \textit{Illingworth} (n 170).
  \item \textsuperscript{174} \textit{Siebe Gorman & Co Ltd v Barclays Bank Ltd} [1979] 2 Lloyd’s Rep 142 (Ch D); \textit{Re
          Keenan Bros Ltd} [1986] BCLC 242 (Sup Ct (Irl)); L Gullifer, \textit{‘Will the Law
  \item \textsuperscript{175} Or, in the case of assets which the debtor only has a power to dispose of, as soon as
          the debtor acquires a right to the new asset which includes a power to dispose of that
          asset.
  \item \textsuperscript{176} See chapter IV, section 2.1.
  \item \textsuperscript{177} Beale et al, \textit{The Law of Security and Title-Based Financing} (n 2) para 6.97.
  \item \textsuperscript{178} \textit{Agnew v Commissioner of Inland Revenue (Re Brumark Investments Ltd)} [2001]
  \item \textsuperscript{179} \textit{Agnew} (n 178) [37] (Millett LJ) (talking about a wasting asset). See also Beale et al,
          \textit{The Law of Security and Title-Based Financing} (n 2) para 6.97 give an example of a
          cow that died but, we ought to add that a cow may not be wasted: it may be turned into
          meat and sold thus procuring proceeds.
  \item \textsuperscript{180} \textit{Bond Worth} (n 125) 267 (Slade J).
  \item \textsuperscript{181} \textit{Re Spectrum Plus Ltd (in liquidation)} [2005] UKHL 41, [2005] 2 AC 680 [107]
          (Scott LJ).
\end{itemize}
“[i]n the meantime the chargor is left free to use the charged asset and to remove it from the security”.

Lord Millett in *Agnew* also thought that withdrawing assets from security without the consent of the charge holder was the hallmark of the floating charge. He added that in terms of the parties’ intention the question is “whether the charged assets were intended to be under the control of the company”. It seems widely accepted that the hallmark of the floating charge is that the chargor has a right to dispose of the assets without the consent of the chargee. The application of this test is not easy but we do not describe these difficulties as it has been done elsewhere in the literature. The nature of the floating charge prior to crystallisation is controversial. By and large the theories that developed focus on explaining two aspects of the floating charge: first, whether or not it attaches to assets prior to crystallisation; second, why third parties take free from the charge even if they are not purchasers of legal title for value without notice. The theories are discussed in more detail in chapter IV. The choice of a theory impacts on the issue of priorities and the rights of the chargee against a third party following an unauthorised dealing with the charged asset, where the third party had notice of it. Further, the choice of a theory impacts on the issue of decrystallisation, which is easier to think of if the nature of the floating charge and fixed charge are similar.

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182 *Spectrum* (n 181) [111] (Scott LJ).
183 *Agnew* (n 178) [32] approving *Smith* (n 172) [41] (Hoffmann LJ); “because the property is (…) a fluctuating body of assets which could be consumed or (subject to the approval of the engineer) removed from the site in the ordinary course of the contractor’s business, it was a floating charge”.
184 *Agnew* (n 178) [32] (Millett LJ).
187 See Chapter IV, section 3.2.A.
188 Beale et al, *The Law of Security and Title-Based Financing* (n 2) para 6.77.
(b) Restriction on the dealing power as a necessary element of the fixed charge

Consistent with the above conceptualisation of the floating charge is the description of a fixed charge in Re Yorkshire Woolcombers.189 Vaughan-Williams LJ said in that case that once a fixed charge is created over assets:

“[it] shall never thereafter at the will of the mortgagor cease to be a security. If at the will of the mortgagor he can dispose of it and prevent it being any longer a security, although something else may be substituted more or less for it, that is not a ‘specific security’.”190

Two points follow from this definition. First, no charge can be fixed unless the creditor is able to ensure that the asset remains covered by the charge. Second, a fixed character of the charge does not prevent it being taken in future assets.191 Ensuring that asset is covered by a fixed charge can be done in two ways. First, the chargee may restrict the dealing power of the chargor, for example by blocking the charged bank account or by otherwise taking control of the charged asset. This causes a problem whether the restriction ought to be legal or factual. A lack of a legal restriction means that the chargor is able to deal with the asset as a legal owner. It is argued in Chapter IV that if the debtor remains the legal owner of the asset, there is a hiatus between what he can legally do and what he is authorised to do by the terms of the

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189 (n 173).
190 Beale et al, The Law of Security and Title-Based Financing (n 2) para 6.97.
191 Spectrum (n 181) [107] (Scott LJ), [138]-[139] (Walker LJ); Agnew (n 178) [22] (Millett LJ) citing Keenan (n 174) 246 (Henchy J); Ibid. (n 2) para 6.107: “Arguably the law has now reached the point, where, in order for a charge to be characterized as fixed, there must be a total restriction on any disposal of the charged assets by the chargor without consent of the chargee”; S Worthington, 'Floating Charges: The Use and Abuse of Doctrinal Analysis' in J Getzler and J Payne (eds), Company Charges: Spectrum and Beyond (OUP, 2006) 25, 28: “The essential difference between a fixed and a floating charge turns upon the ability of the chargor to deal with the charged assets, removing them from the ambit of the security without the consent of the chargee [italics in the original]”; S Worthington and I Mitchkovska, 'Floating Charges: The Current State of Play' (2008) 9 JIBFL 467.
charge. Second, the chargee may mark the asset in a way that would provide a notice of encumbrance to any potential buyer. This places monitoring duties on the chargee to ensure that assets are not withdrawn from security. Such duties are cumbersome, probably even more so in relation to intangibles than tangibles. Without such steps there is always a risk that the chargor may dispose of the asset into the hands of a bona fide purchaser of legal title without notice and thus defeat the security. In practice fixed charges are typically taken over “fixed” and more permanent assets such as land, interests in land, plant and machinery, which are not disposed of in the ordinary course of business. The assets must be unambiguously described in the debenture and subject to real control by the chargee.

The rule that a bona fide purchaser of legal title without notice of an equitable charge takes free of the charge is a necessary tool in a system that functions without a register of all security interests to strike a balance between competing interests of secured creditors and purchasers from the debtor who may have no chance to find out about the encumbrance. The tension between competing interests of innocent buyers and secured creditors in many jurisdictions is resolved by endowing the buyer with an opportunity to check for any existing encumbrance in a register. In jurisdictions, where all non-possessory security interests are registrable, the buyer of an asset or a subsequent creditor only takes the asset subject to security if the security is duly registered although some jurisdictions provide for an exception relating to the sale in the ordinary course of business so that even if a security is

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193 See Chapter IV, section 3.1.B.
194 An attempt to avoid this and relieve the bank from giving consent to every withdrawal on an account, as shown e.g. by the debenture in Re New Bullas Trading Ltd [1994] BCC 36, 1 BCLC 485 (CA Civ Div), will result now in the charge being floating: see Agnew (n 178) [27] (Millett LJ).
196 Once a tangible is “marked” the creditor is not required constantly to check whether the markings have not been removed and whether the asset is still with the debtor
197 Agnew (n 178); Spectrum (n 181); Cousins on the Law of Mortgages (n 147) para 23-23.
registered, the purchaser takes free of the security. In English law the role of registration is less obvious. Not all charges are registrable. A charge granted by a company is registrable in the Companies House if it is a floating charge or a fixed charge over certain type of asset. It is not clear what the register is a notice of and to whom. It seems that registration serves as notice to those who are reasonably expected to search the register, not the whole world as it was sometimes argued. The burden of publicising a fixed charge is shifted onto the shoulders of the chargee. A financier seeking to take a fixed charge in a particular asset ought to ensure that the borrower cannot dispose of that asset. Otherwise, the charge may be recharacterised as floating because the mere fact that the debtor has a power to dispose of the equipment means that he may dispose into the hands of a bona fide purchaser and thus withdraw the asset from security.

**B. Practical consequences of characterisation as fixed and floating security**

Four practical consequences of characterisation are usually identified depending on the character of the charge. First, not all fixed charges have to be registered whilst all floating charges must be registered if the

198 See e.g. Polish Registered Charge and Charge Register Law, art 7(2)(3). Similar effect is achieved in German law by a rule that an encumbrance of the grantor’s asset cannot limit the grantor’s freedom to do business, BGH ZIP 1998/793. If the grantor of security cannot trade because its assets are encumbered in favour of a creditor, this can be perceived as exploitation of another by procuring for himself promised or granted pecuniary benefits, which are conspicuously disproportionate to the performance he promised, which has been described as Knebelung. If this is established, the secured transaction can be set aside on the grounds of public policy (§138 BGB). Therefore, under German law the grantor is allowed to trade although the legal basis for this is not straightforward.

199 Companies Act 2006, s860. Note, however, draft regulations to extend the system of registration to all charges The Companies Act 2006 (Amendment of Part 25) Regulations 2013, to come into force 6th April 2013.

200 See discussion on registration as constructive notice in Beale et al, *The Law of Security and Title-Based Financing* (n 2) paras 12.04-12.17. One of the main problems with the current system is that registration does not ensure priority of registered security interests.


203 Because of this, the meaning of the terms “fixed” and “floating” is normative rather than merely descriptive. For a contrary opinion see P Turner, 'Floating Charges - A "No" Theory: National Westminster Bank v Spectrum Plus' (2004) LMCLQ 319, 322-323.
charger is a company.\textsuperscript{204} If the document creating charge is not sent for registration within twenty-one days of the creation of charge, the charge is void against a liquidator or administrator of the company and against any other creditor of the company.\textsuperscript{205} Non-registrable fixed charges include\textsuperscript{206} charges over shares and other securities, charges over bank accounts and similar cash deposits,\textsuperscript{207} charges over insurance policies when no claim has arisen at the time the charge is created, charges over expected income from Private Finance Initiative contracts and other major projects, over computer software and over film negative rights.\textsuperscript{208} As pointed out in \textit{The Law of Security and Title-Based Financing}\textsuperscript{209} if charges are over shares and the chargor is entitled to the dividends, such a charge could be treated as a charge on a book debt on the grounds that the entitlements to dividends are book debts and thus would qualify for registration but it is exempted from registration under Financial Collateral Arrangements (No 2) Regulations (FCAR).\textsuperscript{210} Charges over contingent debts, such as proceeds of insurance policies when the claim has not yet been made are also not registrable.\textsuperscript{211}

\textsuperscript{204} Companies Act 2006, s 860(7). There are separate registration requirement regarding certain categories of assets (e.g. patents, trade marks, designs, ships and aircraft) but we do not discuss these here.
\textsuperscript{205} Late registration is possible with permission from the court.
\textsuperscript{206} Beale et al, \textit{The Law of Security and Title-Based Financing} (n 2) para 10.29.
\textsuperscript{207} FCAR (see n 210) reg 4 disappies Companies Act 2006, s 860 (if it would otherwise apply), to perfection of financial collateral arrangements (which relate to shares, securities, banks accounts and other cash deposits). For discussion of the role of registration see L Gullifer, 'What Should We Do About Financial Collateral?' (2012) CLP 1.
\textsuperscript{208} See LC CP (n 15) para 3.13.
\textsuperscript{209} Beale et al, \textit{The Law of Security and Title-Based Financing} (n 2) para 10.29
\textsuperscript{211} Paul & Frank Ltd v Discount Bank (Overseas) Ltd [1967] Ch 348, 362 (Pennycuick J); Beale et al, \textit{The Law of Security and Title-Based Financing} (n 2) para 10.25; LC CP (n 15) para 3.13.
Second, priority of charges runs from the moment of their creation, whether they are registered or not. Floating charges are postponed to preferential creditors, whether the company is at the time in the course of being wound up or not, while fixed charges are not. Furthermore, for floating charges created after the Enterprise Act 2002 came into force a proportion of the assets subject to a floating charge is ring-fenced and made available to the claims of unsecured creditors. Unlike a fixed charge, a floating charge is also subordinated to the costs and expenses of administration and liquidation. Compared with fixed charges floating charges enjoy very poor priority but an argument has been rightly made in the literature that floating charges are not taken to ensure priority.

Third, a floating charge created not for new value in the period prior to insolvency may be avoided in the run-up to insolvency. The period is two years if the floating charge holder is a person connected to the company, and within twelve months of insolvency for any other person. By contrast, a fixed charge can only be avoided if it involves a preference. Finally, in certain cases holders of a floating charge may

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212 Rules on priority are exceptionally complicated in English law, involving the rule of *nemo dat quod non habet* with numerous exceptions, see generally Ibid. (n 2) part IV.
213 Insolvency Act 1986 ss40, 175(2)(b); Sch B1 para 65(2). This does not apply to financial collateral arrangements to the extent to which they might amount to a floating charge: FCAR (n 210), reg10(2A). See also reg 10(1) and (2) which provides that the financial collateral cannot be set aside after commencement of a winding up, whether by court or voluntary, which otherwise could be held to be void under Insolvency Act, s127 (winding up by court) and s88 (voluntary winding up) respectively.
214 Insolvency Act 2006, s754. This does not apply to financial collateral arrangements to the extent to which they might amount to a floating charge: FCAR (n 210) reg10(6).
215 Insolvency Act 1986, s176A; on prescribed proportion rules Insolvency Act 1986 (Prescribed Part) Order 2003 SI 2003/2097, art3. This includes the Crown, as the Crown preference has now been abolished. Insolvency Act 1986, s176A does not apply to financial collateral arrangements to the extent to which they might amount to a floating charge: FCAR (n 210) reg10(3).
217 Insolvency Act 1986 s76ZA 9(4), introduced by Companies Act 2006, s1282, reversing *Buchler* (n 163); see also Mokal, 'Liquidation Expenses and Floating Charges - the Separate Funds Fallacy' (n 163); G Moss, 'Liquidators Stung for Costs and Expenses' (2004) 17 Insolvency Intelligence 78.
218 Mokal, 'Liquidation Expenses and Floating Charges - the Separate Funds Fallacy' (n 163).
219 Insolvency Act 1986, s245. This does not apply to financial collateral arrangements to the extent to which they might amount to a floating charge: FCAR (n 210) reg10(5).
220 Insolvency Act 1986, s239.
appoint an administrative receiver. This was once a more widely prevailing advantage of floating charges but the Enterprise Act 2002 has significantly reduced this.

4 The concept of security interest under Article 9 UCC

Article 9 of the Uniform Commercial Code in the USA has adopted a universal, generic concept of a security interest, thus confining terms such as pledge or mortgage to legal history. Similarly, Article 9 UCC does not distinguish between fixed and floating security nor between legal and equitable. The term ‘security interest’ is defined in §1-201(35) UCC. It stipulates that a security interest means an interest in personal property or fixtures, regardless of its form, that secures payment or performance of an obligation. It applies to sale of accounts, chattel paper (a record evidencing both a monetary obligation and a security interest), payment intangibles (any personal property including things in action which the account debtor’s principal obligation is a monetary obligation), promissory notes, consignment and agricultural lien. Since the form of the secured transaction does

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221 Insolvency Act 1986, s72A, introduced by Enterprise Act 2002, s250. A floating chargee can still appoint an administrative receiver (a) in pursuance of an agreement which is or forms part of a capital market arrangement if a party incurs a debt of at least £50 million under the arrangement, and the arrangement involves the issue of a capital market investment; (b) in the case of a project company of a project which includes step in rights of a person providing finance and is a public-private partnership project, a utility project, an urban regeneration project designed wholly or mainly to develop land, a financed project; (c) in the case of a company who created one of the listed financial market charge.

222 McCormack (n 134) 71. Former section 9-102(2) provided that Article 9 applied to “security interests created by contract including pledge, assignment, chattel mortgage, chattel trust, trust deed, factor’s lien, equipment trust, conditional sale, trust receipt, other lien or title retention contract and lease or consignment intended as security”, as cited in R Broude, 'Secured Transactions in Personal Property in the United States' in M Bridge and R Stevens (eds), Cross-Border Security and Insolvency (OUP, 2001) 45, 50.

223 See McCormack (n 134) 71 with literature cited there.

224 Definition critique by Gilmore for being like a declaration of faith carrying little meaning, G Gilmore, Security Interests in Personal Property, Vol I (Boston & Toronto 1965) 334.

225 Broude (n 214) 49; see UCC §9-102(a)(11).

226 Excluding accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, oil and gas or other minerals before extraction, see UCC §9-102(a)(42).

227 UCC §9-102(a)(61).

228 UCC §9-109(a).
not matter, Article 9 applies whether the title to the collateral vests in the secured party, as e.g. retention of title (a conditional sale), or it remains with the debtor. Article 9 UCC employs two crucial notions: attachment and perfection of a security interest. Both are crucial for understanding security interests in the US and England. The terms “attachment” and “perfection” are also becoming common usage in England and they are expressly used in the new scheme proposed by the Law Commission.

4.1 Attachment

Attachment is the creation of the security interest as between the creditor and the debtor. §9-203(a) UCC defines attachment as the enforceability of the security against the debtor with regard to the collateral. A security interest that has attached will give the creditor rights in rem against the debtor but not necessarily against third parties. An attached but unperfected interest will not yet be good against the debtor’s trustee in bankruptcy. A right in rem effective only between the parties may seem similar in effect to a contractual right and be thus a prima facie contradiction in terms. However, such an attached albeit unperfected interest will take effect against certain third parties such as an unsecured non-insolvency creditor. As Professor Goode explains:

“the purpose of the concept is to demonstrate that the debtor cannot dispute the conferment of real rights on the creditor, and the consequent restriction on the debtor’s own dominion over the asset, but that the same is not true of all third parties, some of

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230 Goode on Legal Problems of Credit and Security (n 1) para 2-01.
231 LC CP (n 15) paras 2.13-2.15.
232 Goode on Legal Problems of Credit and Security (n 1) para 2-02.
233 Ibid. (n 1) para 2-02.
234 Gilmore (n 224) 435
235 Goode on Legal Problems of Credit and Security (n 1) para 2-02.
whom may, in the absence of perfection, be able to contend that the grant of the security has no impact on them”. 236

It makes no sense to talk about an “unattached security interest”. Such an interest would be worthless as not enforceable by or against anybody. 237

4.2 Perfection

Perfection signifies a point in time when the security interest becomes enforceable against third parties, including the trustee in bankruptcy, who represents the rights of the whole class of unsecured creditors when the bankruptcy petition has been filed by or against the debtor. 238 Perfection is considered to be an American term for what elsewhere is called publicity. 239 Its purpose is not only to protect the secured creditor against other creditors but also to avoid the impression of false wealth of the debtor in the eyes of other (unsecured) creditors. 240 Generally, publicity can be achieved through possession or control of the collateral by the creditor or a person the parties agreed to; by filing in a register; through a notice; or attornment. 241 Achievement of perfection depends on the type of the collateral.

The most common method of perfection is filing. Unlike the English system, however, which is based on registering of the particulars of the charge (the so-called transaction filing), the US system requires filing of a notice only. This is one of the fundamental differences between the US and English systems 242 and the proposed new regime takes the notice-filing approach as a simple and efficient solution. 243 What is filed under §9-501 UCC is not the security agreement itself but only a

236 Ibid. (n 1) para 2-02.
238 Ibid. 86.
239 Wood (n 34) para 17-01.
240 Ibid. (n 34) para 17-01.
241 Goode on Legal Problems of Credit and Security (n 1) para 2-02.
242 McCormack (n 134) 76.
243 LC CP (n 15) paras 2.24-2.26 (outline) and 3.113-3.181.
financing statement, which contains a limited amount of information.\textsuperscript{244} The notice indicates merely that a person may have a security interest in the collateral. Further information must be ascertained from the parties concerned.\textsuperscript{245} The creditor first to perfect by filing takes priority. This is the so-called ‘first-to-file-or-perfect’ priority rule.\textsuperscript{246}

4.3 Security interests in proceeds and products under Article 9 UCC

Article 9 UCC expressly provides for security interests in proceeds and products. It is commonly thought that a security interest would not fulfil its purpose if it did not extend to the proceeds when the debtor disposes of the collateral securing the interest.\textsuperscript{247} The rules governing debtor’s power to dispose of encumbered assets and security in proceeds of disposition are very closely linked. Without a continuing security interest in the proceeds of the collateral a secured creditor may altogether lose his security when collateral is disposed of because the creditor may not retain interest in the original asset when it leaves the hands of the debtor.\textsuperscript{248} Hence, the law in the USA developed, beginning

\textsuperscript{248} A Kaunders, ‘Substitution of Proceeds Theory for UCC §9-306(5), or, the Expansive Life and Times of a Proceeds Security Interest’ (1994) 80 Va LR 787, 788, see also at 791-794 for the history of development of UCC §9-306(5).

\textsuperscript{245} Special procedure under UCC §9-210 may require the secured party to make a disclosure at the debtor’s request.

\textsuperscript{246} McCormack (n 134) 80.

\textsuperscript{247} A Kaunders, ‘Substitution of Proceeds Theory for UCC §9-306(5), or, the Expansive Life and Times of a Proceeds Security Interest’ (1994) 80 Va LR 787, 788, see also at 791-794 for the history of development of UCC §9-306(5).

\textsuperscript{248} Brook (n 237) 350; R Skilton and D Dunham, ‘Security Interests in Returned and Repossessed Goods under Article 9 of the Uniform Commercial Code’ (1981) 17 Willamette LR 779, 781-782: “the original security interest in inventory is usually lost (…) either because the sale is authorized by the secured party or is to a buyer in the ordinary course of business”.

\textsuperscript{244} UCC §9-502 Official Comment 2. The difference between security agreement and financing statement has been explained in Thorp Commercial Corp v Northgate Indus., Inc. 654 F2d 1245, 1248 (8th cir, 1981): “The security agreement defines what the collateral is so that, if necessary, the creditor can identify and claim it, and the debtor or other interested parties can limit the creditor's rights in the collateral given as security. The security agreement must therefore describe the collateral.... The financing statement, on the other hand, serves the purpose of putting subsequent creditors on notice that the debtor's property is encumbered. The description of collateral in the financing statement does not function to identify the collateral and define property, which the creditor may claim, but rather to warn other subsequent creditors of the prior interest. The financing statement, which limits the prior creditor's rights vis-a-vis subsequent creditors, must therefore contain a description only of the type of collateral.”
with the 1925 Supreme Court decision in Benedict v Ratner,\(^{249}\) in the
direction of prohibiting security arrangements where the debtor would
be allowed to dispose of the property and to be left to use the proceeds
for his own benefit.\(^{250}\)

A security interest under UCC automatically attaches to any
identifiable proceeds of collateral.\(^{251}\) A security interest in proceeds is
perfected if the security interest in the original collateral was
perfected.\(^{252}\) However, whilst a perfected security interest in the
original collateral is normally continuous, a perfected security interest
in proceeds becomes unperfected on the 21st day after the security
interest attaches to the proceeds.\(^{253}\) The secured party is required to
reperfect his interest in those proceeds unless an exception applies, for
example proceeds are of a kind covered by the original filed financing
statement or they are identifiable cash proceeds.\(^{254}\) The time of
perfection of a security interest in collateral is also the time of
perfection as to a security interest in proceeds.\(^{255}\)

5 Summary

This chapter introduced the basic characteristics of security interests in
property. It first canvassed three theories explaining the rationale
behind security interests, one of which – efficiency theory of secured
credit – lead us to explore in detail the economic benefits of security in
derived assets. We saw that whilst extending security by operation of
law to substitutes (proceeds and products) promotes efficiency of the

\(^{249}\) 268 US 353 (1925), 45 S Ct 566.
\(^{250}\) Benedict (n 249) 363 (Mr Justice Brandeis) and see at 364 (Mr Justice Brandeis):
“where the unrestricted dominion over the proceeds is reserved to the mortgagor (...) the mortgage is void”. The decision effectively lead to prohibition of floating liens, see e.g. James Talcott Inc v Wilcox, 308 F 2d 546 (5th Cir 1962).
\(^{251}\) UCC §9-203(f) juncto §9-315(a)(2).
\(^{252}\) UCC §9-315(c).
\(^{253}\) UCC §9-315(d). The loss of perfected status is prospective only, cf UCC §9-515(c)
whereby a security interest is deemed never to have been perfected as against a
 purchaser of the collateral for value when purchased after the effectiveness of the
 financing statement lapses (as a general rule it is a five-year period after the date of
 filing), see Official Comment 4 to UCC §9-315.
\(^{254}\) UCC §9-315(d).
\(^{255}\) UCC §9-322(b).
credit market equilibrium, a rule automatically extending security to
fruits makes the equilibrium less efficient because it creates a
deadweight loss and it may lead to oversecuritisation of the lender.

The overview of main types of security in English law showed that
where the creditor has actual possession of the asset, the debtor’s ability
to deal with the asset is limited. Determining who has possession
(debtor or the lender) may, however, be important for determining who
has a right to fruits, as we will see in Chapter III. In other cases of
security interests collateral may change not only by yielding ‘fruits’ or
income but the debtor may additionally deal away with the collateral,
exchanging it for another asset. As we have seen, dealings with assets
are treated differently depending on whether security is floating and
fixed. In all these cases we deal with a form of derived asset, which are
discussed in the next chapter. The focus of this thesis is on the question
how these changes of the original collateral into a derived asset affect
the rights of the secured creditor. A brief discussion of the functional
approach to security interests under Article 9 UCC led us to observe
that under UCC security interests are automatically attached to
proceeds. We will explore this rule in Chapter III. Before we do so, we
need to clarify the terminology relating to derived assets under English
law.
CHAPTER II – Defining derived assets

1 Introduction

Proceeds, products and fruits can be classed as “derived assets”.256 Derived assets are assets, which come into being in a way that allows us to establish a link with another asset (the original asset). The link could be transactional or based on another event. In a technical legal sense the idea of a derived asset is premised on a pre-existing right in the original asset. This means that the fact that an asset derives from another is not legally relevant unless there exists a right to the original asset.257 During the existence of that right the asset undergoes some changes. Sometimes these changes may be destructive to the right (e.g. if the right cannot exist without the asset in the original form). In other cases the right might not be extinguished despite the changes to the substance of the asset and it may continue to apply to a new asset. We could call this asset a “derived” asset (in a technical legal sense) to reflect the fact that the same right, which used to apply to the previous asset, now applies to the new asset. The term “derived asset” is relative to the right and assumes that the right does not change. Making such an assumption at the start would defeat the purpose of this thesis. For the same reason we do not call security interests that may arise in derived assets “derivative security interests”.258 This work sets out to show how lender’s rights are affected when the collateral undergoes some changes. We cannot therefore assume that the same security interest will apply to new assets. As a result, the term “derived asset” is used in a loose, non-technical sense. All tangible assets are in one way or another derived from other assets. Jumpers are made from wool; wool

256 See also Goode on Legal Problems of Credit and Security (n 1) para 1-58 (suggesting term “derivative assets”).
257 It is irrelevant at this point how we conceptualise this right regarding an asset: whether as a proprietary right, a personal right concerning a thing (a right in personam ad rem) or A’s right against B’s right to an asset.
258 Goode on Legal Problems of Credit and Security (n 1) ch1 section 8 “Derivative security interests”.

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is sheared off lambs; lambs derive from ewes and rams etc. All matter can be broken down to elementary particles,\(^{259}\) which interact leading to a constant change in the matter, which is responsible for transformation of one asset to another. At a level observable by human eye, even an eye clad with a microscopic lens, matter cannot be created \textit{ex nihilo}.\(^{260}\)

In the physical world, all things are products of some other things, even newly born apples on an apple tree or newly born animals. Intangible assets are legal constructs. They cannot “derive” from the original asset in the same way as tangible assets do, which means that different considerations are likely to apply when determining rights to intangible derived assets.

In this thesis we will use the term “derived assets” in a non-technical sense to denote “proceeds, products and fruits” and to highlight that these assets are derived from other assets (original collateral) during the secured transaction relationship, i.e. after security in an asset is created and before the debt is discharged or the lender otherwise relinquishes his interest in the underlying asset. It does not mean, however, that the lender will necessarily have the same interest in proceeds, products and fruits as it did in the original asset wherefrom the latter derived. We will be referring to a “process of derivation” to depict a process as a result of which the collateral undergoes changes. A clause in a security agreement, whereby the parties contractually stipulate that the security interest covers proceeds, products and fruits, will be referred to as a “derived assets clause”.

From the perspective of the parties entering into a security agreement, derived assets have two characteristics, which are relevant to taking a security interest in them. First, derived assets are \textit{after-acquired}\(^{259}\)
property (i.e. future assets) because they do not exist at the time the security is created but are acquired, or come into existence, at a later point. Second, in the case of some derived assets (substitutes) the original asset may be seen as continuing to exist in a changed form. These two features of derived assets may be seen to affect the lender’s security interest. It is sometimes thought that security interests in derived assets may arise either on the basis of a pre-existing right (i.e. security interest in the original collateral) or as security in after-acquired property. If it is the former, theoretically there would only be one security interest in the original asset and in the new asset; if the latter, parties may be seen as creating at least two security interests: one in the original property and another in the after-acquired asset. It is not clear why a security interest in after-acquired property must necessarily be perceived as creating a different and new security interest in the derived asset. One property right may apply to a presently existing asset and when a new asset arises, the existing right may simply extend to it on the basis of the after-acquired property clause. In other words, if we accept that a security interest extends to derived assets on the basis of an after-acquired property clause it does not mean that there are necessarily two security interests. The difference, even if it conceptually exists, it is likely to be negligible in English law. This work argues that security agreements containing derived assets clauses create only one security interest and that unless security extends to derived assets by operation of law, the security interests in derived assets arise on the basis of the parties’ agreement, i.e. on the basis of an after-acquired property clause. The fact that some assets derive in a way that leads to destruction of the original subject matter may in turn impact on the characterisation of security as fixed or floating or on rights of the secured creditor if the ‘derivation’ process was not authorised. How secured creditor’s pre-existing rights may be affected

261 The difference is of importance under Article 9 UCC because security interests in after-acquired property acquired after commencement of insolvency proceedings are not enforceable against the liquidators whilst security in proceeds, which come into being after commencement of insolvency proceedings, is enforceable.
will depend on the type of change, which the original collateral undergoes. This chapter discusses *how assets derive* from the original collateral. It will serve as a map of key concepts that we will use to navigate through the remaining work.

Much of what we know about derived assets comes from Roman law.\(^{262}\) It is therefore necessary to begin the study of derived assets by looking at distinctions drawn in Roman law to see to what extent they could apply in the context of security interests in English law.

## 2 Roman law of derived assets

The principles that developed in Roman law in relation to derived assets can be of some assistance in the specific context of security interests in derived assets. Yet the assistance of Roman law in seeking to answer how secured creditor’s rights are affected by changes of the collateral is limited. First, Roman law addressed problems of accessions, mixtures and fruits, not proceeds of dispositions of assets. Second, Roman law only dealt with the question of ownership and did not deal directly with questions of how security interests, as limited property rights, are affected by changes to the collateral. We look at usefulness of Roman law in the context of security interests in two sections. First, we look at accession, confusion and specification, which relate to situations when assets were mixed or joined. Second, we look at how Roman law dealt with generation of new assets (fruits) where the original asset did not change. This section also shows that Roman law did not treat fruits as a type of accession (accession by natural

increase), which English law apparently does. The confusion of accessions (accretions) with fruits and substitutes in English law has lead to a creation of an unfounded “principle of substitutions and accretions”, the existence of which this thesis aims to disprove.

2.1 Mixed or joined assets

Roman law was relatively casuistic when it came to mixing or joining assets and concerned only ownership of corporeal property. To determine who owned what, Roman law looked at the sort of substances mixed or joined, whether the individual ingredients lost their physical integrity and whether the process of mixing was reversible or not. It distinguished between *confusio* (mixing liquids), *commixtio* (mixing solid things), *specificatio* (joining assets using skill and creating a new asset) and *accessio*, the later being based on the principle *accessorium sequitur principale* (the accessory follows the principal asset). There seems to be no single criterion according to which these processes were distinguished. It was not until the 18 and 19th centuries, when the Pandectist doctrine of components (*Bestandteilslehre*) developed, that lawyers began classifying mixtures or joinders according to whether the component assets lost their individuality became a part of a “single essence or spirit like a horse or a stone”.

**A. Accessio**

When two assets are joined the owner of the principal thing becomes the owner of what was added to it. A result of this process, treated as a mode of acquiring property, is that one asset continues to exist

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263 1 2,1,27 and 28.
265 D 34,2,19,13 (accessio cedit principali).
whilst the other ceases its existence.²⁶⁷ In Roman law *accessio* applied strictly to tangibles²⁶⁸: in cases of joining land with land, movable with land or movable with movable. The rules of accession were complex. For example, the owner of land next to sea or river owned anything that accumulated gradually to his parcel of land by water activity (*alluvio*).²⁶⁹ But where a plot of land became detached (for example by a sudden flood) from one owner’s land and acceded to another’s land (*avulsio*) and continued to be distinguishable, the original owner remained the owner of the added plot of land, at least until trees on that added plot took root in the new ground (presumably because it ceased to be distinguishable from the other land).²⁷⁰ If movable things became added to land by human activity, such as buildings (*inaedificatio*), plants (*implantatio*) or seeds (*satio*), then they also became the property of the land, so long as it became impossible to separate them.²⁷¹

There are two obstacles in establishing accession. First, assets must be sufficiently joined for accession to occur. In Roman law assets had to be seen as inseparable for *accessio* to occur.²⁷² For example, an arm welded onto a statue where both were made from the same material was seen as inseparable. In such cases the owner of the statue became the owner of the compound (*ferruminatio*). However, if joining of two assets was reversible and the attached part could have been detached, the ownership of the part was suspended and was brought back when the part was detached (*adplumbatio*). Modern law recognises that the process of adding one asset to another is usually possible to reverse, although it may often be difficult to do so without substantial cost or

²⁶⁷ Smith, *The Law of Tracing* (n 7) 104.
²⁶⁸ Intangibles were not treated as ‘things’ capable of being subject to property rights.
²⁶⁹ I 1.2.20.
²⁷⁰ I 2.1.21.
²⁷¹ For example, it was considered that plants were inseparable from land if they grew roots, G 2, 74-75. This gave rise to the rule well known in modern laws: *superficies solo cedit*: I 2.1, 30 and 33 (anything built on or sown in the soil accedes to the soil). There were, however, separate rules on whether or not the owner of land was obliged to pay for the materials used or whether he was permitted to destroy the building erected by another.
damage to the constituents. The key point is that accession occurs where the added asset may be annexed to a considerable extent. It may continue to be physically identifiable but in the eyes of law it ceases to exist as a subject matter of property rights.\footnote{Smith, *The Law of Tracing* (n 7) 104-105.}

The second problematic area is deciding which asset is subsidiary (accessory) and which is principal. This is crucial because in the eyes of law the principal asset continues to exist whilst the subsidiary asset “disappears” as the owner of the principal asset becomes the owner of the subsidiary. Where a moveable accedes to land, land is always the principal asset. In cases of joining two moveables it is often much harder to determine which asset is principal. For example, in Roman law adding writing on paper or parchment, even if in gold letters, did not give the writer a better right to the written paper. It belonged to the owner of the paper.\footnote{G 2,77; I 1,2,33; see also Digest 6,1,23,3 (Paulus): picture accessory to the board.} However, making a painting on another’s canvas gave the ownership of the finished product to the painter.\footnote{G 2,78 and later I 1,2,34: “for it is ridiculous that a painting of Apelles or Parrhasius should be an accession to worthless tablet”; see also D 41,1,9,2 (Gaius): board accessory to the picture.} A number of tests have been developed in modern laws to determine which asset is principal.\footnote{See Smith, *The Law of Tracing* (n 7) 105-106; see also S Nickles, ‘Accessions and Accessories under Pre-Code Law and UCC Article 9’ (1982) 35 Ark L Rev 111, 118-127.} The value-based test\footnote{Guest, (n 272) 507 fn 11: “by ‘principal chattel’ is probably meant that which is greater in value”.} seems to have rightly been rejected in favour of a test, whereby the principal asset is an asset, which “predominates as a distinct entity”\footnote{R Goode, *Hire-Purchase Law and Practice* (2nd edn Butterworths, London 1970) 751; S Whitaker, ‘Retention of Title and Specification’ (1984) 100 LQR 35; Peter Birks did not consider accessions as mixtures due to the relationship of a principal-subsidiary, see Birks (n 262) 227.} Although there is some similarity between accession and mixtures as assets become merged, the two concepts differ.\footnote{Smith, *The Law of Tracing* (n 7) 107.} Accession presupposes that one asset is principal and another is accessory.\footnote{Smith, *The Law of Tracing* (n 7) 104-105.} Where neither asset seems to
dominate there is no accession. Where neither item is principal each has lost its identity and a new thing has been created.

In English law accession, also known as “accretion”, comprises two separate concepts. It includes first accession by attachment, which means accession of moveables to moveables, moveables to land (in which case accessions are referred to as “fixtures”) and land to land. Second, the term “accretion” is also used to mean accession by natural increase, which relates to accession of offspring to animals or fruit to land. In its second form of accession by increase, and by contrast to Roman law, the principle was also applied in English law to intangible assets (such as goodwill). These two concepts are unrelated to each other except for sharing the common linguistic root of the doctrine of accessorium sequitur principale mentioned above. The rule accession by natural increase has been said to govern rights to fruits but we argue below that the rule is unhelpful and potentially misleading.

B. Commixtio and confusio

In Roman law, mixing of solid objects, such as wheat, was referred to as commixtio whilst fusion of metals into one mass or mixing liquids was confusio. The rules of ownership were complex in Roman law and differed depending on whether liquid or granular substances were mixed.

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282 Smith, The Law of Tracing (n 7) 107.
283 See e.g. Jones v De Marchant (1916) 28 DLR 561 (fur coat belonging to the owner of beaver skins it was made of after it was given away to a third party).
285 As noted in Foskett v McKeown [2001] 1 AC 102 (HL) 121 (Hope LJ); Guest, (n 272) 506; see also generally J Sohm, ‘The Doctrine of Accession’ (1870) 14 Journal of Jurisprudence 481 (discussing accession and specification).
286 See text to nn 395-406.
287 Text to nn 315-318.
288 The term confusio was also used in the case of rights when the same person became the object of the right and the duty of an obligation (D 46,3,75) for example if a pledgee inherited the estate of the pledgor, the pledge was extinguished since the right of ownership and a pledge were joined in one person. We do not use the term confusio in this meaning here. For discussion of the difference between the two see also Birks (n 262) 232-234.
If solid objects were mixed with owners’ consent, the original owners became co-owners (owners in common) of the compound. 289 If, on the other hand, there was no mutual consent to mixing, either because one owner did not consent or it took place accidentally, each owner of the original thing remained an owner of that thing so long as the individual components were distinguishable and their substance was unaltered. If one owner kept such a compound asset, the other owner could assert a rei vindicatio claim to “take out” his portion of the compound. 290 When liquid substances were mixed, e.g. honey and wine (forming mead) or silver and gold (forming electrum), both owners became owners in common, not only when they consented to mixing, as with solids, but also when mixing was accidental. 291 The situation was even more complicated where mixing was both irreversible and without the owner’s consent. The claim of the owner, who did not consent to his asset being mixed (A), depended on whether the mixing process took place in good faith or in bad faith. If the mixing was in bad faith, A had actio furti or condictio furtiva against the person who became the owner of the mixture, which essentially resembled a claim against a thief. If the mixing was in good faith, A was entitled to compensation but if he did not obtain it he had a condictio for unjustified enrichment292 (probably condictio sine causa293). Condictio furtiva was regarded as either one of condictiones for unjustified enrichment or as based on delict.294 It was used against a thief, who was enriched by the sale price of the stolen thing. It was possible to use condictio furtiva alternatively with actio rei vindicatio or actio ad exhibendum (and in addition to actio furti) in order to recover the res or

289 I 2,1,28.
290 I 2,1,28; D 6,1,5 and 23.
291 I 2,1,27.
293 For definition of the condictio see D 24,1,6.
294 Some have regarded it as based on delict, Minister van Verdediging v Van Wyk 1976 91 SA 397 (T). See in general P Pauw, 'Historical Notes on the Nature of the Condictio Furtiva' (1976) 93 SALJ 395 (see also literature cited there).
its value.\textsuperscript{295} The key point that follows is that application of \textit{commixtio} or \textit{confusio} does not lead to creation of a new asset even though individual components are incapable of separate identification. Modern common law uses the term “confusion” to cover both \textit{commixtio} and \textit{confusion}.\textsuperscript{296} The term “confusion” means that constituent parts can no longer be identified as belonging to a particular person.\textsuperscript{297} Yet mixtures remain divisible, even if it is impracticable to extract from the mixture the exact assets mixed.\textsuperscript{298} For that reason, Professor Smith noted that the claimant is able to follow his asset and the ownership interest is not defeated in the thing that has been mixed.\textsuperscript{299}

\textbf{C. Specificatio}

\textit{Specificatio} was seen in Roman law as a legal event, which occurred when things were mixed into a new asset in a process involving someone else’s skill or workmanship, such as bread-making by C from A’s ingredients or making wine by C from A’s grapes. As a result of specification a new thing was created whilst the component assets ceased to exist in the eyes of law\textsuperscript{300} because they were physically altered or inextricably joined.\textsuperscript{301} Originally, there were two schools of thought in Roman law regarding such newly created assets. Sabinians, who focused on the importance of “substance and matter”, considered the new asset the property of the owner of the materials\textsuperscript{302} whilst

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\textsuperscript{295} M Blecher, 'The Owner's Actions against Persons Who Fraudulently Ceased to Possess His Res (Qui Dolo Desierunt Possidere)' (1978) 95 SALJ 341, 345.
\textsuperscript{296} Common law does not draw distinction between mixing liquids or granular substances, see Birks (n 262) 453-455; G McCormack, 'Mixture of Goods' (1990) 10 LS 293; Smith, \textit{The Law of Tracing} (n 7) 70; E Arnold, 'Confusion' (1923) 23 Colum LR 235, 235-236.
\textsuperscript{297} Mixing oil and water would not lead to \textit{confusio} since they would not create one mass. In an English case mixing of crude oil was held to be a case of \textit{confusio} since the mixture could not be separated “[a]t least for practical reasons”: \textit{Indian Oil Corp Ltd v Greenstone Shipping Co SA (Panama) (The Ypatianna)} [1988] QB 345, 354 (Staughton J).
\textsuperscript{298} Smith, \textit{The Law of Tracing} (n 7) 70.
\textsuperscript{299} Ibid. 71: “discussion [in relation to mixtures] is not concerned directly with any alteration of proprietary rights which such mixtures bring about. Rather, the concern is with following; that is, identifying a thing with the same thing at an earlier time”.
\textsuperscript{300} Ibid. 109.
\textsuperscript{301} Ibid. 111: The test of annexation (whether it is inextricably attached) is the same as in accession.
\textsuperscript{302} G 2,\textsuperscript{79}: \textit{cuius materia sit, ilius et res que facta sit}. 

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Proculeans, to whom form was more significant than substance, thought the new asset belonged to the manufacturer. With time a compromise solution (*media sententia*) was proposed by Gaius and accepted by Paulus. The ownership depended on whether the process of creating a new asset was reversible or not. If it was reversible, the owner of the materials became the owner of the new asset. If the process was irreversible, such as bread baking, the baker was the owner. Additionally, in either case, whoever became the owner of the new product had an obligation to reimburse the other one for materials used or work put in. Modern law draws on Roman law to some extent to determine if a new asset is created but in many situations the Roman law test based on reversibility is unsuitable. As one commentator argued, the rule based on reversibility alone “becomes absurd where a manufacturing process which vastly improves the goods can be reversed but only at considerable cost. Similarly, minor but irreversible changes will not be sufficient to transform goods”. The modern test should therefore look to a number of factors. It was convincingly argued that the crucial factor should be whether the goods have undergone a transformation, which in turn should be answered by taking economic considerations into account. The rules governing ownership in cases of specification become additionally complicated where there is wrongdoing, for example where corn is stolen to make whiskey.

**D. An alternative approach to mixed assets under Article 9 UCC**

Applying the Roman law of *accessio, commixtio, confusio* and *specificatio* was seen as overly complex for the purposes of security interests in assets by the drafters of the UCC. Article 9 UCC seems to resolve a number of problems with security interests in mixed assets

303 D 41,1,7,7.
304 I 1,2,34.
306 Ibid.
307 See e.g. Smith, *The Law of Tracing* (n 7) 112-115.
(mixed substitutions) by drawing a distinction between “accession” and “commingled goods”. “Accession” has a different meaning to the one depicted above. It signifies goods physically united with other goods in such a way that the identity of the original good is not lost whilst “commingled goods” denote goods that are physically united with other goods in such a manner that their identity is lost in a product or mass.

This includes goods, which lost their identity through a manufacturing process, e.g. flour that has become part of baked bread, and goods, which were commingled with other goods from which they cannot be distinguished, e.g. wheat is mixed with other wheat. Under UCC a security interest does not exist in commingled goods as such but attaches to a product or mass that result when goods become commingled goods. If security interest in the commingled asset is perfected, the security in products is also perfected. If more than one security interest is perfected in the product, UCC provides a rule for resolving the conflicting priority, which is that the security interests rank equally in proportion to the value of the collateral at the time it became commingled goods.

Bearing in mind the difficulties with mixed assets and accessions under Roman law the rules in UCC are arguably more suitable for application in a modern secured transaction context because the distinction is merely between combined things that lost their identity and things that did not. Although this distinction may not always be clear-cut, it avoids the problems with identifying accessory and principal assets and a creditor with a perfected security interest does not risk losing its security. The simple rule that the secured creditor continues to have a security interest in the accession, not the whole asset unless the parties so agree, makes it unnecessary to consider which asset is principal and which is accessory.

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308 UCC §9-102(a).
309 UCC §9-336(a).
310 UCC §9-336(b).
311 UCC §9-336(d).
312 UCC §9-336(f).
2.2 Fruits

Some assets are capable of bearing fruits. Fruits are assets derived from the original asset without any other thing becoming a composite element of it, for example an apple from an apple tree, milk from a cow, foal born from a mare. New things are created whilst the original asset continues to exist. The concept of fruits originally developed in the context of tangibles. In Roman law things brought about by natural, physical processes, for example birth of progeny, growth of apples on a tree, and separated from the original thing were referred to as natural fruits (fructus naturales). It seems that only living things can generate natural fruits. A machine that “produces” widgets does not generate them in the same way as a mare that gives birth to a foal. Widgets are products of a manufacturing process, involving mixing of components and using skill or work. Even if widgets are put together by a machine, the machine operates as a result of a human act (work and usually skill). Widgets are not fruits of a widget-making machine.

A. Rights to natural fruits

In Roman law fruits became generally the property of the owner of the original asset. In English law this is known as a rule of “accession by natural increase” by analogy to the accessio principle that subsidiary assets belong to the owner of the principal asset. It is suggested that rights to fruits cannot be governed by the same rules as accretions (i.e. rules of accessio).

313 A machine cannot start operating without a force applied to it first. This results from the first Newton’s law of motion.
314 I 2,1,19. Until about 2 century BCE a child of a slave (partus ancillae) also counted as a natural fruit, Wołodkiewicz and Zabłocka (n 292) para 192; contrast Seay v Bacon (1856) 4 Sneed (TN) 99, 36 Tenn 99 (Tenn), 1865 WL (Tenn) (Sup Ct of Tennessee), cited in Grant v YYH Holdings Pty Ltd [2012] NSWCA 360 [49]-[51], where the default rule was held to be that whatever rights and remedies the owner has against the mother, they extend to the mother’s born children since mother and her children are “aggregate property” until some further act. In the Grant v YYH Holdings the argument that the progeny of the original sheep was “aggregate property” was rejected (at [52] (McColl JA)), so the owner had a separate title to the progeny “once the progeny were no longer in utero” (at [56] (McColl JA)).
315 Goode, Hire-Purchase Law and Practice (n 278) 747; Guest (n 272) 506.
316 See text to n 265.
(a) Accession by natural increase as an unhelpful rule in relation to fruits

Determining legal relationships relating to fruits is more complex than in the case of accretions where one asset accedes to another. In the case of fruits new assets come into being, which have not been previously subjected to a property right. For example, one pear tree can generate twenty pears. The pears have not been owned before. Someone must own them when they acquire separate existence, which is usually when they are separated from the original asset (the tree). The nature of the process of derivation in the case of fruits, unlike accession, does not impose a rule that the new assets (the pears) must be subject to the same property right as the original asset. In the case of accessions one thing becomes a part of another. The end result of the process is that there is only one asset capable of being subject of a property right. The rule of accretions that the owner of the principal thing becomes the owner of accretion means that fruits belong to the owner of the original (principal) asset (partus sequitur ventrem). This rule becomes difficult to apply to fruits if they come into being whilst the principal asset is enjoyed in some way or possessed by a non-owner with the owner’s consent. To use the pear-tree example, the pears may separate from the tree whilst the tree is enjoyed by a non-owner. Property right to the tree does not change through the fact that pears have fallen on the ground but the pears are new assets, which may be subject to a different property right than the tree. It seems that this point has not been fully appreciated in English law, particularly in the context of security interests, where fruits may come into being whilst the principal asset is subject to a security interest. It is therefore useful to lay the basic distinctions in this chapter so that the analysis of the secured creditor’s rights to fruits becomes easier to follow in the next chapter.

317 See also Smith, *The Law of Tracing* (n 7) 21.
318 *Case of Swans* (1592) 7 CoRep 15b, 17a (Coke LJ).
(b) Specifically conferred right to fruits

Whilst owners in Roman law had a right to fruits as an attribute of their ownership, they could part with that attribute by conferring it on another. Right to fruits was conferred by *usufructus* or *emphyteusis*. *Emphyteusis* was a property right over land belonging to another. It was almost unlimited right to the enjoyment of land, which included taking fruits. 319 *Ususfructus* was a right in an asset belonging to another entitling that other (called usufructuary) to use the asset and take fruits from it. 320 The owner was left with “naked” ownership (*nuda proprietas*). 321 For example usufructuary had a right to use another’s house with a garden and take apples from their orchard. When compared with current English law *ususfructus* resembled to a certain extent a profit à prendre in that it entitled the holder of this proprietary interest to take a part of soil, minerals or natural produce and to a certain extent also easement in that it entitled a person to use the asset. It was only conferred on a specific person for a period of time and not longer than the life of that person. 322 It could not be transferred (it was inalienable) but it was enforceable against third parties who became new owners of the asset in which *ususfructus* was established.

(c) Relevance of possession

If the owner does not specifically confer the right to fruits, the ownership of fruits can be determined by looking at the possession of the original asset from which fruits developed. In Roman law if the original asset was in possession of another and the possessor was in good faith, the (non-possessing) owner of the original asset did not obtain the ownership of fruits. 323 For example, a person who possessed the original asset had a right to fruits as a ‘bonus’ for looking after the original asset (*pro cultura et cura*). Usufructuary under *ususfructus* also

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319 D 22,1,25.1.
320 D 7,1.1.
321 This may be compared to the owner being left with a legal title to property only. *Ususfructus* was a type of *servitutes personarum*, and was treated similarly to *servitutes praediarum* (where the entitlement could not exist without land and was alienable only when land was transferred) D 8,1.1.
322 Wołodkiewicz and Zablocka (n 292) para 192.
had possession of the asset but his right to fruits did not arise on the basis of his possession in good faith but on the basis of an expressly conferred attribute under ususfructus. Consequently, there was a difference in timing of acquisition of fruits between a usufructuary and a possessor in good faith: a possessor in good faith became the owner of fruits from the moment the fruits separated from the main asset whilst usufructuary became owner only when he took control of the fruits. The good or bad faith of the possessor of fruits was also relevant when an owner made an actio rei vindicatio claim against the possessor of the original asset. A possessor in bad faith was obliged to return all fruits collected (fructus percepti) and even to give the owner the equivalent value of the fruits he failed to collect through his own fault. A possessor in good faith did not have to return any fruits to the owner but only until the suit began since at that point he became a possessor in bad faith. In post-classical Roman law a possessor in good faith had to return also any fruits that he took but which remained unconsummated (fructus extantes).

In English law the right to fruits has been a matter of some confusion. In Halsbury's Laws of England it was said that the property in the young of domestic animals inhered in the owner of the mother. This statement was expressly (and rightly) criticised as too wide in Tucker v Farm and General Investment Trust Ltd. In that case ewes were let on hire-purchase. During the currency of the agreement lambs were born. The hirer sold both the ewes and the lambs to a third party buyer. The finance company, which owned the ewes, seized not only the ewes but also the lambs. The third party buyer sued the finance company for conversion. It was held that where animals were bought on hire-purchase terms their progeny belonged to the hirer, not their owner. The rule that the owner of the mother owns the progeny may be useful

324 Ibid. para 192.
325 Or to be more precise, until litis contestatio.
326 Wołodkiewicz and Zabłocka (n 292) para 200.
327 (1952) 3rd ed, Vol 1, 656.
328 [1966] 2 QB 421 (CA) 426 (Denning LJ).
in some cases, for example where different persons own the mother and the father, e.g. dam and the stallion, but it should not be extrapolated. Diplock LJ explicitly considered the relevance of the fact that property and possession were divided in a lease of livestock. He held:

“[w]hen you come to a case like this, where there is a lease of livestock and where accordingly property and possession are divided, the English rule and the rule in the civil law is that the progeny and the produce of the livestock belong to the person entitled to the possession: that is to say, the lessee in English law: the usufructuary in civil law”.330

All three Law Lords in Tucker found support for this proposition331 in an old English case of Wood v Ash,332 which made it unnecessary to rely directly on Roman law. The rules in Roman law and English law were held to coincide anyway.333 Wood v Ash concerned a lease of land with a stock of sheep for twenty years for rent. It was held that:

“the increase of the stock of sheepe should be to the lessee, and the lessor shall never have them at the end of the terme: but they agreed, that if the lease were of the stock with lambs, calves, and pigs, there the increase belongs to the lessor.”334

We should note that the right to fruits (lambs) arises on the basis of law (i.e. on the basis of the nature of the legal relationship between the parties) but the parties may modify their relationship by agreement. For example parties may agree that the non-possessing owner will have the

329 This was the scenario considered by Sir William Blackstone (2 Bl Com 390), cited in Tucker (n 328) 426–427 (Denning LJ). The rule apparently did not apply to swans, where the young cygnets were divided equally between the owner of the cock and the hen because – unlike with other animals - the male was well known as constantly associated with the female (“Swans, as we all know, are faithful unto death and beyond” per Lord Denning at 427), which meant that the owner of the cock, as well as the hen, lost the benefit of the animals whilst the hen was pregnant and nurtured: Case of Swans (1592) 7 Co Rep 15b (Coke LJ).
330 Tucker (n 328) 431.
331 Tucker (n 328) 427 and 428 (Denning LJ), 429 (Harman LJ), 431 (Diplock LJ).
332 (1586) Owen 139, 74 ER 958.
333 Tucker (n 328) 431 (Diplock LJ) referring to Morkel v Malan [1933] SCR, CPD (SA) 370, 374, 375.
334 Wood (n 332) 959.
right to fruits and, as in the case of *Wood v Ash*, the lease extends to new assets when they acquire separate existence. It is also possible for the parties to agree that the possessor (e.g. the hirer) will have the right to fruits with an obligation to pay the owner rent with the fruits or by selling fruits. This was labeled by Denning LJ in *Tucker* as “pay as you milk” option: when the farmer milks the cows, the milk becomes his, so that he can sell it and pay the rent with the proceeds of sale of milk.\(^{335}\)

Crucially, the court in *Wood v Ash* is reported to have drawn a difference between fruits (natural increase) and accretions (accession by attachment), which substantiates the argument made in this work that the latter is governed by the principle of *accessio cedit principali*:

> “[a]nd all the Court took this difference, sc. when a lease is made of dead goods, and when of living; for when the lease is of dead goods, and any thing is added to them for reparations or otherwise, the lessor shall have this addition at the end of the terme, because it belongs to the principle: but in case of a stock of cattle, which hath an increase, as calves and lambs, there these things are severed from the principle, and lessor shall never have them, for then the lessor shall have the rent, and the lessee shall have no profit.”\(^{336}\)

The rule that emerged is that the right to fruits inheres with the possessor of the original asset (the lessee), not the owner of the original asset (the lessor)\(^{337}\) unless the parties agree otherwise, for example if the lease agreement provides that the owner leases cattle along with any calves. This is different from a situation where an asset is improved or repaired because then the “increase” falls back to the lessor as the owner of the principal asset.

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\(^{335}\) *Tucker* (n 328) 429 (Denning LJ).

\(^{336}\) *Wood* (n 332) 959.

\(^{337}\) See also Guest (n 272) 506.
B. Rights to “civil fruits” (intangible “fruits”)

In Roman law intangible “fruits”, referred to as “civil fruits” (fructus civiles), such as income from leases, were dealt with by analogy to natural fruits (loco fructus - “taking place of fruits”). Civil fruits were assets acquired on the basis of a legal relationship or a legal act, for example rents from a house lease. A person entitled to an asset yielding income was also entitled to income once it accrued. There are difficulties with drawing an analogy between natural and civil fruits. It is controversial whether intangibles, in contrast to tangible assets, can constitute subject matter of ownership or other property rights. Even if we accept that intangible assets can be subject to property rights, it is also controversial whether intangibles can be possessed. Bearing in mind what we said about the relevance of possession in determining rights to natural fruits, the parallels between natural and “civil fruits” are weak. It is suggested that it is better to think about “fruits” of intangibles as a set of rights attached to an intangible. Shares, for example, usually have three types of rights attached to them: rights to capital, voting rights and rights to income. When we say that a person has a right to income as “civil fruits” of a share, we mean that the person is entitled to the right to income, which is attached to the share, and when the right to income is realised, that person receives income. It is important to understand the relationship between a share, a right to income and the payment of income. A right to income does not mean that a person has a present claim to be paid dividends. A right to


339 For a view that intangibles cannot be possessed see Torkington v Magee [1902] 2 KB 427, 430 (Channell J), reversed on other grounds [1903] 1 KB 644 (CA). See, however, in relation to financial collateral Lehman (n 137) [124] (Briggs J) “in relation to intangibles (…) possession can be demonstrated wherever it is ‘held’ by the collateral taker, that this is sufficient regardless of control, but that to extent that control is also to be demonstrated, it is satisfied by administrative rather than legal control”, see also [131] and [136] (Briggs J).

be paid a final dividend does not arise until dividends are declared.\textsuperscript{341} It is at that point that debt is created.\textsuperscript{342} In the case of interim dividends a right to be paid may arise even later as a resolution to pay such a dividend does not create immediate debt.\textsuperscript{343} But the question of who will have a right to dividend payment once dividends are declared is determined on the basis of who has the right to income. In other words, from the moment a share “comes into being” it is possible to determine who has a right to income. When income “comes into being” (e.g. final dividends are declared) there is little similarity between a right to be paid a dividend and a natural fruit. The latter is a new, previously unowned thing and the right to it may be determined on the basis of the right to possess the old thing from which the new asset (natural fruit) derived. The right to be paid a dividend is determined on the basis of who had a pre-existing right to income (as and when it would accrue), i.e. whether the right to income was still attached to the share or not. Thus, it is suggested it is better to think about rights to “civil fruits” as pre-existing rights attached to, or detached from, intangibles rather than new assets, right to which can only be determined by reference to the right to the original asset.

Perhaps we could go a step further and say that ownership of natural fruits could also be determined on the basis of a pre-existing right to them rather than possession. This would be consistent with the analysis of attributes of ownership, one of which is an attribute to take fruits. As we have seen an owner of an asset transfers parts with this attribute in \textit{emphyteusis} or \textit{usufructus}. We could say in those cases that the owner expressly transfers a pre-existing right to fruits. On this analysis ownership of fruits that come into being and are separated from the other (principal) asset is established by finding who has the pre-existing

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\begin{itemize}
\item \textsuperscript{341} Bond v Barrow Haematite Steel Co [1902] 1 Ch 353, 362 (Farwell J).
\item \textsuperscript{342} Gullifer and Payne, Corporate Finance Law. Principles and Policy (n 340) 58. The debt is immediate when the company declares dividends on its shares (Re Severn and Wye and Severn Bridge Railway Company [1896] 1 Ch 559) even if not due to be discharged immediately, for example because payment date has been postponed (Re Kidner [1929] 2 Ch 121).
\item \textsuperscript{343} Ibid. 58 citing Lagunas Nitrate Co Ltd v Schroeder & Co and Schmidt (1901) 85 LT 22.
\end{itemize}
right to take fruits: whether the owner parted with that right or not. If this is right, ownership of fruits would be derived from the owner and not an example of original acquisition. The possible objection to using the pre-existing right analysis to tangible assets is that in cases where the owner did not expressly transfer the right to fruits to another, we are likely to have to resort to the notion of possession to determine the entitlement to fruits.

Fruits pose different problems in relation to security interests than substitute assets. We may note that a secured creditor is not entitled to an absolute ownership of fruits but is limited to resorting to fruits up to the amount of the secured debt. Generally, two scenarios are possible depending on who collects fruits. First, if the secured creditor collects the fruits, he may be able to resort to fruits automatically on the basis of possession of the original asset (e.g. in the case of a pledge), in which case it is necessary to ensure that the creditor is not paid above the amount of the secured debt. Second, if the debtor collects the fruits, the question is whether the secured creditor has a right to resort to the fruits or whether they are unencumbered with security. These questions are tackled in detail in the next chapter.344

3 Classification of changes to subject matter of security interests

The purpose of this thesis is to establish in what way changes of the original collateral affect the security interest. Different situations, which we looked at above, may conveniently be divided into two groups: where no new asset arises and where a new asset arises. We will call the new asset a “derived asset” even though in some cases there is no actual physical derivation of new asset from the old one. The thesis focuses only on security interests in new assets, as stated in the introduction, but it is important to show where the line is drawn.

344 See Chapter III section 4.
3.1 Changes of subject matter not leading to a new asset

   A. Following into the original collateral (accretions, confusion)

Collateral can be followed despite accretions to collateral or confusion of collateral with other assets. In such cases the creditor is able to resort to the original collateral. Where an accession occurred the creditor simply claims the same asset, even though it may have gained value due to an accretion, fixture or improvement. It is suggested that it is not necessary to say that accretions “enure for the benefit of the creditor”.\textsuperscript{345} The basis for the secured creditor’s right to an improved asset is simply that it continues to be the same asset. It should not be relevant that the value of the asset is now greater or smaller than prior to accretion because a security interest, as a property right, is asserted in a specific asset, not its value.\textsuperscript{346} Market value of assets may also change and the creditor may have to suffer a shortfall of sale proceeds on enforcement. This is a risk that a secured creditor takes.\textsuperscript{347} For the same reason the creditor should not have a right to new shares if rights of issue of shares were exercised just because the original shares are worth substantially less.\textsuperscript{348} Where collateral becomes confused with other assets into a mixture, without a new asset being formed (\textit{confusio, commixtio}), the creditor is said to be able to assert security in the proportion which the value of the original collateral bears to the mixture. It is not clear whether there is a reason why cases of accession and confusion should be treated differently. In both cases assets are mixed or joined in a way that makes separation of the component parts not practically possible. Such cases are outside of the scope of this thesis and we will not discuss them in detail. Suffice it to say that mixtures pose more complex problems than accessions. As we have

\begin{footnote}{345}Goode on Legal Problems of Credit and Security (n 1) para 1-56\end{footnote}

\begin{footnote}{346}It is the assumption of this work that property rights (including security interests) are rights in particular assets, having a discrete identity, not in the exchange value, which the assets represent at a given time, see text to n 8.\end{footnote}

\begin{footnote}{347}There are different ways to offset such risks, e.g. insurance.\end{footnote}

\begin{footnote}{348}For a contrary view see Goode on Legal Problems of Credit and Security (n 1) para 1-56.\end{footnote}
seen above using the example of Roman law, the ownership rules of mixtures are more complex than the ownership rule relating to accession that the owner of the principal asset becomes the owner of the subsidiary. For example a mixture may be co-owned.\textsuperscript{349} It is evident that secured creditor’s right to resort to the mixture is dependent on the right of the owner (the grantor of security) in the mixture. If the mixture is co-owned, the creditor can only have security in the co-ownership share.

\textbf{B. Destruction of subject matter of security}

The creditor cannot assert security in the original asset where the original asset cannot be followed and a new asset did not come into being. The simplest example is when the collateral is physically destroyed.

\textbf{3.2 Changes of subject matter leading to a new asset}

\textbf{A. Proceeds and products (substitutes)}

In some cases a new asset comes into being where the security interest is lost in the originally encumbered asset. This happens in two scenarios. First, the original collateral cannot be followed where it ceased to exist in law because of incorporation of the encumbered asset in another asset (accession) or a manufacturing process using collateral (specification). Two or more things are combined, whether identical or different, and result in an asset, which has its own individuality independent of its individual components (e.g. a house built from bricks and timber). Both processes concern tangibles only. The new assets that arise could be referred to as “products”. The term is ambiguous. It is sometimes used to refer to mixtures of assets, where goods cannot be distinguished but no new asset is formed (cases of confusion). In this thesis we use the term “products” to mean new assets resulting from accession of collateral to another asset or specification, sometimes

\textsuperscript{349} Under English law see Sale of Goods Act 1979, s20A (a buyer of a share of identified bulk, who paid the price, becomes an owner in common of the bulk).
collectively referred to as “commingling”. We do not examine the question of tracing in this work. Thus, we do not ask to what extent the creditor may be able to trace the value of the original collateral in the new product, i.e. whether the creditor can assert his security interest in the entire asset or only in proportion which the value of the encumbered asset bears to the value of the new product. Under the UCC, as we have seen, the issue of whether the creditor makes a proportionate claim or asserts security in the entire new asset depends on competing claims of other creditors who had security interests in the components. Second, the original collateral cannot be claimed because the original asset was transferred to a buyer, who is able to raise a defence of bona fide purchaser of legal title for value without notice against the creditor. The new asset is whatever the debtor exchanged the collateral for with the buyer. The creditor traces the value of the original collateral into a new asset (proceeds of the transaction).

Proceeds and products are both substitutes. Proceeds are clean substitutions while products are mixed substitutions. Both proceeds and products are traceable proceeds. Since the analysis in this work focuses on the question of claiming a new asset (the substitute), and not tracing, drawing a distinction between “proceeds” and “products” is a subsidiary issue. Throughout the thesis we will, therefore, use the term “products” only sporadically. Where we talk about “substitutes” or “proceeds” the analysis will concern both proceeds and products.

B. Fruits

In some cases the original asset can be followed and a new asset arises. In Roman law fruits, e.g. apples from an apple tree, were treated as new assets, not previously owned or subjected to property rights. We have suggested that a preferred way of looking at fruits is to think of them as arising on the basis of a pre-existing right attached to the original  

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350 Goode on Legal Problems of Credit and Security (n 1) para 1-58.  
351 Text to nn 308-312.  
352 Text following n 343.
collateral. A right to the original collateral may or may not carry with it an attached pre-existing right to fruits. It is argued in the next chapter that whether or not the collateral carries with it an attached right to fruits is a matter for the parties to decide. In the case of natural fruits, in the absence of an express agreement, the right to fruits may also be determined on the basis of possession of the original collateral.

We may also note that the approach should not change if after the new asset arises the creditor loses his claim to the original asset because the original asset is destroyed, for example the ewe dies after giving birth to lambs. Fruits cannot become substitutes of the original asset in such a case. Substitutes (traceable proceeds) must arise in the same act as the original asset was disposed of or ceased to exist. Having said that, there is some scope to treat fruits as traceable proceeds in the case of intangible fruits such as income from leased property. In this example, income accrues because the owner parted with a portion of his ownership of the property in return for the right to rents. The new assets (fruits) may therefore be seen as products of alienation of use-value of the original asset, analogous to proceeds of disposition of the asset, and so be treated as traceable proceeds of the asset (the so-called value-based proceeds by contrast to disposition-based proceeds). Yet, there is an important difference between fruits and proceeds (understood as disposition-based proceeds). Professor Smith in The Law of Tracing emphasised that the basis of the claim to a fruit is different from the basis of a claim to traceable proceeds. He argues that an owner of an asset does not need to give up anything to be entitled to a fruit whilst this is not so in the case of tracing where the new asset is acquired by exchange of the original asset for another asset. On this basis, the

353 An example of such treatment of fruits (income) is seen in relation to security interests in proceeds under Article 9 UCC, see text to n 551.
354 Smith, The Law of Tracing (n 7) 23.
355 Ibid. 23 (the asset holder becomes the holder of a new asset “for no other reason than his holding of the original asset at the time the new asset was created”). Contrast this view with the view expressed above (text to nn 323-336) when another person than the owner possesses the original asset.
view preferred in this work is that fruits and proceeds should be treated differently.

Finally, an important point to make is that fruits do not become substitutes (proceeds) just because the value of the original collateral is reduced when fruits come into being. This is a controversial point. Let us consider pre-emption rights in shares.356 Some companies may raise further equity capital through a fresh issue of shares, which may have to be offered first to existing shareholders.357 When fresh shares are issued the value of an individual share drops proportionately. It has been suggested in the literature that pre-emption rights, once exercised, inure for the benefit of the secured creditor because otherwise every such issue would reduce the value of shares subject to security.358 If we agree with the basic premise, on which this thesis is based, that a secured creditor has a right to a specific asset (not its value)359 then a mere fact that the value of collateral is diminished should not extend security interest to new shares acquired by the exercise of a pre-emption right. It is suggested that a pre-emption right, similarly to a right to income, is merely a right attached to a share. Whether the “benefit” of this right is conferred on the creditor or not should be a matter for the parties to decide. In the absence of a clause extending the security interest to such shares newly issued, the secured creditor should not be able to extend security to them by nature of these rights.360

C. Distinction between fruits and substitutes

The distinction between fruits and substitutes can be drawn at a functional level and at a conceptual level. Neither is clear-cut. The difficulty with drawing the distinction between fruits and substitutes is

356 Companies Act 2006, s561.
358 Goode on Legal Problems of Credit and Security (n 1) para 1-57.
359 See text to n 8.
360 If this were not the case, we would probably have to consider consequences of the debtor’s refusal to exercise pre-emption right, depriving the creditor of the benefit. This puts us very closely to the law of fiduciaries. We argue below (text to nn 732-747) that grantors of security interests are not fiduciaries.
illustrated with the example of a long-term contract with amortised payments, where each payment diminishes the value of the contract. Should the contract be assigned after one of the payments is made its exchange value is lower than prior to the payment being made. When all payments due under a contract are made the contract’s exchange value is extinguished as no more debts are owed under the contract. Long-term contracts with amortised payments could be thought of as similar to a book debt where the debt is paid in instalments. Book debts and their proceeds are considered in this work to be self-same assets.

A step removed from this is a situation where payments are made under an arrangement but the exchange value of the original asset is not necessarily diminished by the payments made. An example is payment of a dividend under a share. When a dividend is paid, the exchange value of the share is not diminished by the value of the dividend. This is because the exchange value of the share is determined by factors other than dividend payments, primarily by how much the market is willing to pay for the share. This is usually not dependent on whether dividends have just been paid out or not. Thus in the case of a share and a dividend, the dividend can be seen as a new asset. A right to dividends has a discrete existence. Another example is the relationship between a loan and interest paid on the loan. An interest is a right to paid that accrues periodically. Payment of interest does not diminish the exchange value of the loan.

(a) Functional similarity based on economic efficiency

At a functional level, whether the relationship between assets resembles that of an original asset and its substitute or between an original asset and its fruits, depends, it is submitted, on whether the exchange value of the original asset is determined solely by whether or not derived assets arise. If the exchange value of the original asset is permanently diminished when a new asset arises, the new asset may be functionally similar to a substitute. If the exchange value of the original asset is not affected by the new asset coming into existence, it is functionally
similar to a fruit. Functional similarity is only useful to the extent of assessing whether it is efficient in a legal system to allow security to extend to such assets.\textsuperscript{361} It is not suggested here that functional similarity implies that default rules applicable to fruits and substitutes should be the same as the rules relating to their functionally similar equivalents. When we say that security in amortised payments under long-term contracts are functionally similar to security in substitutes, we mean that a creditor who has a security in a long-term contract does not enjoy any windfall of benefits if his security extends automatically to the payment made under a contract. By contrast, a creditor whose security automatically extends to dividends does enjoy a windfall of benefits because the subject matter of security is enlarged: he has more assets to resort to.

As far as default rules governing security in derived assets are concerned the rules applicable to substitutes and, say, functionally similar amortised payments under a long-term contract are likely to differ. The proper characterisation of such payments is likely to be a question of degree: whether they exhaust the exchange-value of the long-term contract proportionately when each payment is made. If they do, such payments are not likely to be substitutes. The derived asset (payment under the contract) is the same asset as the original asset. Each payment under a long-term contract \textit{constitutes a part-realisation of the contract}. Each payment therefore represents a portion of the original asset and so the relation is similar as between a book debt and its proceeds. There is also a parallel between amortised payments made under a long-term contract and minerals extracted from land. Minerals are not fruits but “simply a subdivision of the original thing”\textsuperscript{362}. 

\textsuperscript{361} Efficiency of security in fruits and substitutes is explained and contrasted in section 2.4 of chapter 1.

\textsuperscript{362} L. Smith, \textit{The Law of Tracing} (n 7) 22.
(b) Conceptual distinctions

Fruits do not derive from a disposition of the original collateral. Natural fruits are born from processes of nature. Intangible fruits arise as a realisation of a pre-existing right, even if for that right to be realised a third party may need to act, for example a right to be paid a dividend does not arise until a company declares it.\textsuperscript{363} Substitutes, by contrast to fruits, derive from an event that affects the original collateral, the event usually being a disposition. We give a wide meaning to the term “disposition” in this work to encompass any act affecting the asset in question, whether the act is physical (e.g. baking bread from flour and yeast) or legal (e.g. sale). The key point is that security interests in original collateral may be lost either through (i) a destruction of the old asset or (ii) a loss of claim to the original asset. The term “destruction” of an asset (in (i)) refers to cases where assets are destroyed in the eyes of law. Destruction does not mean that assets are physically reduced to nothing but rather that they are incorporated into a new product. Yet, the process, which leads to the secured creditor’s loss of right in the old asset is physical, not legal. Legal dispositions are transactions, whereby the debtor transfers a property right in the asset to a third party transferee or creates a property right in the asset in favour of another (a disponee). We are only interested in transactions, where the transferer obtains something in return (a new asset\textsuperscript{364}). In (i) the creditor loses right to the old asset because under a set of default rules (such as specificatio\textsuperscript{365} or commingling under UCC\textsuperscript{366}) the old subject matter ceased to exist as a result of a certain event (process). In (ii) the creditor loses right to the old asset because the law prevents the creditor from claiming the old asset. In both (i) and (ii) the new asset constitutes traceable proceeds. Perhaps it is this dichotomy that makes it still a

\textsuperscript{363} Text to nn 341-342.
\textsuperscript{364} It is a “new” asset in the sense that it previously did not exist in the estate of the debtor.
\textsuperscript{365} See text to nn 300-307.
\textsuperscript{366} See text to n 309.
question of debate whether tracing is merely an evidential process or one of establishing claims.\textsuperscript{367}

One area, which does not fit easily into the term “disposition”, involves cases, probably rare in practice, where tangibles are combined into a new asset accidentally or by an act of a third party outside of the control of the owners of assets joined. In such cases it may be more accurate to refer to an event affecting the original collateral rather than a disposition. An accidental destruction of the old subject matter may occur in cases of accession.\textsuperscript{368} For example, a plot of land may become a part of another plot of land by an earthquake and the subsidiary plot of land loses its existence. Assets may also be joined, whether by accession or specification, by an act of a third party, which is outside of control of the owners of mixed things. The secured creditor’s right to resort to the new asset will depend on the entitlement of the grantor of security in the mixture. In cases of specification, if the debtor ends up with a co-ownership share in the asset, the secured creditor ought to be able to assert security in that share. In cases of accession, where the principal asset belonged to the grantor, the secured creditor’s right to resort to the asset should not be affected (i.e. he may still assert security in the original asset, including the asset that acceded to it, because it is still the same asset). In cases of accession, where the principal asset belonged to a third party, the grantor loses ownership of the subsidiary asset. If the loss of ownership is not accompanied by acquisition of rights in any new asset by the grantor, the creditor seems to lose its security in the subsidiary asset.

In this work we focus on cases where the grantor of security acquires a new asset as a result of an act of the debtor, not as a result of accidental accession or mixing by a third party outside of the debtor’s control. This means that in this work the term “disposition” amounts to an act of the debtor or at least an act in the debtor’s control that led to the

\textsuperscript{367} Text to n 917 and literature cited there.
\textsuperscript{368} Specification cannot be a result of an event because specification assumes that there was work or skill (a human act).

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acquisition of a new asset (a substitute) by the debtor. One key point advanced in this work is that rights to substitutes generated by debtor’s disposition do not arise automatically (i.e. on the basis of a “principle of substitutions”). As a result of the distinction in English law between fixed and floating charges dispositions of collateral are necessarily either authorised or unauthorised. The secured creditor is not entitled to substitutes by nature of the security interest. In order to establish the secured creditor’s rights to the new assets we will need to examine when dispositions are authorised and when they are not. In cases where dispositions of collateral are authorised security interests may arise in substitutes. It will be argued in chapter IV that whether or not security arises in proceeds of authorised dispositions depends on whether parties intended for security to extend to substitutes. If parties did not so intend, the secured creditor has no rights in proceeds of authorised disposition. In cases where dispositions of collateral are unauthorised, rights to proceeds may arise as a result of claims contingent on tracing. The basis for such claims is controversial and will be discussed in chapter V. Whether dispositions are authorised or not, it is argued that rights to proceeds do not arise automatically, as a result of a “principle” of substitutions. The analysis of security interests is different in the case of fruits because they do not derive from a disposition of the original asset by the debtor. As a result, rights to fruits cannot arise as a result of a disposition of the collateral. It is argued in chapter III that security interests in fruits do not usually arise automatically and are not inherent in the nature of the security interest in the original asset. Security interests in fruits are shown to arise as a result of an agreement between the parties. This may result from transfer of possession of the original collateral which bears natural fruits or from transfer of rights to intangible fruits attached to the original collateral, such as a pre-existing right to income attached to a share.

369 See chapter III section 3, chapter IV section 3 and chapter 5.
370 This is particularly controversial in the context of a floating charge, see text to nn 785–797.
3.3 “False friends” of derived assets: rights to payment

Some assets may seem like they undergo a change into a completely different asset but in fact they are not two different assets. This is the case of rights to payment, which are often assignable and valuable assets in the sense that they can be transferred (exchanged) for value. When these rights are exercised, payment is obtained. It seems that a new asset comes into being but in fact there is only ever one asset. Such is the case with book debts, which we examine in detail later when we discuss charges over book debts. A book debt is a right to payment. In the simplest example the right to payment is exercised when the payor (e.g. a buyer) performs her obligation and transfers money to the payee (e.g. a seller). From the perspective of the payee when the right is exercised, the right to be paid disappears and is replaced by cash or money in a bank account. This is not a result of a disposition (assignment) of the right to payment but a result of the exercise of the right. Analogous asset to a collected debt is the revenue from leasing agreements (as distinct from the leased equipment). If from the perspective of the lessor the benefit of the leasing agreement is income-generation, then the relationship between the generated revenue under the agreement and the agreement is analogous to a collected debt and a book debt, even though the right to revenue is not usually exhausted after a single payment under a leasing agreement.

Another example is payment of a dividend that “derives” from a right to dividends on shares. A right to a dividend is merely realised when a dividend is paid. It is analogous to a book debt but only once dividends have been declared. We may also reiterate the point made above that a right to be paid a dividend is separate from a right to a share. A

371 See text to nn 418-447.
372 Obligation to pay may also be discharged in other ways, for example by way of set-off.
373 These types of assets pose problems for characterisation of charges, which is not, however, of primary concern here. For analysis see Worthington and Mitchkovska, 'Floating Charges: The Current State of Play' (n 192).
374 See also text to n 209.
375 Text to nn 341-342.
right to be paid a dividend arises on the basis of a right to income, which may or may not be attached to the share. There is no analogy between a pre-existing right to income attached to a share and a book debt. When the pre-existing right to income is realised it gives rise to a right to payment of dividends. Once dividends are declared, a debt is created. It is at that point that an analogy can be drawn with book debts before a debt to pay is created. The relationship between book debts and proceeds of book debts is analogous to the relationship of an obligation to pay a dividend (once it arises) and the payment of a dividend.

4 Conclusion

We have seen that Roman law focused primarily on the right of ownership, not proprietary interests such as real security. The Roman law classification of derived assets helps to determine when assets mixed with others ceased to exist. Thus, the principles of accessio, specificatio and confusio/commixtio remain important in English law in determining whether a new asset has been created. The Roman law of fruits seems of less use and an alternative approach to understanding fruits has been suggested. Fruits, unlike substitutes, can be seen as arising on the basis of pre-existing rights attached to the original collateral. Whether or not a creditor is entitled to fruits can be determined before fruits come into being. Substitutes, on the other hand, are typically a result of a disposition of the original collateral. Whether or not a creditor can extend security to a substitute depends on whether the disposition was authorised by the security agreement or not. The rest of the thesis is structured to reflect this distinction.
CHAPTER III – Security agreements without a derived assets clause

1 Introduction

Investigation into the extent of security interests requires us to draw a distinction between two situations: first, where parties in the security agreement expressly agree that security is to extend to proceeds, products or fruits and second, where the agreement is silent as to these derived assets. This chapter is concerned with the latter situation. The question posed is whether a secured creditor can resort to assets derived from the original collateral automatically and by virtue of its proprietary interest in the originally encumbered asset if the security agreement is silent in this respect. Security agreements that expressly or impliedly extend security to derived assets are discussed in the next chapter.

There is little authority on the point of automatic security interest in derived assets and the little case law that exists has not attracted much attention. In the leading case in the area, *Buhr v Barclays Bank*, Arden LJ held that a secured creditor could automatically resort to accretions, fruits or substitutes purely by virtue of the nature of the secured creditor’s proprietary interest in the asset originally encumbered. The case concerned a farm mortgaged to two subsequent mortgagees. When the farm was sold the mortgagors used the sale proceeds to discharge the first mortgagee but not the second one. Since the sale was considered as unauthorised by the second mortgagee, the key issue was the right of a secured creditor to proceeds of an unauthorised sale. We treat unauthorised dispositions separately and discuss them in the last chapter. *Buhr v Barclays Bank* is of interest here, however, because Arden LJ spoke of a general principle of

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376 *Buhr* (n 14).
377 See chapter V.
“substitutions and accretions”. The word “principle” seems to have been used by Arden LJ, and is used in this thesis, to mean that a certain result occurs even if the parties do not provide for that result in their agreement: the outcome is generated by the nature of the property right (the operation of law governing that property right). If the “principle” applies, it means that the chargee’s (or a mortgagee’s) proprietary interest automatically extends to both improvements to the property or assets acquired by the chargor in place of the original asset, whether or not the creditor authorised the disposition and whether or not the parties to a security agreement contemplated derived assets. In a section entitled “The general principle: the mortgagee has a right to accretions to and substitutions for the mortgaged property” Arden LJ said that “equity has for a long time taken the view that the mortgagee is entitled to a security interest in the fruits of the mortgaged property” and immediately went on to give an example of a mortgagee’s interest extending to a new lease when the previous lease was surrendered or expired. The case report is not detailed enough to fully assess how wide this “principle” is. It seems that Arden LJ herself talked about the “principle” in relation to unauthorised dispositions, accepting that the position may be different in relation to authorised dispositions. This work considers the accuracy of the notion of a “principle” not only in relation to unauthorised dispositions (chapter V) but it also asks whether the principle could be said to apply in relation to authorised dispositions (chapter IV). Before we do so, we must clarify the default rules on rights to derived assets where no provision has been as to what is or is not authorised, that is we need to consider security interests where no derived assets clause exists.

It seems that the concepts of substitutes, accretions and fruits are confused in English law, as evidenced by the case of Buhr. A new lease, which replaces an old lease, is a substitute, not a fruit or

378 Buhr (n 14) [40].
379 Hughes v Howard (1858) 25 Beav 575, 53 ER 756.
380 Leigh v Burnett (1885) LR 29 Ch D 231.
381 Buhr (n 14) [46].
accretion. Accretions are additions to the original asset that adhere to it while fruits are new assets, which are already separated from the original asset. It is not correct to think of a new lease in a conceptual category of a “fruit” of the mortgaged property. We take each of these three categories (accretions, substitutes and fruits) in turn. It is argued that while a security interest automatically extends to accretions to the originally charged asset, there is no support under current English law to say that security automatically extends to substitutes or fruits. We also make comparative law notes in this chapter. The current English law contrasts sharply with Article 9 UCC, whereby a security interest in the original collateral automatically extends to the proceeds of collateral by virtue of the statute. The definition of proceeds in the UCC is very wide, comprising, for instance, income. We will see that the automatic extension of security interests to income has caused some problems in the US law. Should a similar provision be adopted in English law, as the current proposals indicate, it is suggested that security interests should not automatically extend to income.

### 2 Security interests in accretions

A secured creditor is said to have a right to accretions. As we saw in the previous chapter the idea of accretions has suffered some confusion in general English law. Consequently, the idea of security in accretions has also not been fully understood and this section aims to clarify this notion. It is convenient to consider a basic example first. Let us imagine that a security agreement is entered into between a debtor and a lender to create a charge in a car but no provision is made for what happens to the chargee’s right when the car undergoes some changes. Some time later, in the period of duration of security, the borrower installs new alloys in the car, thus increasing substantially the value of the car. Alloys improve the car and as such are an accretion to the asset. The

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382 LC CP (p 15) paras 3.182-3.187 and DR 2 ("proceeds") and 29 (attachment and perfection of security in proceeds).
383 See text to nn 284-285 and 315-337.
question is whether the secured creditor has a right to enforce his security by selling the car along with the alloys and if so, on what basis.

2.1 Distinguishing rights to accretions from rights to derived assets

In *Fisher and Lightwood’s Law of Mortgage* we read that whatever is added to the property to improve its value is an accretion to the property and is for the benefit of the mortgagee. This is so whether the addition is made by the debtor or a subsequent mortgagee. Pursuant to this definition, the secured creditor in the example above would be able to enforce his security in the car with the alloys because the improvement of the value was for the benefit of the creditor. It is suggested that this definition of accretions is flawed. First, it assumes what it needs to prove: that the improvement is for the benefit of the secured creditor. Second, security interests are property interests in assets, not value. The first aspect has misled authors to treat “new leases” as “accretions”. It is argued below that “new leases” are substitutes, not accretions. If an asset is substituted for another for the benefit of the creditor, the creditor has a right to it. But it is false to assume that a new lease is taken for the benefit of the creditor and therefore is an accretion. In the case of accretions a person has a right to the accretion (i.e. the subsidiary asset) because it becomes a part of the principal asset. If a creditor had an interest in the old lease, it would be incorrect to say that the new lease automatically becomes a part of the old asset; the new lease usually replaces the old asset. The second aspect requires an explanation. It is not helpful to look at changes to the asset through the prism of increased value. If it were so, we would have

385 *Re Kitchin, ex p Punnett* (1880) 16 Ch D 226 (CA).
386 Maxwell v Ashe (1752) 1 Bro CC 444n; *Landowners West of England and South Wales Land Drainage and Inclosure Co v Ashford* (1880) 16 Ch D 411, 433, cited in Clark (ed), (n 384) para 8.7.
387 See text to nn 459-462.
388 A new lease or goodwill may be considered as an accretion when it is part of a business, see below text to nn 395-406.
to treat it on a par with an increase of the market price of a particular asset (increase in value resulting from the willingness of the market to pay more for a particular asset) and mixing of an asset belonging to another with collateral into a mixture. In the latter case, we would be doing an injustice if we said that the mixture represents “increase in value” of the original asset, and that it is “for the benefit of” the creditor (creditor A). Not only would the (possibly innocent) owner (O) of that other asset be automatically subject to a security interest but also any other creditor of O, who had a security interest in O’s asset, would automatically be subordinated to creditor A’s security. A better solution in such cases is to say that the secured creditor can assert interest to the new asset (product) in the proportion in which the originally encumbered asset was mixed with the other asset.389

The definition of accretion as an “increase in value” also covers fruits and income. It was argued above390 that it is not accurate to treat fruits and income as “accretions” because they form an entirely new asset once they are separated from the original asset. Although on a literal reading of the definition in Fisher and Lightwood’s Law of Mortgage “fruits” are not accretions because they are not “added”, but rather form a natural increase from the original asset, it seems clear that “fruits”, e.g. progeny of livestock, have been treated as accretions to the asset in the literature.391 We will show below that there is little support under English law to say that the security interest extends automatically to fruits and income. Therefore, it is suggested that accretions should be treated as assets that are added to collateral, not assets that are generated from the collateral.

Referring back to the example of the car with alloys above, it is better to say that the secured creditor can enforce the security in the car with the alloys because the alloys become a part of the car and it is the car

389 This is the solution under UCC §9-336(f), see text to n 312.
390 See text to n 318.
391 See Fisher and Lightwood's Law of Mortgage (n 384) para 8.7 referring in the section on “accretions” to Webster v Power (1868) LR 1 PC 150 (sheep) and Tucker (n 328).
that is subject to security. It should not be relevant that the car is more valuable with the alloys and can be sold for more than it was possible before the improvement was made. The security interest is in the car, not in its value. Moreover, if the secured creditor takes the risk of diminution of market value of the asset, which may in some cases lead to the creditor’s debt not being discharged in full if sale proceeds are insufficient, it is only fair that he should also be entitled to the sale proceeds of the assets with accretions if the asset is worth more on the market. The secured lender will not be able to recover, however, more than the amount of the secured claim.

A security interest extends to accretions to the original asset because the substance of the original asset does not change. In some cases the line between an accretion and a mixture forming a new asset may be hard to draw but we need not look at this here. The point made here is that the secured creditor can resort to the asset including accretion because it is still the same originally encumbered asset. It should also be added that in the case of a mortgage, where the mortgagee has a title to the encumbered property, although an accretion benefits the mortgagee because it enlarges his security, the asset still belongs to the mortgagor.

2.2 Specific examples

The simplest example of an accretion is a fixture to house. Even if the parties do not agree expressly that the mortgage extends to fixtures, the mortgagee has a right to resort to land including any fixtures. A problematic example of accretion is goodwill. Although it seems clear in law that goodwill of a business, e.g. a public house, passes with the sale of a business, it is not clear whether the mortgagee automatically has a right to resort to the proceeds of sale of both the goodwill and the business.

392 This may not be so if the subsidiary asset attached was subject to another security interest. However, questions of priority are outside of the scope of this thesis.
393 Nelson v Hannam [1943] Ch 59.
394 Kitchin (n 385) 233 (Jessel MR).
A. Goodwill as an accretion to the business not premises

It has been noted in the literature that the general principle that anything added to the property becomes part of the property extends to goodwill. This does not seem to be fully accurate. It seems that whether or not the mortgage extends to goodwill depends on the intention of the parties. If the mortgagee wants the mortgage over premises (e.g. a public house) to extend to goodwill, he ought to bargain for it. However, this intention may be sometimes implied, so that the parties need not expressly state that mortgage extends to goodwill. For example, if the mortgage covers public house business, goodwill is part of the mortgaged property so that the mortgagee is entitled to an assignment of the licence, but may not be entitled to the proceeds of sale of such rights. Further, unless parties intend (expressly or impliedly) for the goodwill to be subject to mortgage, the mortgagee cannot – merely by the nature of the mortgage – restrain the competitive activity of the mortgagor. Where the mortgage impliedly extends to goodwill the mortgagee may be said to have “de facto

395 Cousins on the Law of Mortgages (n 147) para 15-11.
396 Whitley v Challis [1892] 1 Ch 64 (CA) 69 (Lindley LJ): “Would such legal mortgage comprise the goodwill and the business of that hotel? Clearly not, and it would be quite impossible under cover of the last words [i.e. that the mortgage should contain provisions as the mortgagee should require] so to enlarge the subject-matter of the security bargained for. (…) Those words cannot have the effect of bringing in property which the mortgagor had not agreed to mortgage. The security was intended to be confined to the house and buildings [emphasis – MR].”
397 Whitley (n 396) 69 (Lindley LJ): “[The claimant] appears to me to be endeavouring to obtain an enlargement of that security, and to get a benefit to which he is not entitled—a benefit, that is, which he would have had if he had bargained for a mortgage comprising the goodwill of the business of the hotel keeper”; Re Bennett [1899] 1 Ch 316, 321 (North J): “the mortgagees had never been in possession of the property. The goodwill of the business was not conveyed to them in terms” and see also 322-323 (North J).
398 Palmer v Barclays Bank Ltd (1972) 23 P & CR 30 (where the charge did not in terms extend to goodwill and no business was yet in existence when the charge was executed).
399 Chisum v Dewes (1828) 5 Russ 29, 30; 38 ER 938 (Sir John Leach MR): “The good will of the business is nothing more than an advantage attached to the possession of the house; and the mortgagee, being entitled to the possession of the house, is entitled to the whole of that advantage. I cannot separate the good-will from the lease”; Cooper v Metropolitan Board of Works (1884) LR 25 Ch 472 (CA) 479 (Cotton LJ).
400 Garrett v St Marylebone, Middlesex Justices (1884) LR 12 QBD 620.
401 Re Carr [1918] 2 IR 448.
402 Palmer v Barclays Bank (n 398) 37 (Goulding J).
goodwill from being actually in the enjoyment of the property”.

In such cases, when the property is sold with goodwill, the mortgagee is entitled to have his debt paid from the proceeds of sale of both the property and the goodwill. Similarly, in cases where the mortgage is over a company running a business (e.g. a colliery), it seems to be implied that the parties intended that the mortgage extend to the actual business, which means that the mortgagee has a right to appoint a manager of the business. A mortgage does not extend to goodwill, however, if goodwill arises from the mortgagor’s personal reputation, for example as a result of his personal skill or expertise.

B. Additions that diminish the value of an asset

An interesting question arises if as a result of “an addition” to the asset its value diminished though the asset itself is not destroyed. This is essentially a question of the secured creditor’s right to preserve the substance of security. A legal or equitable mortgagee is by virtue of his ownership able to a certain extent to protect his security against the acts of the mortgagor, which lead to reduction of value of the asset. As against the mortgagor the mortgagee is said to have a general right in equity to hold his security undiminished in value, whether or not the mortgaged debt is already due.

It is not clear whether a chargee under

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403 Re Bennett (n 397) 321 (North J).
404 See also Pile v Pile (1876) LR 3 Ch D 36 where the Court of Appeal held that mortgagees who had taken possession of trade premises were entitled on compulsory acquisition to the whole compensation awarded not only for the land, but also for loss of future profits.
405 County of Gloucester Bank v Rudry Merthyr Steam and House Coal Colliery Co [1895] 1 Ch 629 (CA): although the business of the colliery was not expressly mentioned in the mortgage deed (which covered lands, mines, and seams of coal, machinery) it was held that it was intended to pass and that it did pass to the mortgagees. As a result, the mortgagees were entitled to apply in the action for a receiver and manager of the colliery.
406 Cooper (n 399).
407 Loss of value of raw material being transformed into another asset may be interpreted, however, as an implied intention of the parties that title in the raw material is extinguished, see Re Peachdart [1984] Ch 131 (leather hide lost value as raw material when used to make handbags); see also Webb (n 305) 528. This would mean the original asset ceases to exist in the eyes of law and is withdrawn from security assuming the secured creditor had security in the raw material.
408 Cousins on the Law of Mortgages (n 147) para 26-07.
409 McMahon v North Kent Iron Works Co [1891] 2 Ch 148 (this is a floating charge case but the dictum is general).
a fixed charge also has the right to preserve the substance of security but it is difficult to see why he would not. The right to preserve substance of security seems to be based on pre-emption of the debtor’s act rather than sanction for that act. For example, if a mortgagor is wasting the collateral by cutting timber or by removing fixtures included in the collateral, the mortgagee may be able to restrain these acts if he can show the collateral to be insufficient to discharge debt and that it will be prejudiced. By analogy, the secured creditor can restrain accretions by debtor that would result in diminution of value of his security, although, admittedly, such a scenario is unlikely to happen in practice. In addition, the secured creditor may be able to sue the grantor of security for loss. This, however, is a personal claim for damages, not proprietary restitution. Suing for loss only makes sense if the claim is against a third party grantor. The debtor remains personally liable for the outstanding debt in any case where the value of the asset was insufficient to discharge the debt.

3 Security interests in substitutes – the fallacy of a “principle of substitutions”

In *Buhr v Barclays Bank* the secured creditor’s right to substitutes was said to arise automatically and as a matter of law. The term “substitutes” means here both clean substitutions and mixed substitutions (products). The “principle of substitutions” was deduced primarily from two groups of cases on security in leases and

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410 A chargee of a floating charge is not likely to have such a right if the dispositions are in the ordinary course of business. If the chargor can withdraw an asset from security and so altogether defeat the chargee’s right to the asset, then *a majori ad minus* he should also be free to act in a way that diminished the value of the asset. However, in the case of a disposition other than in the ordinary course of business before crystallisation, the chargee can obtain an order for the appointment of a receiver protecting such disposal: *Hubbuck v Helms* (1887) 56 LJ Ch 536; *McMahon* (n 409); *Re London Pressed Hinged Co Ltd* [1905] 1 Ch 576; see also Beale et al, *The Law of Security and Title-Based Financing* (n 2) para 6.74.


412 *Ackroyd v Mitchell* (1866) 3 LT 236; *Ellis v Glover and Hobson Ltd* [1908] 1 KB 388, both cited in *Cousins on the Law of Mortgages* (n 147) para 26-07.

413 *Buhr* (n 14).

414 See above chapter II section 3.2.A.
compensation money. Before we examine these cases as foundations of the “principle of substitutions”, it is useful to note that Arden LJ in *Buhr* rejected arguments made by the counsel that a parallel could be drawn between a mortgagee’s right to accretions to, and substitutions for, the mortgaged property and a chargee’s right to book debts and their proceeds. Although this work questions the existence of a “principle of substitutions”, it is thought that Arden LJ’s rejection of the parallel with security over book debts is correct.

3.1 Rejection of the parallel with security interests in book debts

In dismissing the parallel Arden LJ rightly held that:

“[the mortgagee’s right to the accretions to, and substitutions for, the original asset] does not depend on the indivisibility of property from its proceeds, but rather on the derivation of the proceeds of sale. The authorities on book debts therefore neither assist (…) [nor] undermine the principle”.

It is worth exploring a little further why security interests in book debts and their proceeds are different from security interests in derived assets. Two points are made. First, security interests in book debts and their proceeds are not comparable to security interests in original assets and proceeds of disposition because a debt and a collected debt is one and the same asset, not two different ones. Second, as a result of the first, charge over a book debt automatically carries through to the proceeds of the debt.

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415 Apart from these Arden LJ also mentioned the following legislative provisions as support for the principle of substitutions: dealing with leasehold enfranchisement (Leasehold Reform Act 1967, ss8-13), compulsory acquisition and compensation for blight (for example Town and Country Planning Act 1990, ss 117(3), 162, 250) and provisions concerning disclaimer in the insolvency of the mortgagor (Insolvency Act 1986 ss 181, 320). These were not discussed in detail by Arden LJ, so it is difficult to ascertain in what way they count as support.

416 (n 14) [42]-[43].

417 (n 14) [43].
A. The special relation between book debts and their proceeds

A book debt is a creditor’s right to be paid a sum of money by the debtor. When the debt is paid, the creditor’s right to be paid can be seen as being “substituted” by the payment (“collected book debts”), whether cash in hand or – more likely – an increased balance in a bank account, which in itself is another right to be paid.\(^{418}\) In terms of their relation to each other book debts and their proceeds can be viewed as:

(i) the same asset because they share and represent the same economic value; or

(ii) as different assets but intrinsically economically linked in such a way that they form an indivisible asset; or

(iii) as different assets.\(^{419}\)

The third conceptualization has been accepted in *Re New Bullas Trading Ltd*\(^{420}\) and subsequently rejected in *Agnew v Commissioner of Inland Revenue*\(^{421}\) and *Re Spectrum Plus Ltd.*\(^{422}\) The question has stimulated a rich academic debate and it is useful to revisit some of the arguments made in order to understand when a charge over an asset extends automatically to its proceeds.

(a) Arguments in favour of the divisibility of book debts and their proceeds

In *New Bullas* Nourse LJ held that book debts and proceeds could be

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\(^{418}\) If the bank account is in credit, the bank owes its customers an obligation to pay the amount represented by the bank balance, see D Fox, *Property Rights in Money* (OUP, Oxford 2008) para 1.43. In a sense one right to payment is substituted by another right to payment. A right to be paid is a more risky asset than payment in hand due to the residual likelihood that the debtor will not pay. In the case of banks this risk is considerably reduced, particularly due to depositor protection schemes.

\(^{419}\) M Armstrong, “Return to First Principles” In New Zealand: Charges over Book Debts Are Fixed - but the Future's Not! (2000) 3 Insolvency Lawyer 102, 105.

\(^{420}\) (n 194).

\(^{421}\) (n 183).

\(^{422}\) (n 181).
treated as separate assets on the basis of freedom of parties.\textsuperscript{423} The divisibility of the two assets also has some academic support.\textsuperscript{424} First, it has been argued that collected book debts, once paid into a bank account, are an entirely different asset.\textsuperscript{425} Second, the value of a debt lies in more than just a right to sue the debtor for debt payment. A security on debts can be realised by factoring the uncollected debts.\textsuperscript{426} Third, the priority of security in receivables depends, according to the rule in \textit{Dearle v Hall}\textsuperscript{427} on notice given to the person owing debt, which in the case of a charge on book debts is the debtor of that book debt whilst in the case of proceeds paid into a bank account it is the bank assuming the account is in credit.\textsuperscript{428} Fourth, it was also argued that a contractual prohibition on the assignment of debts does not prevent the assignee from having to account for the proceeds of the debts, once received, to the assignor.\textsuperscript{429} It is difficult to see that this last point supports the argument that debt and debt proceeds are two separate assets. They do not exist simultaneously but when the original debt is paid and proceeds are paid into the hands of the assignee, a new debt (duty) arises to pay the proceeds to the assignor.

\textbf{(b) Arguments in favour of the indivisibility of book debts and their proceeds}

The approach in \textit{New Bullas} was criticised first by Professor Goode and then judicially by Lord Millett in \textit{Agnew}\textsuperscript{430} and Scott LJ in \textit{Spectrum}.\textsuperscript{431} Professor Goode argued that it is impossible to separate a debt from the proceeds since a debt is worth nothing unless and until it is collected

\begin{itemize}
\item \textsuperscript{423} \textit{New Bullas} (n 194) 492 (Nourse LJ) citing Tailby \textit{v} Official Receiver (1888) 13 App Cas 523 (HL) 545 (Macnaghten LJ).
\item \textsuperscript{424} G McCormack, ‘The Nature of Security over Receivables’ (2002) 23 Company Lawyer 84, 85-86; see also approving \textit{New Bullas} Berg, ‘Charges over Book Debts: A Reply’ (n 185).
\item \textsuperscript{425} Berg, ‘Charges over Book Debts: A Reply’ (n 185) 451.
\item \textsuperscript{426} E Ferran, ‘Fixed Charges on Book Debts - the Story Continues’ (2000) 59 CLJ 456, 456.
\item \textsuperscript{427} (1823) 3 Russ 1, 38 ER 475.
\item \textsuperscript{428} Berg, ‘Charges over Book Debts: A Reply’ (n 185) 451
\item \textsuperscript{429} \textit{Linden Gardens Trust Ltd v Lenesta Sludge Disposals Ltd} [1994] 1 AC 85, [1993] 3 WLR 408 (HL); \textit{Re Turcan} (1888) 40 Ch D 5.
\item \textsuperscript{430} (n 178) [46].
\item \textsuperscript{431} (n 181) [114].
\end{itemize}
and turned into money.\textsuperscript{432} If the chargor has authority to collect debts, he can do so but for the charge to be consistent with a fixed security, the chargee must have a fixed security in the proceeds. The chargee must have a contractual control over the proceeds and the chargor cannot be collecting the proceeds for his own account.\textsuperscript{433} A security granted over the debt but not the proceeds would be worthless. Lord Millett contrasted inseparability of debts and their proceeds with the ability to separate a capital asset from its income in \textit{Royal Trust Bank v National Westminster Bank Plc}.\textsuperscript{434} In this respect debts are a distinctive subject matter of security because they are “realised by payment, upon which they cease to exist”.\textsuperscript{435} A response to this argument is that the value of book debts can be realised also by selling them, not only by collection.\textsuperscript{436} A counterargument is found in the dicta of Lord Millett in \textit{Agnew}:

“A debt is a receivable; it is merely a right to receive payment from the debtor. Such a right cannot be enjoyed \textit{in specie}; its value can be exploited only by exercising the right or by assigning it for value to a third party. An assignment or charge of a receivable, which does not carry with it the right to the receipt, has no value. It is worthless as a security. Any attempt in the present context to separate the ownership of the debts from the ownership of their proceeds (even if conceptually possible) makes no commercial sense.”\textsuperscript{437}

The reasoning of Professor Goode and Lord Millett in \textit{Agnew} is compelling. It does not of course mean that debt and its proceeds are the same asset, but merely that they are closely linked. The link works only in one direction, though. A book debt is a right to proceeds (right

\textsuperscript{432} Goode, 'Charges over Book Debts: A Missed Opportunity' (n 185) 602.
\textsuperscript{433} Ibid. 602.
\textsuperscript{434} [1996] BCC 613 (CA) 618: “while it is obviously possible to distinguish between a capital asset and its income, I do not see how it can be possible to separate a debt or other receivable from the proceeds of its realisation”. See also Worthington, 'Fixed Charges over Book Debts and Other Receivables' (n 185).
\textsuperscript{435} Goode, 'Charges over Book Debts: A Missed Opportunity' (n 185) 602.
\textsuperscript{436} McCormack, 'The Nature of Security over Receivables' (n 424) 85-86.
\textsuperscript{437} Agnew (n 178) 469.
to be paid), so debt is inevitably linked to proceeds, but proceeds, once collected, are not linked with the debt. Professor Worthington made a similar point. She argued that although uncollected receivables and collected proceeds can be treated as quite distinct and so subject independently to a fixed or floating charge or even no charge at all,438 she noted that it is logically impossible for the parties to categorise a charge over receivables as fixed without considering how the parties have agreed to treat collected proceeds. Once proceeds of debt are collected and are held for example in a bank account439 they constitute an individual asset, capable of being a subject matter of a property right440 and it seems that its origin is not relevant for the purposes of taking security. Moreover, the argument of Nourse LJ that parties are free to treat debt and debt proceeds separately441 was met with a response in Spectrum by Lord Walker, in whose view the reason for overriding the freedom of the parties to draft the contract as they wish was public interest in the guise of the protection of preferential creditors.442

The key point then is that when a book debt is collected it ceases to exist. A charge on a book debt cannot exist unless the chargee has not only a right to resort to the asset by selling the uncollected book debt but also by collecting proceeds of the debt. “Proceeds” of book debts generated when book debts are paid are a different type of asset than sale proceeds of an encumbered asset (including a sale of a book debt generating sale proceeds). Collected book debts are not a new derived asset; they are the same asset. The difference between proceeds of books debts and proceeds of sale of encumbered property is that in the latter case the original asset does not cease to exist upon sale.

439 The book debt can be substituted for a new asset in a number of ways, either as credit in a bank account or reduction of indebtedness (reduced debt).
440 Berg, 'Charges over Book Debts: A Reply' (n 185) 451.
441 Text to n 423.
442 Spectrum (n 181) [141].
B. Automatic right to collected debts

Since a debt and proceeds of debt are indivisible, a charge over a book debt is a single, continuous security interest moving from assets to proceeds. This has important, if inconvenient in practice, consequences for characterisation of the charge over book debts. If the charge over book debts is to be fixed the chargee must have control over proceeds of book debts, whether resulting from sale of uncollected book debts or from collection of debts. If a company is free to collect proceeds and pay them into its own bank account the charge is floating, even if the chargee has a right to give instructions to the chargor how to deal with debts but does not in fact exercise this right. Similarly, a charge is floating if the debenture comprises a clause prohibiting the chargor to deal with or to charge, assign, discount or factor the uncollected debts without prior consent of the chargee but fails to do the same with the collected debts. The requirement of control over collected proceeds means that it is very difficult for the borrower to collect or deal with collected proceeds, which is often a commercially undesirable outcome. The once successful attempts to draft debentures creating a fixed charge over present and future debts and a floating charge over proceeds of the debts, enabling the chargor to collect the debts, now result in creation of just one (floating) charge. Following Agnew and Spectrum courts look at the agreement of the parties to determine not only the intention but also the effect of what the parties agreed is a matter of law. This means that a debenture enabling the debtor to collect the proceeds and to pay them into anything other than a blocked account is likely to be characterised as a floating charge. Similarly, a charge over book debts is floating if the debenture remains silent as to how proceeds of debts

443 Re Brightlife Ltd [1987] Ch 200, 209 (Hoffmann J), cited with approval in Agnew (n 178) 723 (Millett LJ) and Spectrum (n 181) [104]-[105] (Scott LJ); similarly Keenan (n 174) and Supercool Refrigeration [1994] 3 NZLR 300.

444 A formal provision for a blocked account is not enough “if it is not operated as one in fact”: Agnew (n 178) 730 [48] (Millett LJ).

445 Spectrum (n 181) [140] (Walker LJ).

446 See e.g. clauses in Siebe Gorman (n 174); New Bullas (n 194).

447 See also Ashborder BV v Green Gas Power Ltd [2004] EWHC 1517 (Ch), [2005] BCC 634 [183] (Etherton J).
are to be collected and kept, i.e. does not specify that the chargee has control over them.

The absence of a parallel between security in debt proceeds and security in derived assets can be appreciated against the background of characterisation of charges. As we have just seen, a debenture creating a fixed charge in book debts must ensure the chargee has control of both book debts and their proceeds. By contrast, a fixed charge in a piece of equipment will not be recharacterised as a floating security if the chargee has control over the piece of equipment but no control over sale proceeds. This difference is understandable if we realise that the taking of control of a book debt is not a matter between the chargor and chargee but the chargee and the third party owing the debt. Restriction of the chargor’s power to deal with the book debt does not solve the problem of withdrawal from security as it does in the case of a piece of equipment because the debt subject to security may be paid and the proceeds withdrawn from security. The “transformation” from a book debt into proceeds, unlike the substitution of a piece of equipment for its sale proceeds, is not dependent on an act (a disposition) by the chargor. By taking control of the equipment the chargee diminishes the risk that the equipment will be sold and withdrawn from security because the chargor is not able to deal with the asset without its consent.

3.2 Lack of support for the “principle of substitutions”

It seems that the support for the “principle of substitutions” in *Buhr v Barclays Bank* is threefold. First, Arden LJ relied on two groups of cases: one relating to new leases, the other to compensation money.448 Second, an assumption seems to have been made, albeit without detailed analysis, that rights to substitutions were the same as rights to accretions as the two were gathered under the umbrella of the “principle of substitutions and accretions”. Third, reliance was placed

448 *Buhr* (n 14) [41] (Arden LJ noting similarity between the facts of *Buhr* and facts of a case, where security extended to compensation money).
on scholarly writings. Taking these in turn, this section questions the support that the two groups of cases have to offer for the “principle of substitutions”; it underlines the distinction between rights to substitutions and accretions and, finally, it notes that the academic support was misconceived.

A. The questionable support in case law for the “principle” of substitutions

(a) Security over new leases

In *Hughes v Howard* \(^{449}\) the defendants were entitled to the equity of redemption of leaseholds encumbered with a mortgage. They attempted to get rid of the mortgage by fraudulently incurring forfeiture. They first induced the lessor to take advantage of the forfeiture and then obtained a new lease from him and subsequently sold it to bona fide purchasers. John Romilly MR had no difficulty finding that it was a case of fraud and enabled the mortgagee to assert mortgage in the new lease. \(^{450}\) In *Leigh v Burnett* \(^{451}\) Pearson J talked about a long-established doctrine that the mortgagor of a renewable lease could hold a renewed lease only subject to the mortgage. \(^{452}\) Neither case seems to provide support for the “principle” of substitutions. *Hughes v Howard* can be explained as a case of an unauthorised disposition of the subject matter of security: the mortgagee obtained a mortgage in the new lease because the new lease was traceable proceeds of an unauthorised disposition of the old lease. Although there is a controversy as to the basis of claims to proceeds of unauthorised dispositions, which we discuss in chapter V, a “principle” of substitutions is not needed to explain this case. *Leigh v Burnett* is a case with complicated facts and it seems that Pearson J may have misinterpreted the previous case law purportedly underlying the doctrine he talked about. In *Leigh v Burnett* a lease was mortgaged by lessors in favour of Ingram and Dawkins.

\(^{449}\) (n 379).
\(^{450}\) *Hughes* (n 379) 580.
\(^{451}\) (n 380).
\(^{452}\) *Leigh* (n 380) 234.
The lessor normally renewed the lease by custom. The lessor then assigned the reversion Ecclesiastical Commissioners, who would not renew the lease. Almost thirty years later, when the lease coming to an end, Ecclesiastical Commissioners negotiated the sale of the reversion with Newman, who took a loan from Leigh promising that a mortgage would be created as soon as the conveyance was completed securing the repayment of the borrowed sum. The conveyance was executed. Newman soon went bankrupt. The question was whether Leigh’s mortgage was subject to prior mortgages of Ingram and Dawkins, which turned on the question whether Ingram and Dawkins could assert mortgage in a substitute asset – the reversion in fee that Newman acquired. They argued that they could because the agreement for sale was made when lease was still in existence so Newman could not acquire fee except for the benefit of Ingram and Dawkins. Pearson J, holding in favour of Ingram and Dawkins, made two points. First, he said that Newman was a mortgagor of the lease and so held the reversion on the same terms as he would have held a renewed lease of the property. Second, because Newman’s reversion took place of the renewed lease, Newman held the lease subject to the mortgage based on Rakestraw v Brewer. Pearson J in Leigh did not consider the fact that the court in Rakestraw applied this rule in order to ensure that the mortgagors are protected from the mortgagees. When mortgagees obtain a new term (and so enlarge the subject matter of security), the mortgagor’s right to redeem ought not change. Hence, a new term would be subject to the same equity of redemption. It does not automatically follow that a mortgagee would have a right to a new lease if the mortgagor renews it. It is arguable that when a mortgage is taken over a renewable lease the parties impliedly agree that the mortgage covers both the current lease and any renewed lease. The basis for the

453 Leigh (n 380) 234-235.
454 (1728) 2 P Wms 511, 24 ER 839.
455 Rakestraw (n 454) 513: “This additional term comes from the old root, and is of the same nature, subject to the same equity of redemption, else hardships might be brought upon mortgagors by the mortgagees getting such additional terms more easily, as being possessed of one not expired, and by that means worming out and oppressing a poor mortgagor”.

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mortgagee’s right would be the agreement of the parties (more specifically, how the parties decided to describe the subject matter of security), not a “principle” of substitutions.

(b) Security over compensation money for compulsory sale

Under Law Guarantee and Trust Co Ltd v Mitcham and Cheam Brewery Co Ltd\(^{456}\) a company specifically mortgaged leasehold beerhouse to trustees. The company was refused the licensing authority to renew the licence to sell excised liquors, which entitled it under a statute to compensation. There was nothing in the mortgage deed about the compensation money, as it had not been contemplated that any would be received. The mortgagees were held to be entitled to receive the compensation money awarded to the company although they could not apply it to reduce the mortgage until the security became enforceable.\(^{457}\) We need to look carefully at the reasoning in the case. Despite the lack of an express provision in the security agreement extending security to compensation money, Kekewich J though that “the words of the deed must be applied to circumstances which were not contemplated, and so applied they do not entitle the mortgagor to come in and claim [proceeds of compulsory purchase] as his money.”\(^{458}\) It seems that the mortgagees were able to assert security in compensation money on the basis of an implied bargain, not by operation of a “principle of substitutions”.

B. Insufficiency of support for analogies between substitutions and accretions

Substitutions are sometimes treated analogously to accretions. An example used is a new lease, which is considered to be an accretion to estate. This is misconceived. It is suggested that there is a difference

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\(^{456}\) Law Guarantee & Trust Society Ltd v Mitcham & Cheam Brewery Co Ltd [1906] 2 Ch 98, followed in Noakes v Noakes & Co Ltd [1907] 1 Ch 64; Dawson v Braime’s Tadcaster Breweries ltd [1907] 2 Ch 359. See also Cousins on the Law of Mortgages (n 147) para 15-12.

\(^{457}\) Law Guarantee (n 456) 105-106 (Kekewich J).

\(^{458}\) Law Guarantee (n 456) 104.
between rights to accretions and to substitutions, which seems to have been thus far overlooked.

(a) Argument from authority

Arden LJ may have been misled by insufficiently discriminating wording in prior case law. For example, in *Re Biss*, a case to which Arden LJ referred, courts of both instances talk about a new lease as an “accretion” to an estate. It is argued, however, that insufficient care was taken in the way a new lease was considered to be an “accretion”.

It had nothing to do with a substitution. In *Re Biss* a lessor (Stone) granted a lease for seven years of a house, in which the lessee (Biss) carried out a profitable business. When the lease expired Stone refused to renew but allowed the lessee to stay as a tenant from year to year. Biss subsequently died intestate, leaving a widow and children, who continued the business and the yearly tenancy. Stone then granted to one of the children “personally” a new lease for three years. Buckley J in the first instance held that the son stood in such a position as if he were a *trustee for the estate* and as a result of this the new lease was treated as an accretion to the estate of the deceased. The Court of Appeal disagreed with this ruling on the grounds that the renewal had been determined by the lessor himself, not the son. The son was only one of the next of kin and did not stand in a fiduciary position towards the estate. He did not obtain the new lease as a result of his possession or entitlement to the goodwill of the business. The new lease was therefore not traceable to the son’s interest in the old lease. The true question considered by the courts was whether the new lease was taken for the benefit of the estate. It was held that it did not and so the new lease was not an accretion. The point is that some assets may arise for the benefit not of a specific person but of a business (e.g. goodwill). If the creditor had a right in a business (here: estate) and a new asset is

459 [1903] 2 Ch 40 (CA).
460 Buhr (n 14) [47].
461 *Biss* (n 459) 48; on the authority of *Ex p Grace* 126 ER 962, (1799) 1 Bos & P 376.
462 *Biss* (n 459) 58-59 (Collins MR) distinguishing *Grace* (n 461).
acquired for the benefit of the business rather than a particular person, it seems that the security interest may extend to such new asset automatically because it is seen to accede to the business as an accretion. There is, however, no analogy between cases where a new lease was treated as a substitute. Neither in *Hughes v Howard*\(^{463}\) nor *Leigh v Burnett*\(^{464}\) did the court find that the new lease would have been subject to a mortgage because it was acquired for the benefit of the asset. In *Hughes* the right to a new lease arose in order to avoid fraud whilst in *Leigh* it arose on the basis of an implied bargain between the parties. The courts did not draw an analogy between substitutions and accretions. Just because a new lease may in some cases be considered in the categories of an accretion and, in others, as a substitute, does not suggest that rights to accretions and substitutions arise in the same way.

(b) Argument from principle

It is argued that a new lease is a substitute of the old lease (traceable proceeds of the old lease), not an accretion to the estate. A new lease is a new legal relationship between the lessor and the lessee, whereby the lessee has a right to use an asset and a duty to pay rent whilst the lessor has a right to be paid the rent in return for making his property available for use of another. A property right in estate can exist without extending to rents from a lease. For example, an owner of a leased estate, which is subsequently sub-leased, need not have right to rents from a sub-lease just because he is an owner of the estate. A right to receive rents from a sub-lease may be created by a separate contract by the owner of the estate (the lessor) and the lessee. This contract concerns the estate but it is separate from it. By contrast, in the case of accretions, a property right to the principal asset cannot be separated from a right to the accretion. Consequently, a right to accretion to an asset has a different legal basis than a right to a substitute. The right to accretion to an asset arises on the basis of the property right to the principal asset, to which the subsidiary asset attaches. For example, if a

\(^{463}\) (n 379).

\(^{464}\) (n 380).
person (X) installs at his own expense heating in another’s (Y’s) house, the heating accedes to Y’s house; Y acquires a right to the heating system because the house is his and the heating system became a part of it, even if Y may be liable to reimburse X for expenses. Y may have a negotiorum gestio claim against X if it will be necessary. It is controversial whether English law recognises negotiorum gestio but we assume so here. It is not necessary to show that X owed fiduciary duties to Y to give Y a right to the improvement in the house. The basis for a right to accretion to an asset is the property right to the original asset, which continues to exist. The same consideration cannot apply in the case of a right to a substitute precisely because the original asset no longer exists in the hands of Y. From the perspective of the exercise of a security interest it does not matter whether accretions to the original asset were authorised or not. The secured creditor’s right to resort to the encumbered asset is not affected so long as the asset still exists and so long as it remains encumbered. If the alterations made to the asset decreased the value of the asset, this does not give the secured creditor any additional or new proprietary right because there is no new asset to have a property right in.

Since “accretions” and “substitutions” are conceptually different, parallels between security in accretions and in substitutions do not hold. The correct analysis should therefore be that: (i) a security interest automatically extends to accretions to the original asset because the original collateral does not change; (ii) a security interest may extend to substitutes of the original collateral but this requires a different explanation to the one underlying (i). Although there is no single “principle of substitutions and accretions”, there could be two separate principles. We know already that the secured creditor’s right to resort to an accretion that acceded to the original asset is an automatic right, so it

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could be called a “principle of accretions”, although, it is suggested, it is unnecessary to employ the term “principle” to explain accretions.

C. Misconceived scholarly support for an automatic right to substitutes

The fact that accretions and substitutions are different does not yet mean that there is no “principle of substitutions”. Both the High Court and the Court of Appeal in Buhr v Barclays Bank relied on\(^{467}\) writings of Professor Goode in the third edition of Commercial Law\(^{468}\) and in the second edition of Legal Problems of Credit and Security\(^{469}\) to support the view that security in an asset carries through to its proceeds. We will examine these passages in detail and suggest that this reliance was misplaced. On a proper analysis, the relevant sections quoted by the courts contain no support for an automatic security interest in proceeds. It is convenient to quote both passages in full as they were used in Buhr.

The section in Commercial Law reads as follows:

“(iv) Security in an asset and security in its proceeds

Unless otherwise agreed, security in an identifiable asset carries through to it products and proceeds, in accordance with the equitable principle of tracing. It is quite possible for the creditor to have rights in the same item of property both as proceeds and as original security, as where he takes a charge over debtor’s stock in trade and receivables and the debtor then sells items of the stock, producing receivables. The strength and quality of a security interest in an asset is not necessarily the same as in its proceeds. The debtor who gives a charge over his stock and receivables may be allowed full freedom to dispose of the stock

\(^{467}\) Buhr (n 14) [11], [39] and especially [45].
in the ordinary course of business free from the charge without reference to the creditor but be required to hold the proceeds separate from his own monies and pay them to the creditor or to an account which the creditor controls. Such a charge will be a floating charge as regards the stock but a fixed charge as regards the receivables. The security interest in proceeds, unless separately created, is not a distinct security interest but is part of a single and continuous security interest, which changes its character as it moves from asset to proceeds. Moreover, a security interest in a debt cannot co-exist with a security interest in its proceeds, for upon collection debt ceases to exist.

There are dicta, which on a superficial reading suggest that an obligation on the debtor to apply the proceeds of his asset towards discharge of the debt, and not for any other purposes, creates an equitable charge not merely over the proceeds but over the asset itself. But the dicta must be taken in context and are not, it is submitted, intended to lay down any such rule, which would lead to great confusion. A security interest in an asset carries forward to the proceeds”.

The passage in *Legal Problems of Credit and Security* reads as follows:

“Security in an asset an in its proceeds

Security in an asset will almost invariably carry through to the proceeds of an unauthorised disposition by the debtor and will also extend to proceeds of an authorised disposition where it is effected on behalf of the creditor rather than for the debtor’s own account”.

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470 Goode, *Commercial Law* (n 468) 667-668, as cited in *Buhr* (n 14) [12]; see also parallel text in the more recent edition *Goode on Commercial Law* (n 115) 659.

These passages seem far from suggesting that a right to proceeds arises automatically by operation of law and a mention of a “principle of substitutions” is nowhere to be found here. Of course, the lack of mention of the “principle” does not prove the lack of its existence in law. It does show, however, that the passages cannot be relied on as support for its existence. There is an important distinction between the right to proceeds arising from authorised dispositions and a right to proceeds of unauthorised dispositions. Arden LJ herself seems to recognise this distinction although chooses not to decide this point.\textsuperscript{472} This is crucial because the security interest in proceeds of an authorised disposition has a different basis than security interests in proceeds of an unauthorised disposition.\textsuperscript{473} Where dispositions are authorised, the secured creditor may be able to assert the same security interest in the proceeds as existed in the old asset. Where dispositions are unauthorised, it is not clear why the creditor should be able to assert the same security interest in the proceeds. We will argue in this thesis that the security interest does not carry through to the proceeds of an unauthorised disposition, which means that there are two rights: a security interest in the original asset and a new right in the proceeds of disposition. A “principle” of substitutions is not capable of coherently explaining secured creditor’s rights to substitutes.

3.3 Inconsistency of an automatic right to substitutes with current English law

We have seen above that there is insufficient support for a principle of substitutions in English law. We should now also observe that an automatic right to substitutes would not be consistent with the current English law. Explanation of this point will take the rest of the thesis but it is useful to signal and outline our arguments here. An automatic right to substitutes seems inconsistent with the fixed and floating charge divide, as it is understood in the current English law.

\textsuperscript{472} As mentioned already above see n 381.
\textsuperscript{473} See chapter IV subsection 3 and chapter 5.
A. The significance of the fixed and floating charge distinction

If a secured creditor had an automatic right to substitutes in English law, we would have to accept that every substitution is effected on behalf of the creditor and for the creditor’s account. We know that this is not the case in English law because of the difference between fixed and floating charges.\(^{474}\) Dispositions of collateral subject to a floating charge are not on behalf of the creditor but on debtor’s own behalf. By contrast, substitutions of assets subject to a fixed charge are effected on behalf of the creditor. In chapter IV we develop an explanation of the fixed and floating charge as a creditor’s interest in an asset, where the debtor is given either very restricted authority to deal (fixed charge) or wide authority to deal (floating charge). Every disposition of an asset subject to a charge, whether fixed or floating, is either authorised or unauthorised by the secured creditor. Even if parties make no express provisions as to whether or not the chargor has authority to deal with the asset, the presence or absence of the authority is implied in the type of security.\(^{475}\) When a charge is fixed an authorised disposition leads to an “automatic” right to a substitute (proceeds of the authorised disposition) but this right arises not on the basis of a “principle” of substitutions but on the basis of the parties’ bargain, namely a specifically conferred right to withdraw an asset coupled with a sufficiently specific obligation to substitute. Where a charge is floating, the secured creditor does not acquire an automatic right to proceeds of the disposition just because the disposition was authorised. The right to withdraw is not coupled with an obligation to substitute. This means that a holder of the floating charge does not automatically acquire a security in the substitutes.\(^{476}\) Where dispositions are unauthorised, whether under a fixed or a floating charge, as we have already indicated, a right to proceeds of such a disposition has an

\(^{474}\) The security in \textit{Buhr} (n 14) was fixed.

\(^{475}\) See chapter IV, sections 3.1.B and 3.2.B.

\(^{476}\) This is controversial; see text to n 785-799.
entirely different basis than a right to proceeds of authorised dispositions.477

B. Further example: no automatic right in insurance proceeds

We argued above that the cases cited in Buhr v Barclays Bank to support the “principle of substitutions” could be explained in other terms than by operation of this “principle”. A further example of the rule that security interests do not automatically arise in substitutes involves insurance proceeds, i.e. proceeds paid out upon the occurrence of a certain event affecting original collateral. Insurance proceeds are not derived from a disposition of the collateral. As a result, claims to insurance proceeds cannot be analysed in the categories of authorised or unauthorised disposition. A new asset,478 which is a personal right against the insurer, comes into being when a specified event occurs. It is far from clear under English law whether a secured creditor is able to assert a right to insurance proceeds by virtue of the property right that the creditor holds in the original asset.

A view expressed in Legal Problems of Credit and Security479 is that the debtor, who insured the asset for its full value as opposed to the value of its interest represented by equity of redemption, must account to the secured creditor for an amount that exceeds the debtor’s interest. The case of Hepburn v A Tomlinson (Hauliers) Ltd480 is cited as support for this. The case concerned a property policy to cover a bailee from whom a consignment of cigarettes had been stolen in transit. The bailees insured the goods for the full value, not just to cover their insurable interest. It was held, inter alia, that the bailees could retain so much as would cover their own interest and they would be trustees for the owners in respect of the rest. It seems that the case could be

477 See detailed discussion in chapter V.
478 See Smith, The Law of Tracing (n 7) 234-236 (who argues that in the case of indemnity insurance the new asset is acquired through diminution in value of the insured asset and the payment of insurance premiums, at 234).
479 Goode on Legal Problems of Credit and Security (n 1) para 1-61.
distinguished on the grounds that mortgagors are not bailees. Although the detailed categories of bailment listed by Holt CJ in *Coggs v Bernard* included security (pledge), it was the pledgee who was listed as a bailee, not an owner who retains possession of charged goods.\(^{481}\) Further, bailees come under a tort duty to take care of the goods in their possession.\(^{482}\) Grantors of security are not subject to such a duty. There are also cases suggesting that the mortgagee has no right to the policy monies if the mortgagor insures the asset for his own account, which mean that there must be a contractual or a statutory provision that creditor’s interest would extend to insurance proceeds.\(^{483}\)

The importance of a contractual agreement that insurance proceeds are to be applied for the benefit of the mortgagee is illustrated in *Lees v Whiteley*.\(^{484}\) In that case the claimant was an assignee under a bill of sale of certain chattels. Although the mortgage deed contained a covenant to insure, there was no provision for the application of the policy monies in case of fire. The plaintiff was claiming there that he was entitled to have the money, which was received by the mortgagor, applied to the reduction of the mortgage debt. It was held that there were no terms in the bill of sale that the benefit the policy would pass by assignment.\(^{485}\) Hence, the mortgagee does not have a right to insurance proceeds purely by virtue of its property right in the original asset. As a result, the debtor does not generally hold the insurance proceeds on trust for creditor.\(^{486}\) In addition, we may note that there is also no automatic right to insurance proceeds in the base of bailment.

\(^{481}\) *Coggs* (n 114) 916 (Holt CJ).


\(^{483}\) *Lees v Whiteley* (1866) LR 2 Eq 143; *Sinnott v Bowden* [1912] 2 Ch 414, 419 (Parker J); *Halifax Building Society v Keighley* [1931] 2 KB 248, 254-255 (Wright J); *CCG* (n 438) 585-6 (Lindsey J); *Colonial Mutual General Insurance Co Ltd v ANZ Banking Group (New Zealand) Ltd* [1995] 1 WLR 1140.

\(^{484}\) *Lees* (n 483).

\(^{485}\) *Lees* (n 483) 148-149 (Sir Kindersley V-C); see also *Rayner v Preston* (1881) LR 18 Ch D 1 (CA) (the purchaser, who had completed his contract for sale of a house which had been insured by the vendor against fire, was not entitled as against the vendor to the benefit of the insurance).

\(^{486}\) *Halifax* (n 483) 255 (Wright J).
unless the parties agreed otherwise. In *Re Dibbens* 487 a company stored some furniture for a fee for its customers. Some customers expressly requested insurance and paid a premium while others did not. One of the warehouses burnt down and the company went into liquidation. It was held that the company owed a fiduciary duty to pay insurance proceeds only to those customers who had asked for and paid for insurance.

As far as statutory right to insurance proceeds is concerned, a secured creditor can rely on section 108(4) of the Law of Property Act 1925 and ask to have the secured debt discharged from the proceeds received on an insurance of property against loss or damage by fire or on an insurance for maintenance. 488 It seems that the effect of this section is similar to a security in proceeds based on an express provision with one difference. If the mortgagee’s right to insurance proceeds is based on the statutory provision, it is suggested that there is no risk of recharacterisation of the charge on the original property as floating if the borrower is left free to deal with insurance proceeds because section 108(4) LPA 1925 merely states that the mortgagee may require the insurance proceeds to be applied to discharge the debt, not that the charge continues in the proceeds.

The fact that there is a statutory rule in relation to insurance proceeds (at least of a certain kind and in relation to certain type of property) but not in relation to other type of proceeds can be seen as evidence of intention that security interests are not to extend in English law *de lege lata* to such types of proceeds. An example of similar reasoning can be seen in the Convention on the International Interests in Mobile

488 Law of Property Act 1925, s108(4): “[w]ithout prejudice to any obligation to the contrary imposed by law, or by special contract, a mortgagee may require that all money received on an insurance of mortgaged property against loss or damage by fire or otherwise effected under this Act, or any enactment replaced by this Act, or on an insurance for the maintenance of which the mortgagor is liable under the mortgage deed, be applied in or towards the discharge of the mortgage money.”
Although the Convention allows priority to extend to proceeds, the term “proceeds” is confined to insurance and other loss-related proceeds so long as they are identifiable in the hands of the debtor. This is explained on the basis of a policy decision that the Convention does not govern receivables finance but merely interests in tangible assets (aircrafts, objects, railway rolling stock and space assets). Otherwise there might be a clash between harmonisation instruments since receivables are covered by the UN Convention on the Assignment of Receivables in International Trade.

4 Security interests in fruits

This section considers whether a secured creditor has a right to fruits derived from the encumbered asset in the absence of an agreement between the parties. In *Buhr v Barclays Bank* Arden LJ referred to *Fisher & Lightwood’s Law of Mortgage* to support a statement that a mortgagee is entitled to fruits of the mortgaged property. This section suggests that the statement is not supported under English law. Pursuant to *Legal Problems of Credit and Security*, which follows views expressed by Professor Lionel Smith in *The Law of Tracing*, in the absence of an agreement to the contrary, fruits may belong to either the debtor or the creditor, depending on the circumstances. More specifically it depends on the rights the debtor has in the asset. If the debtor is lawfully in possession of a tangible asset, fruits belong to the

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489 Cape Town Convention, referred hereafter as CTC, presently applicable only to aircraft (on the basis of Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Aircraft Equipment) as the other two Protocols (relating to rolling stock and space assets) are not yet in force.

490 CTC, arts2(5) and 29(6).

491 CTC, art1(w).


493 Unlike the CTC the UN Convention is not yet in force (as of 17 October 2012), so the clash of between the scope of these two international instrument is merely theoretical.

494 *Buhr* (n 14) [40].

495 (1988, 10th edn) 55-57, as cited in *Buhr* (n 14) [40].

496 Goode on *Legal Problems of Credit and Security* (n 1) para 1-61.

If, however, income is received by the debtor from an asset, with respect to which the debtor had no right to possession or had lost such right, e.g. because the creditor has a pledge of the asset, or in respect of which he had no right to enter into the transaction producing the income, fruits are said to belong to the creditor, “not, however, as proceeds but as the fruits of the creditor’s property”. The case of intangible property is more complicated due to the requirements of control in the case of a fixed charge. If the creditor has control of such property, for example an account is in the name of the creditor, income accruing on the account will enure to the creditor and the debtor will only have a contractual right to it for as long as the security interest lasts. Even if this is so, the creditor in such a situation will not acquire beneficial ownership of fruits but merely a right to resort to these assets in order to discharge the debt. As a result of the nature of the right, the creditor cannot recover over and above the secured claim. Fruits, like substitutes, are therefore treated differently to accretions. However, in contrast to many cases of substitutes, fruits are not generated through an act of the debtor, of which we would be able to say that it is authorised or not.

498 Tucker (n 328).
499 Goode on Legal Problems of Credit and Security (n 1) para 1-61.
500 Turner v Walsh [1909] 2 KB 484 (CA) 494-495 (Farwell LJ); this is derived from Casborne v Scarfe (1737) 1 Atk 603, 605; 26 ER 377, 379 (Hardwick LJ); Fairclough v Marshall (1879) 4 Ex D 37 (CA) 48 (Cotton LJ). Farwell LJ also noted in Turner (at 496) that the mortgagee is not a trustee for the mortgagor except in special circumstances explained by Sir Thomas Plumer in Cholmondeley v Clinton (1820) 2 Jac & W 1, 182; 37 ER 527, 593.
501 There seem to be some parallels between fruits and insurance proceeds (which are substitutes, see text to n 478) insofar as neither are generated through a disposition by the debtor (and cannot be claimed on the basis of the disposition being authorised or not).
4.1 Mortgagee in possession

A. Right to income but with duty to account

(a) Right to rents as an incident of possession

Right to receive rent when land is subject to a lease has traditionally been considered as an incident of the right to possession. The question of who is entitled to the income of the mortgaged property was expressed in *Turner v Walsh* to depend on:

“whether the mortgagee has taken possession or given notice of his intention to take possession of the mortgaged property or not: if he has done so, then he is entitled; if he has not, the mortgagor was always and is still so entitled, and he receives and retains such income for his own benefit, without any liability to account either at law or in equity.”

Therefore, if the security is non-possessory the mortgagor is entitled to rents and profits for as long as he remains in possession and once profits accrued and were received prior to enforcement of the security the mortgagee could not recover them.

(b) Duty to account

A legal mortgage confers on the mortgagee a right to take possession of the asset immediately and irrespective of the state of the mortgage debt. To determine the rights to fruits it is crucial to look at the character of

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502 *Turner* (n 500) 494 (Farwell LJ); *Re Ind Coope Co Ltd* [1911] 2 Ch 223 (Ch) 231 (Warrington J); *Rhodes v Allied Dunbar Pension Services Ltd* [1989] 1 WLR 800 (CA), 806 (Nicholls LJ); *Re Atlantic Computer Systems Plc* [1992] Ch 505 (CA), 532-534 (Nicholls LJ).

503 *Turner* (n 500) 494 (Farwell LJ).

504 *Heath v Pagh* (1881) 6 QBD 345, 359 (Selborne LJ), affirmed (1882) LR 7 App Cas 235 (HL). See also *Ind Coope* (n 502) 231-232 (Warrington J), declaring as no longer applicable earlier authorities to the contrary (*Moss v Gallimore* (1779) 1 Doug KB 279, 99 ER 182 and *Rogers v Humphreys* (1835) 4 Ad & El 299, 314; 111 ER 799, 805 (Lord Denman CJ), according to which the rent payable under a lease dated prior to mortgage could only be received by the mortgagor in possession by leave of licence of the mortgagee since the mortgagee was the reversioner expectant on that lease.) However on the facts of *Ind Coope* the mortgagees had a right to the specifically mortgaged rents in arrears. See also *Cousins on the Law of Mortgages* (n 147) para 26-13 and *Ocean Accident & Guarantee Corp Ltd v Ilford Gas Co* [1905] 2 KB 493 (CA) 498 (Collins MR) (relating to right of action for trespass).
the mortgagee’s right to possession. Equity treats this right to take possession as part of the mortgagee’s security, not as a right to beneficial enjoyment. Consequently, a mortgagee in possession of the encumbered asset will be called on to account strictly for his use of it. The mortgagee is not entitled to get anything from the property beyond his security. He cannot obtain any profit for himself. Hence, the mortgagee will have to account for any profits he has taken or ought to have taken from the property. In taking the profit, the mortgagee may be able to obtain credit for his expenditure, but he cannot charge for his own time and effort unless he stipulates so in the contract. He can apply the profits to the discharge of the debt but he must account for the rest. The mortgagee’s right to income and the duty to account applies whether the subject matter of the mortgage is tangible or intangible. From the perspective of the mortgagor it means that the mortgagor is still entitled to the profits but his right is subject to the mortgagee’s right to devote them to the satisfaction of the mortgage debt. In some cases, the mortgagee has to account for profits whilst the mortgage lasts. For example, if the mortgagee personally occupies land the mortgagor is entitled to obtain a fair occupation rent.

As Cousins and Clarke note, the mortgagee is bound to be diligent in collecting rents and profits. The mortgagee must give account to the mortgagor not only for rents and profits actually received but also for rents and profits, which but for his own gross negligence or wilful

505 Ibid. (n 147) para 29-11.
506 Cockburn v Edwards (1881) LR 18 Ch D 449 (CA), 457 (Jessel MR); Ibid. (n 147) paras 26-13, 29-11.
507 Ibid. para 26-20.
508 Hughes v Williams (1806) 12 Ves 493, 33 ER 187; Chaplin v Young (No 1) (1864) 33 Beav 330, 55 ER 395; Parkinson v Hanbury (1867) LP 2 HL 1; Shepherd v Spanheath (1988) EGCS 35 (CA).
509 Langstaffe v Fenwicke (1805) 10 Ves 405, 34 ER 1071.
510 It seems that it would not be considered as a “fetter” on the right of redemption: Biggs v Hoddinott [1898] 2 Ch 307.
511 E.g. profits of a business, Chaplin (n 508).
512 Marriott v The Anchor Reversionary Co (1861) 3 De GF & J 177, 193; 45 ER 846, 852 (Turner LJ).
513 Cousins on the Law of Mortgages (n 147) para 26-18.
default he would have received.\textsuperscript{514} The mortgagee must also take the usual steps to recover any arrears of rent in full from tenants who were able to pay it.\textsuperscript{515} However, the mortgagee need not, and even must not, speculate with the property (e.g. shares). If he does, he is liable for any losses.\textsuperscript{516} The duty to account whilst taking profits and income arises only when the mortgagee enters into possession in his capacity as a mortgagee, not, for example, as a tenant.\textsuperscript{517} The liability to account does not cease if the mortgagee decides to relinquish possession.\textsuperscript{518} Although the mortgagee is not liable if the property deteriorates in value in the ordinary way, he is so liable if he was grossly negligent.\textsuperscript{519} Mortgagees who subleased property are also liable for losses resulting from wrongful acts of the subsees.\textsuperscript{520}

The extent to which the mortgagee is liable to account to the mortgagor depends on the circumstances. If the mortgagee was not in possession of the asset and took possession in order to sell it or to take net rents or profits because the debtor defaults it is likely that there may be no rents and profits left after the mortgagee paid any outgoings (e.g. insurance or taxes) and discharged his claims. A mortgagee may apply the rents or profits to payment of interest or to the reduction of the capital debt.\textsuperscript{521} If the mortgagee applies rents and profits to discharge interest and after doing so a surplus remains, the mortgagee is not obliged to apply the surplus to the reduction of the capital sum.\textsuperscript{522} This is by analogy with a rule that a mortgagee cannot be made to accept the

\textsuperscript{514} Hughes (n 508); Parkinson (n 508) 9 (Chelmsford LC); Medforth v Blake [2000] Ch 86 (CA).
\textsuperscript{515} Noyes v Pollock (1886) 32 Ch D 53 (CA), 61 (Cotton LJ).
\textsuperscript{516} Hughes (n 508); Rowe v Wood (1822) 2 Jac & W 553, 556; 37 ER 740, 740-741.
\textsuperscript{517} Page v Linwood (1837) 4 Cl & Fin 399, 7 ER 154 (HL).
\textsuperscript{518} Re Prytherch (1889) LR 42 Ch D 590.
\textsuperscript{519} Wragg v Denham (1836) 2 Y & C Ex 117, 160 ER 335.
\textsuperscript{520} Taylor v Mostyn (1886) LR 33 Ch D 226 (mortgagees liable for full value of coal wrongfully removed).
\textsuperscript{521} Cousins on the Law of Mortgages (n 147) para 26-19.
\textsuperscript{522} The mortgagee may hand over the sum to the mortgagor or he may pay the sum to the subsequent secured creditor if he received a notice from that creditor. If the first mortgagee received the notice from the subsequent mortgagee but nevertheless paid the surplus of rents and profits to the mortgagee, the first mortgagee is liable to account to the subsequent mortgagee: Berney v Sewell (1820) 1 Jac & W 647, 650; 37 ER 515, 516 (Eldon LJ); Wrigley v Gill [1905] 1 Ch 241, 254 (Warrington J), affirmed [1906] 1 Ch 165 (CA).
return of his capital in instalments.\textsuperscript{523} As with the timing of the account, the mortgagee is not usually made to account periodically.\textsuperscript{524} Rents and profits, which the mortgagee took, are taken into the equation when the final account is taken.

**B. Examples**

(a) **Right to crops**

In terms of fruits that are not yet detached from the original asset, the mortgagee in possession is also entitled to them. This issue was examined in relation to growing crops. The mortgagee is entitled to all growing crops on the mortgaged land when he takes possession of land\textsuperscript{525} unless under an express contract of tenancy the mortgagor can claim them as emblements (i.e. fruits produced, not spontaneously, but by labour).\textsuperscript{526} Thus, a mortgagee on entering into possession may apply for an injunction to restrain a mortgagor or any person claiming under him, such as a trustee in bankruptcy, in order to prevent severance and removal of crops from land.\textsuperscript{527} However, if a mortgagee failed to take possession of severed crops before the mortgagor’s bankruptcy, the crops become personal chattels and the mortgagee has no rights to them against the trustee in bankruptcy.\textsuperscript{528}

(b) **Right to rents with respect to tenancies**

A mortgagee can enter into receipt of rents and profits by serving notice to the tenant of the mortgaged property to pay rents to himself instead of the mortgagor.\textsuperscript{529} This applies in respect of any tenancies created

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\textsuperscript{523} Nelson v Booth (1858) 3 De G & J 119, 122; 44 ER 1214, 1215 (Turner LJ); Cousins on the Law of Mortgages (n 147) para 26-19.
\textsuperscript{524} A special periodical account may be ordered in exceptional circumstances, Wrigley (n 522); Cousins on the Law of Mortgages (n 147) para 26-20.
\textsuperscript{525} Bagnall v Villar (1879) 12 Ch D 812.
\textsuperscript{526} Bagnall (n 525); Re Phillips, ex p National Mercantile Bank (1880) LR 16 Ch D 104 (CA).
\textsuperscript{527} Bagnall (n 525).
\textsuperscript{528} Phillips (n 526).
\textsuperscript{529} See Horlock v Smith (1844) 1 Coll 287, 298; 63 ER 422, 428 (Sir Knight Bruce); Heales v M’Murray (1856) 23 Beav 401; 53 ER 157, 158 (Sir John Romilly MR) (mortgagee giving notice to tenants not to pay their rents to the mortgagor is liable to the mortgagor for any loss); Mexborough Urban DC v Harrison [1964] 1 WLR 733 (Ch) 736, 737 (Pennycook J); Cousins on the Law of Mortgages (n 147) para 26-09.
before the mortgage. If tenancy is created after the mortgage, the mortgagee does not have a right to rents just by virtue of his possession as the mortgagor but must serve a notice to the tenant that the tenant should pay the mortgagee, not the mortgagor. 530 If the tenant pays rents to the mortgagor after the mortgagee served him notice, the tenant is liable to pay the sums over again to the mortgagee. 531

4.2 Mortgagor in possession – mortgagor has no right to profits

For as long as the mortgagor remains in possession, he is entitled to take all the profits from the security without being in any way obliged to account for them or to apply them in discharging the mortgage interest. 532 This is so even if the originally encumbered asset is insufficient. 533 A mortgagor in possession cannot be considered a bailiff for the mortgagee 534 and so does not collect the rents or profits on mortgagee’s behalf, unless of course the parties so agree. In Ex p Wilson 535 the mortgagor went bankrupt. The mortgagee had a mortgage over leased land. Lord Eldon refused to compel the assignee to account for past rents received by him. He held that the mortgagor had not received the rents for the mortgagee and that there was no instance when a mortgagor could be called to account for rents. 536

4.3 Equitable mortgagee or chargee

A. Principle: no general right to rents or income

An equitable mortgagee, unlike a legal chargee, does not have a right to take possession. Although this is debatable, it seems to be the

531 De Nicholls v Saunders (1870) LR 5 CP 589; Lord Ashburton v Nocton [1915] 1 Ch 274 (CA) 282 (Lord Cozens-Hardy MR).
532 Trent v Hunt (1853) 8 Exch 14, 22; 156 ER 7, 10 (Alderson B); Heath (n 504) 359 (Selborne LJ), affirmed HL (n 504).
533 Cousins on the Law of Mortgages (n 147) para 29-12.
534 Ibid. para 29-12.
535 (1813) 2 V&B 252, 35 ER 315. Cf Colman v Duke of St Albans (1796) 3 Ves 25, 30 ER 874; Hele v Lord Bexley (1855) 20 Beav 127, 52 ER 551.
536 Wilson (n 535) 253. See also Usborne v Usborne (1740) 1 Dick 75, 21 ER 196; Hippiestey v Spencer (1820) 5 Mad 422, 56 ER 956.
prevailing view.\footnote{Barclays Bank Ltd v Bird [1954] Ch 274 but see Megarry & Wade, The Law of Real Property (7th edn, 2008) para 25-046.} Given that the right to rents, profits and income in the case of a legal mortgagee was based on the mortgagee being in possession, it is unlikely that a chargee or an equitable chargee, whose right to take possession is uncertain\footnote{See Cousins on the Law of Mortgages (n 147) para 28-04.}, will have a right to rents or income. For an equitable security to extend to fruits, parties must agree so in the security agreement.\footnote{See e.g. Arthur D Little Ltd (In Administration) v Ableco Finance LLC [2002] EWHC 701 (Ch), [2003] Ch 217, which contained an express provision in the debenture which charged the entire bundle of rights making up the shares, including the right to receive dividends and to exploit the shares, including distribution rights, although this gave rise to doubts over the character of the charge; it was held the charge was fixed.} The equitable mortgagee has no right to direct the tenants to pay the rents to himself, nor to collect such rents\footnote{Finck v Tranter [1905] 1 KB 427; Cousins on the Law of Mortgages (n 147) para 28-06.}, unless he has an order of the court. The mortgagee cannot give good discharge to the tenants so they would still remain liable for the rents to the owner or a legal chargee even if they paid to the equitable chargee.\footnote{Tenants cannot claim they made the payments of rents under a mistake of fact, Finck (n 540).} However, if a prior legal mortgagee is in possession and has collected rents and profits, the subsequent equitable mortgagee may ask for any surplus of rents and profits to be paid to himself, rather than to the mortgagor.\footnote{LPA 1925, s101(1)(iii); Cousins on the Law of Mortgages (n 147) para 28-06.}

B. Charge over income of financial collateral – an exception?

It is not clear whether a charge over financial instruments covers both the original collateral (the financial instruments) and dividends or interest payable under them. This issue does not seem to be fully resolved.\footnote{Goode on Legal Problems of Credit and Security (n 1) para 1-61: “In relation to investment securities market usage considers it fair that dividend income and other distributions should enure for the benefit of the debtor“} A charge over financial instruments seems to extend ex
lege to the income derived from them under FCAR\textsuperscript{544} since the term “financial instrument” includes:

“claims relating to or rights in or in respect of any of the financial instruments included in this definition, privileges or benefits attached to or arising from any such instruments”.\textsuperscript{545}

Yet, in practice it seems unlikely that a bank taking security in shares would expect his right to extend to dividends unless this was contracted for. Practice seems even more complicated because in many cases the securities account is in the name of the creditor so that the creditor can show that it has sufficient “control” for the purposes of perfecting its security. In such cases it is customary for the creditor and the debtor to agree that so long as the debtor is not in default the creditor will pass all the benefits to the debtor. These are referred to as “manufactured dividends”.\textsuperscript{546} These obligations are undertaken by the creditor (a firm) owed to the debtor (the firm’s client) in a stock-lending transaction to pay a sum equivalent to the dividends on those securities to the client. The firm has, however, a mere contractual liability to pay a sum to the client.\textsuperscript{547}

It seems \textit{prima facie} that under the current law the right to dividends inheres automatically in the creditor, not the debtor, if the account is in the name of the creditor. This, it is submitted, is a result of technicalities of the law, put in place in order to ensure that the creditor has a fixed charge by having the account of securities in his name. Taking dividends is usually seen as an attribute of an owner of a share and it is unlikely that the secured creditor would be treated as such; the

\textsuperscript{544} (n 210).
\textsuperscript{545} FCAR, reg3.
secured creditor is not, for example, seen as acquiring any voting rights.548

Even if under current law the secured creditor has an automatic right to the dividend (which he may contractually pass to the debtor), it does not mean that the relationship between the share and the dividend is the same as between a book debt and its proceeds. Suffice it to say that unlike a book debt, a share does not cease to exist once the dividend is paid, even if the market value of the share may drop immediately after payment of a dividend.549 It is notable, however, that it is the “right to income” which is treated as a book debt, not the share. This is consistent with our analysis of intangible fruits in chapter II.550 Even if we were to say that security automatically extends to dividends, we do not mean that dividends are “fruits” from shares analogous to natural fruits but that a charge over shares automatically also extends to cover right to income, which – when realised – produces dividends. Thus, unlike in the context of charges over book debts, a charge over shares should not be recharacterised as floating if the debenture provides for a floating charge over dividends.

5 Security in proceeds under Article 9 UCC

Two notions of proceeds have emerged under Article 9 UCC: disposition-based and value-based concept of proceeds. Disposition-based proceeds are distinguished on the grounds of passage of title while value-based proceeds focus on the occurrence of an event that exhausts or consumes the economic value of collateral or its productive

548 Scots law presents a good illustration of problems and consequence that must be accepted if the secured creditor is treated as an owner of the shares: Farstad Supply A/S v Enviroco Limited [2011] UKSC 16, it is particularly interesting to see reaction and arguments of Mr Moss QC sitting as a deputy judge in lower instance court, rendering a different judgment to the Supreme Court judgment (the case concerned the question of who a company was a subsidiary of if the shares were pledged, which under Scottish law can take place by transfer of ownership). For plans of Scottish reform in the area see Scottish Law Commission, Discussion Paper on Moveable Transactions (Discussion Paper No 151) 44.
549 See text to nn 356-360.
550 See text to nn 340-343.
capacity. The formulation of proceeds was expanded in the 2001 revision from the previous disposition-based definition to the value-based model of proceeds. The current definition in §9-102(a)(64) UCC therefore reads:

"'Proceeds' means the following property:

(A) whatever is acquired upon the sale, lease [includes rents], license, exchange, or other disposition of collateral;

(B) whatever is collected on, or distributed on account of, collateral;

(C) rights arising out of collateral;

(D) to the extent of the value of the collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; or

(E) to the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral."

§9-102(a)(64)(D) and (E) UCC concern tort claims and insurance proceeds respectively, whilst the remaining sections focus on different

551 In correspondence on the issue of proceeds prior to the expansion to value-based concept of proceeds, one author stated "[i]t seems to me the ‘exchange’ idea has the benefit of fairness; it allows the secured party to make up what the secured party has lost" F Miller, ‘Letter to Professor C Mooney’ (1990) Permanent Editorial Board for Uniform Commercial Code, PEB Study Group Uniform Commercial Code Article 9 (Oct 11, 1990), Document Nos 3-5.

552 Under previous UCC §9-306(1): "proceeds" included anything received upon the "sale, exchange, collection or other disposition of the collateral"; under §9-306(2) (1990): "Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor."

553 Prior to the revision collateral did not extend to tort claims Bank of New York v Margiotta 416 NY S 2d 493 (Sup Ct 1979) but see McConigle v Combs 968 F 2d 810, (9th Cir 1992), cert dismissed 113 S Ct 399 (1992).
types of proceeds in the narrow sense (substitutes) and fruits. The expansion of the definition concerned primarily inclusion of the right to income and rents. It is therefore useful to examine what led to that extension of the definition to include fruits. In order to do so we will first look briefly at the historical approach of the US law to rents and we will then show examples of cases that were perceived as problematic prior to the change. Finally, we will investigate the rationale for the wide definition of proceeds and ask whether, based on the American experience, inclusion of a right to income and rents in the collateral would be a good solution in English law.

5.1 Historical development of security in rents and income

Historically, the question of fruits in the US, like in Roman law and English law, arose first in relation to mortgages over land. A mortgage has developed as an outright transfer (conveyance) of legal title, which involved right to possess the land and to collect rents from the real property. The traditional approach has been to allow the mortgagee to collect proceeds, e.g. rents accruing on land, and to apply them to the discharge of debt, unless the mortgage document provided otherwise, even prior to default by the debtor. The right to collect rents was treated as a substitute for collecting interest, which was a violation of ecclesiastical and legal prohibitions on usury. This approach later changed. On the prevailing theory of the mortgage the mortgagee does not implicitly have a right to collect rents arising from the mortgaged real property and to apply them towards the discharge of the debt. Another way of looking at the right to rents is to treat it as implicit in the right to possess. In some US states the mortgagee’s right to possession accrues immediately upon default by the mortgagor, even if foreclosure proceedings have not yet been instituted, which enables the


mortgagee to collect rents.\textsuperscript{556} To ensure that the mortgage lenders have this right to collect rents the mortgagor is required to separately assign rent payments in the event of default\textsuperscript{557} but prior to the completion of foreclosure.\textsuperscript{558}

As far as unaccrued rents were concerned common law traditionally treated such rents as an interest in land – an incorporeal hereditament,\textsuperscript{559} which required execution and delivery of an instrument conveying an interest in rents (an assignment of rents).\textsuperscript{560} This was problematic in the context of income received under licence agreements,\textsuperscript{561} for example boat slip fees at marinas or hotel room charges. If a lender wanted to take security in such income, they needed to either obtain an assignment of that income as “rents” in the land or create a security interest in the present and after-acquired accounts and perfect it by filing a financing statement covering “accounts” under Article 9 UCC.\textsuperscript{562} A cautious lender needed to use the “belt and braces” approach by both requiring the debtor (e.g. a marina owner) to execute an assignment of rents and filing a financing statement covering accounts in a relevant UCC filing office.\textsuperscript{563} Although this solved the issue of a perfected and enforceable security interest outside of bankruptcy, the question of classification of the lender’s interest was crucial in the US in the context of bankruptcy because a security agreement covering after-acquired property did not (and still does not)

\textsuperscript{556} Freyermuth cites Maryland, New Jersey, Pennsylvania and Vermont, Freyermuth, (n 554) 6.
\textsuperscript{557} Article 9 UCC does not apply to mortgages over land and individual states have not enacted the relevant legislation dealing away with that requirement.
\textsuperscript{558} When the process of foreclosure sale is completed the purchaser can collect rents as an incidents of its ownership of the land.
\textsuperscript{559} In the US law see Independence Tube Corp v Levine (In re Tavern Motor Inn Inc) 80 BR 659, 661-662 (Bankr D Vt 1987); R Freyermuth, 'Of Hotel Revenues, Rents, and Formalism in the Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance' (1993) 40 UCLA L Rev 1461, 1481.
\textsuperscript{560} Freyermuth, 'Modernizing Security in Rents: The New Uniform Assignment of Rents Act' (n 554) 30.
\textsuperscript{561} In the US it seems to be common to treat as licences the relationship between certain categories of occupiers and owners, e.g. marinas, nursing homes, parking garages, golf courses, student dormitories and hotels, see ibid. 9-10 and cases cited there.
\textsuperscript{562} Ibid. 10.
\textsuperscript{563} Ibid. 11, 21.
attach to property that falls in the bankruptcy estate post-petition.\textsuperscript{564} It was perceived as key to characterise such income from licences as “rents”, “profits” or “proceeds” of land in order to insure that the security interest in newly accruing assets was enforceable after the bankruptcy proceedings commenced.\textsuperscript{565}

5.2 Difference between “proceeds” and after-acquired property in insolvency

After petition for bankruptcy has been filed the interests of the secured creditor and the debtor with respect to accruing assets may diverge. The mortgagee is interested in preserving the post-petition rents so that they could be applied to the discharge of the mortgaged debt if necessary while the mortgagor is interested in applying the rents to fund its efforts to restructure the mortgage debt and to pay professional fees and expenses.\textsuperscript{566} The US Bankruptcy Code preserves any security interest acquired prior to bankruptcy so long as it is valid and perfected under state law.\textsuperscript{567} This applies to proceeds but not after-acquired property due to an express exclusion under section 552(a) of the US Bankruptcy Code, whereby a security agreement covering after-acquired property is not considered to create enforceable security in property acquired after the commencement of bankruptcy proceedings. By contrast, a pre-petition security interest\textsuperscript{568} is valid and enforceable in post-petition property if the security agreement extends to “property of the debtor acquired before the commencement of the case and to proceed{s,}

\textsuperscript{564} Title 11 of the United States Code (hereinafter referred to as 11 USC) §552(a).
\textsuperscript{565} For problems in the US see R Freyermuth, 'The Circus Continues - Security Interests in Rents, Congress, the Bankruptcy Courts, and The "Rents Are Subsumed in the Land" Hypothesis' (1997) 6 J Bankr L & Prac 115; Freyermuth, 'Of Hotel Revenues, Rents, and Formalism in the Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance' (n 559).
\textsuperscript{566} Commerce Bank v Mountain View Village Inc 5 F 3d 34 (3rd Cir 1993); In re Jason Realty LP 29 F 3d 423 (3rd Cir 1995); Sovereign Bank v Schwab 414 F 3d 450 (3rd Cir 2005); Freyermuth, 'Modernizing Security in Rents: The New Uniform Assignment of Rents Act' (n 554) 7 and 32-33.
\textsuperscript{567} 11 USC §544(a).
\textsuperscript{568} Security interests are defined separately in 11 USC §101(51) as a “lien created by an agreement” and applies not only to Article 9 UCC security interest.
products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case.\textsuperscript{569} There are exceptions to this. For example, the rule does not apply to the extent that the trustee or debtor in possession may use, sell or lease proceeds, product, offspring or profits.\textsuperscript{570} The provision also allows the court to consider the equities in individual cases, for example to take into account and evaluate any expenditures by the estate relating to proceeds and any related improvement in position of the secured party. The difference in post-petition treatment of security in after-acquired property and security in proceeds and products has lead to significant changes in law in 2001, to which we now turn. It was driven to a large extent by desire to count rents as “proceeds” and not as “after-acquired property”. It is worth noting at this point that the difference in treatment of security in after-acquired property and proceeds is not a matter of doctrinal logic but rather a policy-driven rule. It is possible as a matter of logic, though may be undesirable,\textsuperscript{571} that security interests in assets acquired after commencement of insolvency proceedings be available for the secured creditor to resort to.

5.3 Examples of problems prior to the 2001 revision of UCC

A. Rental and licence fees

Prior to 2001 case law suggested that rental and licence fees were not proceeds.\textsuperscript{572} Such assets were generated as a result of consumption, not disposition of the original collateral. “Disposition” was interpreted as a

\textsuperscript{569} 11 USC §552(b).
\textsuperscript{570} 11 USC §363.
\textsuperscript{571} For reasons outlined in text to nn 88-100 (prejudicial to interests of unsecured creditors).
\textsuperscript{572} In re Value-Added Communications Inc 139 F 3d 543 (5th Cir 1998) (coins inserted in a pay phone); Gen Elec Credit Corp v Cleary Bros Constr Co (In re Cleary Bros Constr Co) 9BR 40, 41 (Bankr DS Fla 1980) (holding that rental equipment does not generate proceeds).
transaction effecting a transfer of property\textsuperscript{573} or a “permanent transfer of possession”.\textsuperscript{574} For example, in \textit{Value-Added} case coins for use of pay telephones were held not to be proceeds of telephones because use of telephones was not a “disposition” within former §9-306UCC.\textsuperscript{575}

\textbf{B. Stock dividends as proceeds}

Dividends can be seen as proceeds in the broader, value-based sense, as they reflect on the productive capacity of shares, but were not considered as “proceeds” under the disposition-based definition.\textsuperscript{576} Interestingly, a distinction was drawn between a liquidating cash dividend and an ordinary cash dividend.

\textbf{(a) Liquidating dividend}

When shareholders of a company decide to dissolve the corporation, upon the dissolution the company pays its shareholders a liquidating dividend. Each shareholder exchanges its possession of a share certificate for a dividend. The transaction resembles a disposition – an exchange. The liquidating dividend derives its value from shares, but it is a functional equivalent of a “casualty that totally destroys stock”. Once the dividend is paid, the share certificate retains no value; it cannot be exchanged for anything else. A liquidating dividend was considered as falling within the term “proceeds” even prior to 2001 revision.\textsuperscript{577}

\textbf{(b) Ordinary cash dividend}

Liquidating dividends were contrasted with ordinary cash dividends. \textit{Re Hastie}\textsuperscript{578} is an instructive case. Hastie borrowed $750,000 from First

\textsuperscript{573} Weisbart \& Co v First National Bank 568 F 2d 391, 395 (5th Cir 1978).
\textsuperscript{574} Mechanics National Bank v Gaucher 386 NE 2d 1052, 1055 (Mass App Ct 1979).
\textsuperscript{575} Value-Added Communications (n 572).
\textsuperscript{576} UCC §9-102(a)(64)(B). The former UCC §9-306(1) originally only included collections but not “whatever (…) is distributed on account of”. It was amended in 1994 to include “payments or distributions made with respect to investment property”. The revised version of Article 9 does not limit “distribution” to investment property collateral.
\textsuperscript{577} Under §9-306(1); see Aycock v Texas Commerce Bank NA 127 BR 17 (Bankr South Distr Tex 1991).
\textsuperscript{578} In re Hastie 2 F 3d 1042 (10th Cir) 1043-44.
National Bank in Oklahoma City. Hastie granted a security interest in 248 shares of stock of FirstBank to its creditor FNB. The security agreement provided that the secured party would have the right to receive from the issuer the share of dividends, profits and other distributions to which the debtor would be entitled. Subsequently the Federal Deposit Insurance Corporation (FDIC) succeeded to the interest of First National Bank. FDIC took possession of the stock certificates and perfected the security interest in the stock under Oklahoma law but FDIC never asked the FirstBank to register a change of stock ownership. Hastie, therefore, continued to be listed as a registered owner of the FirstBank stock.\(^{579}\) After Hastie filed for bankruptcy (a voluntary Chapter 11 petition) FirstBank paid cash dividends three times to Hastie. FDIC asserted a lien against those dividends under its security agreement but Hastie sought a declaration that FDIC had no perfected security interest in those dividends. The bankruptcy court agreed with Hastie that FDIC failed to perfect its security interest in the dividends. It was held that at any time FDIC had the opportunity to cause the transfer of ownership of the FirstBank stock to be recorded, which would have ensured that it would receive notifications or dividends, to which the registered owner is entitled. The district court agreed. On appeal, FDIC tried a different argument. It submitted that its security interest in the dividends remained unaffected by Hastie’s bankruptcy filing because the dividends constituted proceeds of the stock under §9-306(1), which meant that even if “proceeds, products, offspring, rents, or profits” of collateral are acquired after the petition for bankruptcy is made, the security interest extends to them notwithstanding the bankruptcy.\(^{580}\) It was key how the term “proceeds” was understood.

The Tenth Circuit, in finding for Hastie, focused on the transactional nature of (then) §9-306(1) UCC. Brorby Circuit Judge held:

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\(^{579}\) *Hastie* (n 578) 1044.

\(^{580}\) 11 USC §552(b). Note that the present formulation of that section has slightly changed.
“With respect to this definition, the term "sale" may be defined generally as "[a] revenue transaction where goods or services are delivered to a customer in return for cash or a contractual obligation to pay. [The] [t]erm comprehends [a] transfer of property from one party to another for valuable recompense." Similarly, the term "exchange" may be defined as "[the] [a]ct of giving or taking one thing for another," and the term "collect" in the context of a debt or claim may be defined as "payment or liquidation of it." Lastly, the phrase "other disposition" may be defined generally as the "[a]ct of disposing; [or] transferring to the care or possession of another; [or] [t]he parting with, alienation of, or giving up [of] property." Accordingly, each of the foregoing events describes an event whereby one asset is disposed of and another is acquired as its substitute”.

With this characterisation of proceeds as transaction-derived assets and in the absence of direct authority on whether dividends classed as proceeds, the Tenth Circuit court, concluded that:

“The receipt of cash dividends by a registered owner of certificated securities bears no resemblance to the events specified in the definition of proceeds or to an act of disposition generally”.

For dividends to fall within the category of transaction-based proceeds the generation of dividends would need to involve a change in ownership or other disposition of the stock. It did not. Ownership interest in the issuing corporation was represented by the common stock (shares) not dividends. Payment of dividends, at least under Oklahoma law, was a distribution of the issuing corporation’s surplus or retained earnings. Therefore, the subject matter of security (the

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581 Hastie (n 578) 1045 (references to Black’s Law Dictionary (5th edn 1979) 1200, omitted here).
582 The present definition is wider, §9-102(a)(64) and encompasses dividends.
583 Hastie (n 578) 1045.
584 Kerrigan v American Orthodontics Corp 960 F 2d 43, 46 (7th Cir 1992), referred to in Hastie (n 578) 1045.
stock) is not disposed of. Since dividends did not count as “proceeds” of shares, perfection of security interest in shares did not lead to perfection of security interest in the dividends. A security interest in dividends had to be perfected separately. In the lack of acts leading to perfection of security interest in the dividends, FDIC’s security interest in the dividends was not perfected.

The decision was met with some criticism. Freyermuth, for example, argued that in some sense the payment of a dividend involved a disposition of the value represented by the issuer’s assets because “simple math demonstrates that the payment of a cash dividend has the effect of reducing [the shareholder’s] residual claim”. This does not seem to be right, however. If a shareholder wants to realise the value of its share prior to the issuer’s dissolution, they can only do so by selling the shares in a market transaction and the price of shares on the market is determined by a number of factors, least of which is whether dividends have just been distributed or not.

C. Rents from leases

Where a secured party held a perfected security interest in equipment, it did not have a perfected interest in the lease of the equipment. Therefore, proceeds of the collateral referred only to sale of the equipment and not to rents form the lease of the collateral. The seminal case in relation to proceeds of leased collateral is Re Cleary Brothers Construction Co. In that case Cleary granted a security interest to General Electric creditor Corp (GECC) in a crane. After filing for bankruptcy Cleary, without GECC’s permission, leased the crane to a third party for ten days for a specified rent. GECC argued:

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585 Hastie (n 578) 1046: “[A]lthough the cash dividend distributes assets of the corporation, it does not alter the ownership interest represented by the stock. The cash dividend, therefore, is not a disposition of the stock. Normally, stock is not disposed of, sold, or exchanged in any way unless a change in the ownership interest in the issuing corporation is thereby effected”.


587 Cleary Bros (n 572) 41.

588 Cleary Bros (n 572), see other cases cited in Freyermuth, ‘Rethinking Proceeds: The History, Misinterpretation and Revision of UCC Section 9-306’ (n 586) 661, fn 72.
that the rents paid on the lease of crane were proceeds but the court disagreed. The rents were not generated as a result of a disposition of the crane.

D. The non-existent collateral problem

Let us imagine that a company A manufactures and sells widgets to retailers. It has a £1m credit line with Bank X to finance its trading activity. X has a security on A’s accounts receivable. A’s competitor – company D pays A £1m to stop manufacturing and selling widgets. A accepts the payment and closes the business. The question is whether Bank X can assert its security interest in the payment A obtained from D as proceeds of its collateral. The problem is that the original collateral – the accounts receivable – never came into existence.\(^589\) This is known as a non-existent collateral problem. It has emerged in the US case law in relation to government agricultural subsidy payments\(^590\) and proceeds of business interruption insurance.\(^591\) Some courts took the view that the lender had an opportunity to take a security interest in these assets.\(^592\) Arguments to the contrary are that (a) the debtor would not have received the subsidy or other payment but for the participation in the subsidy or insurance program; (b) if the debtor proceeded and manufactured widgets or planted crop, these assets would have been covered by the security interest; (c) the payment obtained was a substitute for widgets that would otherwise have been manufactured (or crops grown).

\(^{589}\) Ibid. 676.

\(^{590}\) Farmers could agree with the government not to plant certain designated crops on a certain percentage of their acreage in return for a payment (in kind or in certificates) for the foregone crop. See In re Schmidt 38 UCC Rep Sev (Callaghan) 589, 590 (Bankr DND 1984).

\(^{591}\) Re Kroehler Cabinet Co 129 BR 191 (Bankr WD Missouri 1991) (stating that the proceeds from a business interruption insurance policy were not insurance proceeds resulting from the destruction of the collateral but were paid as a result of the actual loss of business income, which was not subject to the security interest), reversed sub nom MNC Commercial Corp v Rouse 1992 WL 674733 (WD Mo 1992), cited in Freyermuth, 'Rethinking Proceeds: The History, Misinterpretation and Revision of UCC Section 9-306' (n 586) 691.

\(^{592}\) Re Schmaling 783 F 2d 680, 684 (7th Cir 1986) (in relation to federal payment-in-kind agricultural subsidy program received by the debtor who had granted security to a bank over all “crops grown or growing (…) together with all property of a similar nature or kind (…) which may be hereafter acquired” at 681).
Prior to the 2001 amendment in the US such payments were not treated as proceeds as they did not fall within the term “disposition”. Freyermuth argued that the payments made in such cases, e.g. the subsidy paid for not growing the would-be covered crops, are proceeds of the collateral on the basis of the parties bargain. When the debtor and the secured party enter into a security agreement their mutual understanding is that the debtor will e.g. grow the crops, to which the secured creditor’s interest will attach. If the debtor accepts the subsidy or other payment the debtor is depriving the secured creditor from its bargained-for collateral, which is comparable to the debtor e.g. growing crops and selling them for cash. Freyermuth’s argument is therefore that the lack of recognition of the collateral in such payments “frustrates the ex ante bargain of the parties and accords [d]ebtor a windfall”. 593 Under the current law post-2001 the subsidy would count as “rights arising on account of collateral”.

If the rationale was to preserve the bargain between the parties, the problem of ‘non-existent collateral’ is that the bargain does not exist. Let us imagine that the farmer who creates security in crops finds a substitute use of his land and instead of growing crops hosts a rock concert. 594 The question is whether the proceeds from renting the ground for such a purpose could be regarded as proceeds of crops. This would clearly be going exceedingly far since the security was agreed to extend to crops, not land itself. We could view proceeds of ticket sales from a rock concert as proceeds if we use the value-based definition of traceable proceeds 595, but ticket sales would be proceeds of land, not crops. Even if we were to follow Professor Smith’s analysis that rent counts as traceable proceeds of leased land because the right to rent arises on the basis of a separate agreement whereby the owner of land

593 Freyermuth, 'Rethinking Proceeds: The History, Misinterpretation and Revision of UCC Section 9-306' (n 586) 683, citing some state court decisions which – unlike the federal court ones – recognized classification of agricultural subsidy as proceeds, e.g. Sweetwater Production Credit Association v O'Briant 764 SW 2d 230, 232 (Supreme Crt of Texas 1988).
594 Argument made in Schmaling (n 592).
595 See text to n 551.
parts with a portion of his ownership, namely the use of land\textsuperscript{596}, we cannot say that ticket sales are proceeds of crops because they are generated on the basis of a different agreement of the owner to part with land use. Freyermuth himself admits that tickets sales would not be proceeds because the land-owner does not act as a farmer.\textsuperscript{597} Since farmers grow crops and do not host rock concerts it cannot be reasonably expected that a reasonable person in the position of the debtor and the secured party concluding a security agreement would have understood that the security over land extended to rents from rock concerts.

5.4 The rationale for a wide ‘proceeds rule’

The revised Article 9 UCC was expanded to cover not only proceeds that the debtor received as replacements for the original collateral (as a result of a “disposition”) but also to proceeds generated by or related to the original collateral.\textsuperscript{598} This enlarged concept of proceeds resolved the specific issues mentioned above by allowing classification of share dividends, rent collections or royalties from licensing as proceeds. It is particularly useful to look at these reasons since the Law Commission Draft Regulations also extend security interests automatically to proceeds but it is not yet clear how widely the term “proceeds” should be understood, in particular whether it should cover only substitutes or also fruits.\textsuperscript{599}

A. Arguments in favour of a wide definition of “proceeds”

In the USA a number of reasons can be identified for the expansion of the definition of proceeds. First, reporters for Article 9 revision, Professors Steven Harris and Charles Mooney argued that changes

\textsuperscript{596} Smith, \textit{The Law of Tracing} (n 7) 22.
\textsuperscript{597} Freyermuth, ‘Rethinking Proceeds: The History, Misinterpretation and Revision of UCC Section 9-306’ 685 fn 172.
\textsuperscript{598} UCC §9-102(a)(64), cf former UCC §9-306(1).
\textsuperscript{599} DR 2(1) defining term “proceeds” \textit{juncto} DR 29. See also LC CP (n 15) paras 3.182-3.187.
were needed to expand the lending base available to secured creditors, thereby increasing the debtor’s ability to obtain financing.600 Second, Freyermuth explained, the rationale for the proceeds rule is to “achieve efficiency of secured transactions by codifying the ex ante bargain of the hypothetical rationale debtor and secured party”.601 It is the presumed intention of the lender and the borrower that the security should extend to sums that reflect the economic value of the collateral.602 The law takes a paternalistic approach in inferring that intention. The UCC automatically gives the parties “a right to collateral (proceeds) that is usually bargained for even in those cases in which the parties have forgotten to implement their bargain by appropriate language in the security agreement.”603 This was meant to tie in with the UCC’s stated purpose, which is to simplify and clarify the law of commercial transactions through deterministic rules so as to decrease the transactional costs and increase predictability of the results of security interest disputes.604

B. Critique of a wide “proceeds” definition

There are two assumptions made by the drafters of the UCC legislative provisions and it is not obvious whether they hold every time. One relates to codification of the parties’ bargain and the other to efficiency.

(a) Codification of a bargain, which may not exist

The law sometimes codifies the perceived typical bargain of parties to a transaction. Providing a regulatory structure, which most parties would choose were they to bargain for these rules individually, reduces transaction costs and hence increases efficiency. The parties do not

601 Freyermuth, ‘Rethinking Proceeds: The History, Misinterpretation and Revision of UCC Section 9-306’ (n 586) 647.
602 Ibid., 659-666, 692-700; Freyermuth, ‘Of Hotel Revenues, Rents, and Formalism in the Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance’ (n 559) 1524-1535.
603 W Hawkland, ‘The Proposed Amendments to Article 9 of the UCC Part II. Proceeds’ (1972) 77 Com LJ 12, 16.
604 Kaunders (n 247) 806-807.
need to spend money on drafting rules from scratch because the law provides a set of default rules. In providing a set of default rules an assumption is made that the legislature is able to establish with a reasonable degree of certainty what parties usually bargain for. Such predictions as to parties’ behaviour are not unprecedented in commercial law. In the US, for example, under the Bankruptcy Code a bankrupt debtor cannot retain and use collateral unless the debtor has provided the secured party with adequate protection of its interest in the collateral: the debtor must at a minimum insure the collateral in order to provide the secured party with adequate protection. The rule is seen as a substitution for the need to include contractual clauses to that effect, which is what parties would normally do if the statutory provision did not exist. Naturally, the bargain envisaged by the law need not be a reflection of the true bargain between the parties. It rather reflects the usual bargain under the circumstances, which serves as a benchmark for legitimate expectations of the parties.

In relation to collateral extending automatically to proceeds understood widely (i.e. including fruits), it is questionable whether the legislature has not gone too far in inferring intention that would never have been there. Unless it can be shown that parties to a secured transaction would typically agree that security interest extends to fruits it cannot be said that there exists any bargain to codify. If the typical bargain does not exist, the legislature should not be imposing default rules on commercial parties only for the parties to have to contract out of them. There appears to be no evidence of any such pattern of behaviour of commercial parties and further, empirical research would be needed to prove this point. Such research is, however, outside of the realm of the present work. Notwithstanding the outcomes of such future research, there are additional efficiency arguments against broadening the scope of the term “proceeds”, to which we now turn.

605 11 USC §§361(1)-(3), 362(d)(1), 363(e).
(b) Inefficiency of treating fruits as proceeds

If it is true that commercial parties usually bargain for proceeds, products and fruits, then a legislative provision implementing what is usually bargained for into the general commercial law seems to be a cost-saving measure because the parties no longer need to spend time drafting proceeds clauses but can rely on a legislative provision. This argument rests on an assumption that parties typically bargain for security in widely understood proceeds. If parties do not normally extend security to fruits, it cannot be said that the legislative provision is a cost saving measure. To the contrary, if parties do not typically want fruits to constitute collateral a legislative provision extending security to them would increase transaction costs because parties would have to incur cost in order to exclude the provision.

Furthermore, it was suggested in chapter I security interests are efficient\(^\text{606}\) and that extension of security interests to substitutes promotes this efficiency because it reduces the risk of moral hazard and information asymmetry posed by the possibility of disappearance of the collateral.\(^\text{607}\) By contrast, extension of security interests automatically to fruits or income generated from collateral creates a problem of deadweight loss,\(^\text{608}\) which means that the secured creditor’s encumbrance grows, the debtor’s lending base shrinks and the debtor acquires no benefit from having her new assets (fruits, income) automatically subjected to security.

It is sometimes argued that a broad proceeds rule broadens the debtor’s lending base so she may use all her assets, as they come into being, to raise finance. This point about broadening of the lending base was rightly refuted by Warner, who argued that this purpose is fulfilled by broad validation of after-acquired property clauses under §9-

\(^{606}\) Chapter I section 2.3.
\(^{607}\) See text preceding n 105.
\(^{608}\) See text to nn 106-109.
201(a)UCC\textsuperscript{609} and that the expanded proceeds rule in fact does not lead to the achievement of the purpose because it captures ‘extra collateral’ in cases “where the parties did not care enough about the item to describe it in the security agreement”.\textsuperscript{610} Warner also argued that the broad expansion of security to proceeds violates bankruptcy rules (the deference rule) by diverting a wide pool of assets away from unsecured creditors, which is of particular importance in reorganization proceedings. Thus, it seems that not only is a rule extending security interests automatically to fruits inefficient but it also fails to advance the purpose of fair distribution of assets.\textsuperscript{611}

\section*{6 Should English law follow Article 9 UCC?}

Bearing in mind that under current English law a secured creditor has no automatic right to proceeds and fruits arising by operation of law, a question arises whether English law should follow the path of Article 9 UCC extending security interests to proceeds widely understood, i.e. including fruits and income.

There is little doubt that efficiency should be promoted by codifying the parties’ bargain. The legislator must, however, be very careful in inferring what the parties’ bargain is. It appears from anecdotal evidence that in commercial practice it is not expected that fruits (e.g. income, dividends) will fall within the scope of security.\textsuperscript{612} If the law imposes such a rule on commercial parties, the opposite effect to what is intended might happen. Instead of improving the efficiency of transactions, commercial parties will spend time and effort when dealing with the unexpected rule imposed by the legislator.


\textsuperscript{610} Warner, 'Article 9's Bankrupt Proceeds Rule: Amending Bankruptcy Code Section 552 through the UCC "Proceeds" Definition ' (in 609) 523.

\textsuperscript{611} On the issue of fair distribution by security interests see chapter I section 2.3.D.

\textsuperscript{612} Based on discussions of Working Group A of Secured Transactions Law Reform Project, Meeting 2 (20\textsuperscript{th} March 2012).
It seems that while an automatic proceeds rule should be encouraged, the term “proceeds” should not extend to fruits. Even though fruits could be seen as traceable proceeds arising as a result of alienation of a limited interest in the original asset (alienation of use-value of the original collateral), it is important that fruits accrue alongside the existing collateral, not instead of it.\footnote{Text to n 324.} When a security interest extends to a substitute asset, the creditor only gets what he bargained for: a right to resort to an asset with priority to other creditors, even if it is not an asset the creditor originally bargained for but an equivalent. An automatic right to proceeds preserves the security interest, which otherwise would likely be defeated. The narrow proceeds rule preserves the existence of security. Consequently, efficiency of security interests, discussed in chapter I,\footnote{See above chapter I section 2.3.} is promoted. For example, the creditor continues to be able to limit monitoring of the debtor to the asset, thus reducing the cost of lending.\footnote{See text to n 104} At the same time substitution of original collateral for proceeds of disposition does not substantially affect the lending base of the debtor. If the debtor decided to subject a portion of her estate to a security in favour of a creditor, substitution of some assets for other assets does not substantially affect the proportion in which the debtor’s estate is encumbered. This is different in the case of automatic extension of security to fruits because new assets as well as the original collateral become subject to security. The lending base of the debtor diminishes as the proportion of encumbered assets in the debtor’s estate increases without any additional benefit to the debtor and probably only with an incremental benefit to the creditor.\footnote{Text to nn 106-109.} As a result, automatic extension of security to fruits is an inefficient form of asset distribution. Security interests should not extend to fruits or income without an agreement to that effect.
7 Conclusion

It seems that introduction of a rule in English law automatically extending security interests to substitutes would promote efficiency justifications of security. However, adoption of a rule extending security to fruits by operation of law would be likely to be inefficient. For this reason a possible future law reform of English law should not follow the example of Article 9 UCC, where security interests extend to proceeds, widely understood and comprising fruits. The state of current English law with respect to security in derived assets seems to be one of confusion. This thesis suggests that a principle, whereby security interests extend automatically (that is, by virtue of the property right) to fruits and substitutes does not find a sufficient support, in particular there is no parallel between the rights in accretions and rights to substitutes and fruits. Security interests automatically extend to accretions where a subsidiary asset (an accretion) accedes to collateral by attachment because the collateral does not change into a new asset. The reference to accession by natural increase in relation to fruits has caused lack of clarity in English law as it suggested analogous treatment to accretions. However, security interests do not, and should not, extend to fruits merely by virtue of the secured creditor’s property right in the original asset. Rights to fruits are related to possession of the original asset. Even if a secured creditor has a right to fruits by virtue of possession of the original asset, this is only by way of security. A secured creditor without possession of the original asset has no right to fruits unless he bargains for it.

In relation to rights to substitutes (proceeds and products) the automatic extension of security to such assets is inconsistent with the distinction between fixed and floating charges in English law. The right to substitutes, being derived assets that usually arise as a result of an act of disposition of the original asset, must be looked at through the prism of whether the borrower was authorised to dispose or not. Rights to proceeds (sensu largo, i.e. comprising also products) of authorised
dispositions are analysed in chapter IV while rights to proceeds (*sensu largo*) of unauthorised dispositions are examined in chapter V.
CHAPTER IV – Security agreements covering derived assets

1 Introduction

It was argued in the previous chapter that security interests in substitutes and fruits do not generally arise as a matter of “principle”, that is by virtue of the secured creditor’s proprietary interest in the originally secured asset. As a matter of future changes to English law a rule extending security automatically to substitutes would arguably promote efficiency of security interests; an analogous rule in relation to fruits would not. In the current English law, as seen, the rule in relation to fruits does not have sufficient support unless the creditor has possession. In relation to substitutes the “principle” does not apply because substitutes are proceeds of disposition of the original asset, which are necessarily either authorised or unauthorised. When claims to substitutes arise, they do so through the prism of the debtor’s authority to dispose stemming from the agreement between the parties, not through the operation of a “principle of substitutions”.

This chapter looks at security agreements, in which parties contemplated the extension of security interests to proceeds, products or fruits, whether expressly or impliedly by including a clause to that effect. The purpose of this chapter is twofold. First, it examines the effect of clauses in security agreements whereby parties expressly extend security to assets that derive from the original collateral or whereby derived assets may fall within a class of assets subject to security under the security agreement (derived assets clause). It is not clear under the current law whether or not derived assets are covered by a security interest as original collateral and independently of their status as derived assets.\(^{617}\) Clarification of this point is needed to see whether

\(^{617}\) See Goode on Legal Problems of Credit and Security (n 1) para 1-66 (asserting that derived assets can be covered as collateral and as an asset).
security agreements with derived clauses create one security interest (in original and derived assets) or multiple (in original asset and in each derived asset). If there are multiple security interests, a new security is created each time a new derived asset is acquired. A new and separate security would mean that fresh consideration and new registration would likely be needed. A new security would also be likely to have different priority than security in the original asset if priority dated from the date of creation of a security interest. In *Goode on Legal Problems of Credit and Security* it is argued that there are compelling reasons for there being one security. This seems to be based on a parallel analysis of charges in book debts and their proceeds. We observed, however, that proceeds of book debts are not derived assets but the same assets as book debts. It is therefore unsurprising that charges on book debts and proceeds are viewed as a single, continuous charge. This may be more difficult to establish where derived asset and original collateral are different assets. It is argued that whether there are multiple security interests or a single, continuous security depends on the parties’ intention. In some cases parties want to create multiple security interests, often of different character, for example a fixed charge over one asset (e.g. shares) and a floating charge over another (e.g. dividends on shares). In other cases parties may wish to create a single security in the original asset and the derived asset. A clause extending security to derived assets is similar to a clause creating security in an after-acquired property. If it can be shown that after-acquired property clauses create a present security at the moment of security agreement it seems that we can also say that a security agreement with a derived assets clause creates a single security that covers from the date of the agreement both the original collateral and derived assets. In order to demonstrate that after-acquired property

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618 Ibid. (n 1) para 1-64.
619 Ibid. (n 1) para 1-64.
620 Ibid. (n 1) para 1-64.
621 See text to nn 372 and 418-447.
clauses create present security under English law, we contrast such clauses with cases of conditional security.

Second, this chapter examines the way in which security interests extend to proceeds of dispositions (substitutes of the original asset) where the debtor had authority to dispose. It looks therefore at authorised dispositions of the asset subject to security. Claims to proceeds of unauthorised dispositions are different and so we discuss them separately in chapter V. Authorised disposition of collateral need not lead to proceeds; the debtor may simply withdraw an asset from security without receiving anything in exchange. We do not investigate such scenarios. We are only interested in cases where a new asset (a substitute) is obtained. The question posed is whether the creditor can assert a security interest in such a new asset. The answer sometimes given pertains to disposition of original collateral being either for the debtor’s own behalf or on the creditor’s behalf. Whether or not a disposition is on behalf of the creditor depends on characterisation of the charge as fixed or floating. Dispositions of assets subject to a fixed charge are in principle not “allowed” and a term in the debenture enabling the debtor to dispose is likely to be characterised as creating a floating security. Although dispositions to which the fixed chargee specifically consented are likely to be consistent with a fixed character of the charge, as soon as the consent is given in advance this character of the charge is less certain. Dispositions of assets are of course characteristic of the floating charge. Yet dispositions of assets subject to a floating charge prior to crystallisation are on the debtor’s own behalf, not the chargee’s. These points have already been made in literature but it has not been fully explored why this is so. This chapter aims to fill this gap. A new way of looking at fixed charge is suggested. This new perspective focuses on the differing degrees of authority to dispose in a fixed and a floating charge. Whilst authority to dispose is limited, debtor’s power to dispose usually is not so limited.

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622 Goode on Legal Problems of Credit and Security (n 1) para 1-59 fn 232.
This leads us to analysis of the charge in terms analogous to agency. It is proposed that a fixed charge can be seen as what would be an agency with very limited authority to dispose. This analysis allows us to view fixed and floating charges as similar devices and makes it redundant to look at whether or not the charge is an attached immediate interest in the assets subject to it.

2 Security in derived assets as security in after-acquired property

Derived assets can be seen as a sub-category of after-acquired property in that they do not yet exist at the time the agreement is made. What we say here about enforceability of security in after-acquired property ought to therefore apply also to derived assets. Security interests in after-acquired property raise a number of problems. Their clarification would be useful not only for the purposes of better understanding of security in derived assets but also to inform the debate on what the law is with respect to security in future assets. This section deals with the following questions. First, it is asked whether creation of security in future assets should be viewed as conditional security, the condition being the coming into existence of an asset. It is argued that it should not and we attempt to explain its nature as an “inchoate security” in the period between the security agreement and the coming into being of the property (part 2.1). Second, it is asked whether fresh consideration is required when the new asset comes into existence (part 2.2).

2.1 Security in after-acquired property distinguished from conditional transfers

Parties to a security agreement must intend to create a security interest in a particular asset. They do so by intending to create an immediate right to resort to an asset in case the debtor defaults. Only then a

623 Swiss Bank Corporation v Lloyds Bank Ltd [1979] Ch 548, 566 (Browne-Wilkinson J) noting a difference between an intention to create a security and intention to merely pay from a specified source (decision on other grounds reversed in CA [1980] 3 WLR 457; appeal upheld by HL (n 157)).
security interest can arise immediately. A security agreement contingent on some future event is a mere contract because there is no intention to create an immediate right. A charge expressed to cover after-acquired property also has an element of contingency: the charge cannot attach until the future property comes into existence. This could be seen as preventing the security interest being immediately created. Yet it is clear, both from authorities and literature, that such a charge is more than a mere contract. It is said to create an “inchoate interest” attaching automatically, and retrospectively, when the property comes into existence. This is explained in Legal Problems of Credit and Security in the following way:

“an agreement for security over after-acquired property (...) creates an inchoate security interest which is waiting for the asset to be acquired so that it can fasten on to the asset but which, upon acquisition of the asset, takes effect as from the date of the security agreement. Acquisition of the asset produces the situation in which the security is deemed to have continuously attached to the asset from the time of execution of the security agreement”.

We will show, by contrasting a security in future property with security contingent on future and certain/uncertain events, that an agreement to create an immediate right in future property is not a mere contract because the parties’ intention to create a proprietary right is immediate and not contingent on any event.

Contingencies can be classified depending on the certainty of the event occurring. The events can be future and certain or future and uncertain. Examples of future and certain event is deference in time, e.g. “I create a charge over my present car but I want it to take effect tomorrow” or “when my grandmother dies”. Both the advent of tomorrow and the death of someone are certain events and should not be treated

624 Goode on Legal Problems of Credit and Security (n 1) para 2-13.
differently: we know that they will happen, although in some cases we do not know when. Events that are future and uncertain depend on the occurrence of future event, which may or may not occur, e.g. “I create a charge over my present car provided that I do not receive a loan from my neighbour”. It is probably fair to say that most future events are uncertain, although some may be more so than others. The future uncertain events can be either within a person’s control, in particular within the debtor or grantor’s control (for example, the debtor’s default on the obligation to pay) or outside of anyone’s control (such as an earthquake). We therefore propose the following distinctions, which are discussed in more detail immediately below:

(a) parties to a security agreement express intention to attach at a later date than the security agreement (the contingency is a future and certain event) – intention to attach is not immediate because it is deferred in time;

(b) parties to a security agreement express intention to create security upon the occurrence of a future and uncertain event – intention to create security is not immediate, it is conditional; it amounts to parties saying: “we do not intend to create any security unless X occurs”;

(c) parties to a security agreement express intention to create security in after-acquired property. Even though the coming into being of future property can be seen as a future and uncertain event, parties do not make their intention conditional upon it. It is merely the proprietary effect of the security (its creation) that is conditional upon the property coming into existence.

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625 See Countess of Mornington v Keane (1858) 2 De G&J 292, 313; 44 ER 1001, 1010 (Chelmsford LC), later referred to as Mornington.
A. Security interest conditional upon a future and certain event

The parties to a security agreement may wish the security to attach at a later point, for example when the owner of a car, presently existing, agrees with the creditor on July 1 that the security created is to take effect in a few days’ time, on July 6. There will be no present security created on July 1 as their intention is to attach on July 6, which means that the intention parties expressed on July 1 was not to attach immediately. When the parties agree to create a security interest over presently existing assets in such a way that the security is to take effect at some point in the future, it seems it is not possible for the creditor to acquire any proprietary right in the asset prior to the agreed time. Equally, as soon as the certain future event occurs, the security should attach to the asset automatically, without any need for another security agreement as in the scenario (b), where attachment depends on a future and uncertain event. In the present scenario the security arises simply on the basis of the parties’ agreement to attach. The security interest is deemed to attach on the agreed date (July 6) and does not take any effect prior to that date. Unlike in the case of security interests in future assets the intention is not to create security immediately but at a future certain event. Therefore, we cannot say that the security attaches retrospectively from the date of the agreement.

In the present scenario no security will have been created in favour of the creditor on July 1, 2, 3, 4, or 5. Consequently, the creditor cannot enforce the transfer on any of these days until July 6. What if an event occurs before July 6 that prevents the transfer from taking place? Let us imagine that the grantor in the meantime (between July 1 and July 6) purported to transfer the title to the asset (car) to a third party, for example by selling the car to a third party on July 3. The third party

626 Cf Draft Companies Act 2006 (Amendment of Part 25) Regulations 2013, to come into force 6th April 2013 (subject to Parliamentary approval), introducing s859E, which sets out the dates when the charge is created. For example, where the instrument creating security is a deed held in escrow, the date of creation of the security is the date of delivery into escrow; similarly, where an instrument does not have an immediate effect upon execution, the charge is created when the instrument takes effect.
will argue that they acquired a legal title to the car on July 3. On July 6
the disposition of interest in the car would have taken place in favour of
the creditor. We clearly have a competition between the claims of the
creditor and the third party to the asset. The creditor, it seems, had
assumed the risk of the grantor disposing of the asset in the period
before July 6. The grantor had an unimpaired power to dispose of the
asset before July 6, which he could exercise. Agreeing to postpone the
exercise of the power created a risk for the creditor that the grantor
might transfer the title to a third party. As a result, it seems, the third
party acquires a full legal title to the car (on July 3) and the creditor can
only sue the grantor for damages for loss incurred, including a loss of a
promise to transfer incurred on July 6.

Support for this reasoning is found in *Mornington v Keane* which is a
case concerning the distinction between a covenant to create a charge
of immediate effect and a covenant that is to have operation by a future
act to be done by the covenantor. The case involved a covenant
contained in a separation deed between a husband (Earl of Mornington)
and his wife (Helena, Countess of Mornington) that “the earl would on
or before the 1st day of February 1835” charge his freehold estates of
inheritance “to be situate in England or Wales” to secure payment of an
annuity to Helena. The question was whether Helena could assert an
interest binding the defendant, which she could have if the separation
deed actually created a charge. The parties did not identify the assets to
the charge. It was an interest to be created on a future day and on any
property “to be situate in England or Wales” on 1st February 1835. The
formulation of the separation deed suggested it was a general covenant
to specify and settle property at a later point in time, which would not

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627 (n 625).
628 A note should be added that the case of *Mornington v Keane*, as many other cases in
that period, did not use the term “charge” to mean security interest but rather a rent-
charge or annuity. The difference does not matter here because these are also
encumbrances on assets and the points made in relation to rent-charge are relevant in
the context of security interests.
629 *Mornington* (n 625) 292-293.
be enforceable. The counsel for Helena sought to distinguish the covenant in the case from a general covenant, arguing that the covenant contained a time limitation to do a particular act on that date and such would have created a charge because “a Court of Equity has then the means of saying when the covenant ought to have been performed”. Lord Chelmsford V-C, however, thought there was no such difference between a general and indefinite covenant and one with a time fixed for performance because:

“If a definite time is fixed, a charge should be immediately created, whereas if the time be the whole of the covenantor’s life, so as to expire at his death, no charge should be created, or why the death in the latter case should not be equivalent to the fixed time in the former.”

What is crucial is that the question to Lord Chelmsford was not about the effect of a covenant creating a general charge on all the lands of Earl of Mornington. His Lordship did not agree that an additional act needed to be done to determine which assets fell within the charge and which did not. The problem was that the property was after-acquired property. If it had been future property covered by the charge in the covenant, Lord Chelmsford said, “it ought to be held to be bound by the agreement by reason of the purpose for which it was acquired”. He said further:

“A covenant that particular lands shall be charged may of itself create a charge upon those lands, or (which is the same thing) that a covenant that all the lands which the covenantor shall have on a particular day shall stand charged will create a charge without more. But it is not the same thing when the covenant is

630 Mornington (n 625) 300; see also Lord Chelmsford V-C (at 316): “it is giving a startling effect to say that every part of the covenantor’s property is to be so bound that he cannot deal with it except subject to the charge”.
631 Mornington (n 625) 308-309.
632 Mornington (n 625) 313 (Chelmsford LC).
633 Mornington (n 625) 311.
to do an act on a future day which will create a charge on some unspecified property". 634

These dicta, it is submitted, are crucial because they illustrate that an incumbrance over future property takes effect on the basis of an agreement provided it contains all the ingredients necessary to create the charge, such as an intention to create the charge, identifiability of assets, an appropriate form, if required, and that the chargor has a power to dispose of the assets. The properly asked question was therefore whether this was a covenant, which took effect as a charge, albeit with a deferred effect, or whether it was merely a personal obligation to settle (again) on a particular day. 635 On the facts there was merely a covenant to do an act in the future to create a charge. Yet, it is clear from the case that a charge would have taken effect on the deferred date on the basis of the parties’ agreement. 636 Thus a security agreement in which parties agree to create a charge on a particular day takes effect on that particular day. Such agreements are distinguished on the circumstance of each case, from “agreements to agree again” on a particular date, which do not take effect, other than contractually, until the particular date comes. 637 A more modern authority can be found in the dicta of Lord Scott in Smith v Bridgend County Borough Council, 638 who distinguishes a floating charge, which he considers to be a present security from:

“a charge expressed to come into existence on a specified future event and then to attach to assets then owned by the company. Such a grant would not (...) vest in the grantee any immediate equitable interest in the company’s assets for the time being”. 639

634 Mornington (n 625) 313 (Chelmsford LC).
635 The authorities that were cited did not relate to the question of difference between a covenant and a covenant to settle on or before a particular day: Mornington (n 625) 301-303 (Knight Bruce LJ) and 307 (Turner LJ).
636 Mornington (n 625) 313 (Chelmsford LC).
637 See also Re Jackson v Bassford Ltd [1906] 2 Ch 467, 476-7 (Buckley J).
638 Smith (n 183) [61] and [63].
639 Smith (n 183) [61] (Scott LJ).
A note to make about this decision is that whilst Lord Scott held that security interest subject to a future certain event was not a present security, His Lordship suggested that an agreement to create a future charge over assets that cannot be identified until the future event happened was a present security – it was a present floating charge albeit “not (…) a classic floating charge”\(^\text{640}\) and thus registrable. This point was rightly criticised in the literature.\(^\text{641}\) It departs from the existing authority of Mornington v Keane. An agreement to create a future charge over assets not identifiable until a future event occurs would be what we have termed here as “agreements to agree” as such would not create any security.

Referring back to our example above, could the parties expressly say that they wish the security to attach on July 6 but with a retrospective effect of attachment from July 1? It seems not. Such an intention would be treated either as an intention to attach immediately, on July 1, or on July 6. There would not be a period of any inchoate security between July 1 and July 6.

**B. Agreements to create security upon a future and uncertain event**

If an agreement to create security upon a future and certain event does not create security, then *a maiore ad minus* an agreement to create security upon a future and *uncertain* event also does not create present security. Thus, a security agreement contingent on a demand of the creditor to give security,\(^\text{642}\) default by the debtor or occurrence of other uncertain event, is a mere contract, not present security.\(^\text{643}\) For example,
if the intention is to create a security interest in an asset (say, a car) in favour of a creditor (Anton) as soon as the debtor (Darcy) enters into a security with another creditor (Brendan) it will amount to no more than a mere contract\textsuperscript{644} as the event that the debtor will in fact contract with Brendan is both future and uncertain. The fact that no one can tell if the event will ever occur is not relevant to the arrangement being a mere contract. What is relevant is that there is no immediate intention to create security. This distinguishes this scenario from security in after-acquired property, where parties do intend to create security, as we explain below.

Agreements to create security contingent on a future uncertain event are similar to agreements creating security contingent on a future certain event because parties express willingness to create an interest at a later point in time, whether the advent of that time is certain or not. Prior to the occurrence of the event parties do not intend to create a proprietary interest. Without the presence of intention to create a proprietary interest, the agreement can only have effect between the parties.

C. Immediate intention to create a security interest in after-acquired property

Agreements where parties purport to create a security interest in a future asset (scenario (c) above) could also be seen as contingent on future uncertain events: the coming into existence of a future asset is, after all, a future and – most likely – uncertain event. We illustrate the similarity, and explain the difference, by using examples. Let us imagine that the debtor (Dominique) creates security by assigning an interest to his creditor (Aliona), which will accrue on a loan that Dominique made to a third party (Tess). Unless the loan is a fixed term loan, we cannot be certain that Tess will not decide to pay up the loan earlier thus putting a stop to all interest accruing. The accrual of interest is uncertain. Each accrual of interest is a new debt that may or may not

\textsuperscript{644} The Asiatic Enterprises (Pte) Ltd v United Overseas Bank Ltd [2002] 1 SLR 300 [16], cited in Goode on Legal Problems of Credit and Security (n 1) para 1-76.
arise depending on whether the loan is still outstanding. Prima facie this is similar to the intention to create security depending on Darcy’s entering into a security agreement with another creditor, Brendan, in the example above. There is a difference though. In the example of the security agreement between Darcy and Anton the intention to create security is dependent on a future event. Parties express no willingness to create a security for as long as Darcy has not entered into an agreement with Brendan. One could say that parties agree not to create a security interest unless a specified event takes place. Another example of this arrangement is security in a dividend on a share not yet declared (but not the share). Declaration of a dividend on a share is a future and uncertain event. The parties can be seen as agreeing not to create a security unless and until the dividend is declared. By contrast, when Dominique and Aliona make a security agreement over after-acquired property (interest accruing in the future on the loan), their intention is not conditional on any event. They wish to create a security interest at the moment of creating the agreement but that security cannot take any proprietary effect until the asset comes into being (the interest accrues). Darcy/Anton add a contingency to their intention to create security while Dominique/Aliona’s intention is unconditional.

The immediate intention to create security exists from the moment the parties enter into an agreement to create security in after-acquired property. The security does not attach to the future asset because there is nothing to attach to. Although the proprietary effect of security is postponed until the asset comes into existence, the agreement between the parties is unconditional. When the asset comes into existence, the security takes proprietary effect from the moment of the security agreement because this is when the parties first expressed intention to create security. This explains why the security takes effect retrospectively from the date of the security agreement once the asset comes into existence. Although at common law an agreement to give

645 See text to n 644.
646 See text to nn 341-343.
security over future property creates no proprietary rights even after acquisition of the asset by the grantor of security (i.e. no disposition or grant of a proprietary interest takes place), in equity security is said to attach to the asset at the moment of acquisition by the debtor. This is on the authority of Holroyd v Marshall, where machinery in a mill was mortgaged in favour of Holroyd. The owner of the mill covenanted that when new machinery would be purchased in substitution for the old one he would ensure that it was subject to the same encumbrance as the old machinery. Although at law a new asset needed a formal act of conveyance it was held that in equity the covenant could take effect without any additional separate act of transfer. Thus creation of security in a future asset takes place by virtue of the agreement without a separate “act of transfer”. There are, however, exceptions, an example of which is the security in after-acquired property granted by individuals and unincorporated businesses under Bills of Sale Act 1878 and Bills of Sale (1878) Amendment Act 1882, which we need to briefly address.

**D. Problems of security in after-acquired property under Bills of Sale Acts**

Under section 5 of the 1882 Act, headed “bill of sale not to affect after-acquired property”, a bill of sale shall be void, except as against the grantor, in respect of any personal chattels specifically described in the schedule thereto of which the grantor was not the true owner at the time of the execution of the bill of sale. This section is thus understood as a prohibition of transfer of after-acquired property in a bill of sale. The operation of this section is important also to the extent that it impacts on registrable charges under Companies Act 2006, although under the

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647 (1862) 10 HL Cas 191, 11 ER 999; see also Tailby (n 423).
648 Holroyd (n 647) 209 (Westbury LJ), 210-211 (Westbury LJ), 216 (Chelmsford LJ).
649 Hereinafter referred to as 1878 Act and 1882 Act respectively.
650 Companies Act 2006, s860(7)(b): a charge must be registered if “a charge created or evidenced by an instrument which, if executed by an individual, would require registration as a bill of sale”.
The first note to make is that section 5 of the 1882 Act does not use the words “after-acquired property” but “personal chattels not specifically described (…) of which the grantor was not the true owner”. The first step is therefore to understand whether future property can count as “personal chattels” under the Acts. In *Reeves v Barlow*, which concerned a future right to materials brought on a building site under a building contract, it was argued that it did not because the instrument did not confer a right to a personal chattel in equity but in law. As a result, Bowen LJ held that the Acts did not apply because there was never any existing right to future property: the right to materials was acquired only once they were brought to the building site, not before, so there was only ever a right to presently existing materials in the building site.

A right to future chattels did, however, exist in *Thomas v Kelly and Baker* where a bill of sale assigned by way of security both existing chattels and future chattels of the mortgagor. A question asked was whether an instrument which purported to assign a right to resort to future property could fall within the Bills of Sale Acts formality provision making such assignments void. It was held that present assignments of goods not capable of specific description were not in accordance with the form and therefore void. Lord Macnaghten’s interpretation in this case was different because he thought future goods fell within the scope of section 5 of the 1882 Act because they did not count as “personal chattels” because personal chattels were only things “capable of complete transfer by delivery” at the time when the bill of sale was executed and clearly things that did not exist (in the hands of

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651 Draft Companies Act 2006 (Amendment of Part 25) Regulations 2013, to come in force 6th April 2013 (subject to Parliamentary approval), introducing s859A.
652 (1884) 12 QBD 436.
653 *Reeves* (n 652) 441-442 (Bowen LJ).
654 Bills of Sale Act 1878, s4.
655 (1888) 13 App Cas 506 (HL).
656 *Thomas* (n 655) 512 (Halsbury LC) and 516 (Lord Fitzgerald concurring).
the transferor) were not. Lord Macnaghten’s view was therefore that the term “personal chattels” excluded after-acquired chattels because they were not capable of transfer by delivery. But this seemed to have been an isolated view and the proper reading of the case is that the bill of sale was not in the required form because the after-acquired property was not specified in a schedule to the bill contrary to section 9 of the 1882 Act, “not that a security over after-acquired property cannot in any circumstances be a bill of sale”.

Lord Macnaghten’s dicta have been criticised and not followed in Welsh Development Agency v Export Agency v Export Finance Co Ltd, where Browne-Wilkinson V-C held that equitable rights over future property are clearly within the scope of the Act, so a document purporting to create a charge, sale or other transfer of such assets can be considered under section 5 of the 1882 Act. In order to avoid the invalidity sanction the rights must be described in accordance with the form in the schedule to the Act. This requires chattels to be specifically described in the schedule in the Act, and if the assignment is by way of security it must be for a sum advanced at the time of the execution of the bill of sale and the interest rate must be specified, the parties must also have included terms for maintenance of security or defeasance and it is necessary that section 7 of the 1882 Act is incorporated by reference (the section restricts the right of the grantee to take possession).

This brings us to the meaning of “void but enforceable against the grantor”, which is also puzzling. It could mean that the security in after-acquired property is validly created so that the grantee has a right enforceable against the grantor to resort to the asset, even if not

657 Thomas (n 655) 518-519 (Macnaghten LJ).
658 By means of a digression, it is not entirely clear what Macnaghten LJ had in mind when he said “Notwithstanding a remark made by Lord Chelmsford in Holroyd v Marshall which obviously was not required for the decision of the case … [emphasis – MR]”.
659 Chapman v Wilson [2010] EWHC 1746 (Ch) [95] (Vos J).
661 Welsh Development Agency (n 660) 956-7 (Browne-Wilkinson V-C).
662 Thomas (n 655) 516 (Lord Fitzgerald).
enforceable against third parties such as purchasers from the third party or other creditor (view 1). Alternatively, it could be understood as a contract to grant security in property in the future, not as a right to resort to the asset when it comes to existence (view 2). If the first view is true, a security in an after-acquired property is created under the Bills of Sale Acts, but the security is unperfected (i.e. not enforceable against third parties) and requires another bill of sale to be entered into when the property comes into existence, in order to make the right effective against third parties. The second view is preferable. A bill of sale with respect to after-acquired property does not give rise to any present security right to an asset but merely confers a contractual right to demand another bill of sale being executed to create security over existing property. This has also been the preferred interpretation by the courts.

Analogously, a bill of sale with respect to a derived asset does not give rise to any right in the derived asset. It may only create a present right in the presently existing original asset. It is important to note, however, that Bills of Sale Acts provide a possibility of substitutions of collateral, albeit in very limited circumstances such as maintenance or upgrading.

2.2 Consideration for security interests in future assets

Like in any other area, the security agreement must satisfy conditions of a valid and enforceable contract, including a requirement of consideration. Although promised consideration need not be executed for a security agreement to be valid at law, it is often said that the case is different in equity for equity will not assist a volunteer. For example, equity will not enforce an uncompleted agreement for a gift or a charge by way of a gift, even if a security agreement is in the form a deed. Thus, advancement must be made. A mere promise to advance money

663 Westen v Fairbridge [1923] 1 KB 667, 671 (Bray J) “Sect. 5 of the Bills of Sale Act, 1882, has nothing to do with creditors; its first and main object is to provide against the assignment of after-acquired property, and it was rather for the protection of the true owner of the goods than for that of creditors”; see also Chapman (n 659).
664 See text to nn 687-689.
665 Re Lucan (1890) 45 Ch D 470.
in the future will not be sufficient for creditor to enforce the security.\textsuperscript{666} If consideration must be executed for the contract to create security to be enforceable, a question arises whether security in after-acquired (and also in derived assets) property should be supported by fresh consideration when the asset is acquired.

In the case of security governed by section 860 of the Companies Act 2006, fresh consideration is not needed because a charge is created when the charge instrument was executed if this is what the parties intended\textsuperscript{667}, whether or not a loan has been advanced. If a charge is created under section 860 Companies Act but loan has not yet been advanced, the charge is valid but unenforceable. The creditor cannot resort to the asset and enforce security until the loan has been advanced because otherwise there is no debt to be discharged from the security. For the creditor to be able to enforce the created charge it must also have been registered within the required period\textsuperscript{668} as otherwise it is void.\textsuperscript{669}

Where the Companies Act does not apply to security, the question is whether the creditor seeking to enforce a promise to create security in the security agreement must show that he has actually advanced the money. There are conflicting views on this.\textsuperscript{670} On one view, security can take effect in equity only if the consideration is executed, i.e. the

\textsuperscript{666} Equity will not treat the creditor’s promise to make advancement as done; a contract to borrow money will not be specifically enforced, \textit{Rogers v Challis} (1859) 27 Beav 175, 54 ER 68.

\textsuperscript{667} Cf under the Draft Companies Act 2006 (Amendment of Part 25) Regulations 2013 (revised), to come into force on 6th April 2013 (subject to Parliamentary approval), the date of creation of charge is defined (draft s859E).

\textsuperscript{668} Companies Act 2006, s870 cf similar 21-day period Draft Companies Act 2006 (Amendment of Part 25) Regulations 2013 (revised), draft s859A(4) (though the period begins on the day of creation of the charge, which is defined in draft s859E).

\textsuperscript{669} Companies Act 2006, s874 cf similar sanction Draft Companies Act 2006 (Amendment of Part 25) Regulations 2013 (revised), draft s859H. However, this reform removes the sanction of criminal penalty for not registering the charge, which is present under Companies Act s860.

\textsuperscript{670} This problem has been discussed in the context of the so-called affirmative negative pledges. A clause prohibiting the debtor to grant security to a third party does not confer, without more, a proprietary right but such a clause may be also purport to create conditionally a security, see J Stone, "The "Affirmative" Negative Pledge" (1991) 6 JIBL 364, 365-366; P Gabriel, \textit{Legal Aspects of Syndicated Loans} (Butterworths, 1986) 85-90.
money has been actually advanced. This means that if the security agreement stipulates some contingency, security cannot automatically attach unless money has been advanced in consideration of the “new” security. On the opposite view, consideration given at the time of the agreement is sufficient to support both the agreement and the security interest. This work accepts the latter view. Consideration given at the time of the agreement is sufficient to support the security interest in after-acquired property. This is supported by cases on enforceability of security in property acquired after commencement of the grantor’s insolvency proceedings but without new funds being injected by the creditor. Authorities suggest that a new asset is caught by the security interest even if it falls into the hands of the grantor after the insolvency proceedings began. The only requirement for this to happen is that the consideration for security must have been executed before the proceedings began.

3 Impact of the character of security on the right to proceeds

When a security agreement contains a derived assets clause extending security to derived assets, it may create one, single security, as we have just seen, if such are the parties intentions. However, it may raise a problem of characterisation of security. It will be remembered from chapter I that security interests in England are either fixed or floating. If assets are in control of the secured creditor, the debtor’s power to deal with them is restricted and the charge is likely to be fixed. If assets

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672 Beale et al, The Law of Security and Title-Based Financing (n 2) para 8.81; C-H Tan, ‘Charges, Contingency and Registration’ (2002) 2 JCLS 191; Stone, (n 670); Goode on Legal Problems of Credit and Security (n 1) para 1-76.
673 Re Reis [1904] 2 KB 769 (CA) affirmed Clough v Samuel [1905] AC 442; Re Lind [1915] 2 Ch 345.
674 Re Collins [1925] Ch 556; Goode on Legal Problems of Credit and Security (n 1) para 2-13.
675 See chapter I section 3.4.A.
are in control of the debtor, who can deal with them without the creditor’s consent, the charge is floating. The focus of this section is not to examine the criterion dividing charges into fixed and floating, which is assumed to be correct, but rather to conceptually analyse the impact of the accepted distinction on the right to proceeds of dispositions. In this chapter we examine rights to proceeds of dispositions that are authorised within the framework of fixed and floating security interests. We will do so by drawing parallels between agency and charges. What we will say here will be important for our understanding of rights to proceeds of unauthorised dispositions, which are discussed in the next chapter.

3.1 Fixed charges over proceeds of authorised dispositions

The purpose of this section is twofold. We first outline the circumstances, in which a fixed character of security is consistent with the debtor’s powers of disposition. We will then examine the nature of the fixed charge from the perspective of the debtor’s powers of disposition and propose to conceptualise the fixed charge as what would be an unorthodox agency with very limited authority to deal and no fiduciary duties. Thus, the second part proposes a new way of rationalising fixed charges in English law. It will also prepare the ground for the analysis of unauthorised dispositions in chapter V.

A. Consent to dispositions (the meaning of authorisation)

For a substitute (a new asset) to be acquired, the original (old asset) must be disposed. Dispositions of charged assets with the consent of the chargee are consistent with a fixed charge. The need for the chargor to obtain consent to dispose is, in turn, a reflection of the chargee’s control over the charged assets. Typically, for the charge to be fixed,
consent must be given for each substitution; blanket consent is not consistent with the fixed character of the charge.678

(a) Requirement of consent to each specific substitution

Following the HL decision in *Spectrum*,679 for a charge to be fixed the chargor must be totally restricted in his dealing with the collateral. Consequently, if assets subject to a fixed charge are to be dealt with and substituted, the chargee must give consent to every substitution.680 It will be recalled from chapter I that Vaughan-Williams LJ held in *Re Yorkshire Woolcombers*681 that withdrawal of an asset from security even with another asset being “substituted more or less for it” is not consistent with a fixed charge. For the charge to be fixed the chargee ought to give consent to every *specific* substitution.682 Giving consent means that the chargee authorises disposition. Consent can only be given if there is a sufficiently specific obligation to substitute. If consent is given, i.e. disposition is authorised, a fixed chargee automatically has a fixed charge over substitutes (i.e. proceeds of authorised dispositions). Thus, in cases of fixed charges a right to substitutes seems to arise as a result of a new agreement between the parties modifying the previous one with respect to every disposal: the parties agree to a new asset becoming subject matter of the already existing charge. The meaning of “specific” is not clear. It is submitted that the degree of specificity will depend on the type of asset involved (tangible or intangible and, if intangible, whether it is any more than a right to obtain value). For example, parties may agree that a particular printing press can be sold and a new one can be purchased of similar technical specifications when the former ceases to print. But it is questionable whether criteria for substitution of intangibles could be any more specific than by referring to the value and type of asset.

679 (n 181).
680 See generally Beale et al, The Law of Security and Title-Based Financing (n 2) paras 6.120-6.127.
681 (n 173) 294 (Vaughan-Williams LJ).
682 Beale et al, The Law of Security and Title-Based Financing (n 2) para 6.121.
What is also problematic is a situation where the chargee gives consent in advance and combines it with the chargor’s obligation to substitute.

(b) Insufficiency of consent given in advance

Following *Spectrum* cases that provided support for the creditor’s ability to give consent in advance to a substitution no longer seem to be good law. Consent given in advance with an obligation to substitute was seen as consistent with a fixed charge on the basis of *Holroyd v Marshall*. It was noted that consent could be given in advance if the criteria for substitution were specific and where there existed an obligation to substitute. This was because the creditor was likely to be seen as having sufficient control of the asset. In *Re Cimex Tissue* it was held that some freedom to deal might not be inconsistent with a floating charge where assets do not fluctuate. In that case an analogy was draw with Bills of Sale Acts 1878 and 1882. According to the Schedule to 1882 Act provision can be made for the maintenance of security, which includes substituted chattels. Substitutions for the purpose of upgrading were also allowed. Substitutions under the Bill of Sale Acts seem to be, however, distinguishable from substitutions under a fixed charge granted by a company, so the analogy, it is suggested, does not hold. The reason for the imposition of the requirement of control by the chargee of a fixed charge is to ensure that the debtor does not deal with the asset and does not sell it to a bona fide purchaser, thus withdrawing it from security. A similar risk is absent in relation to security interests granted under Bills of Sale Acts because of the requirement to register such security in a searchable register.

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683 Ibid. paras 6.120, 6.122.
684 (n 647).
686 See also Beale et al, *The Law of Security and Title-Based Financing* (n 2) para 6.123.
687 The 1882 Act, Sch to s9: “insert terms as to insurance, payment of rent, or otherwise, which the parties may agree to for the maintenance or defeasance of the security.”
688 *Coates v Moore* [1903] 2 KB 140.
689 The 1882 Act, s6(2); *Seed v Bradley* [1894] 1 KB 319.
690 1882 Act, s16: any person can search the register; bills of sales are entered by name, residence and occupation of the grantor. See also 1882 Act, s 11 (where to search).
third party purchaser is then bound by the security so the risk of withdrawal of security does not exist.\textsuperscript{691}

(c) \textbf{Substitution of assets in financial collateral}

In charges over certain types of assets, such as investment portfolios, the chargees are mainly interested in the value of the subject matter being above the value of the outstanding indebtedness.\textsuperscript{692} The chargor will have an obligation to add security if the value of the assets decrease and will have a right to withdraw security if the secured debt decreases or the value of the portfolio increases. Since economic value of the security is the primary concern, the chargee in such cases is not worse off if the chargor has a right to substitute assets within the portfolio so long as the overall value remains above the secured debt. The right of substitution is expressly provided for under Financial Collateral Arrangements (No2) Regulations (FCAR),\textsuperscript{693} which broadly speaking apply to security interests in securities, cash and credit claims. FCAR state as follows:

“any right of the collateral-provider to substitute financial collateral of the same or greater value or withdraw excess financial collateral (...) shall not prevent the financial collateral being in the possession or under control of the collateral-taker”.\textsuperscript{694}

The motivation behind requiring the chargee under FCAR to be in possession or control is to ensure that the chargee is able to resort to sufficient value, not that the assets are to stay exactly the same.\textsuperscript{695} Possession and control under FCAR is understood differently than the

\textsuperscript{691} Bills of Sale Acts contain no express provision on the effect of a registered bill of sale on a purchaser but under s8 of the 1882 Act a bill of sale not registered within 7 days after the execution thereof is rendered void with respect to chattels comprised within it and under s9 of the 1882 Act a bill of sale given by way of security is void unless made in accordance with the form provided. \textit{A contrario}, a bill of sale in the appropriate form and duly registered is not void and binding on the world.

\textsuperscript{692} Beale et al, \textit{The Law of Security and Title-Based Financing} (n 2) para 6.120.

\textsuperscript{693} (n 210); see also Financial Collateral Directive, art2(2).

\textsuperscript{694} FCAR, reg3(1).

\textsuperscript{695} Beale et al, \textit{The Law of Security and Title-Based Financing} (n 2) para 6.126.
control that a fixed chargee must have. 696 Under FCAR the chargee must have a legal right to possession and control and he must have taken practical steps ensuring that the chargor cannot deal with collateral freely. 697 The requirement and meaning of control are controversial. 698 The right to substitute provided under FCAR could be inconsistent with a fixed charge, leading to recharacterisation of financial collateral as a floating charge. Despite the lack of clarity as to the extent in which a floating charge may fall within FCAR, the possibility of recharacterisation is not met with the usual undesirable consequences because registration requirements 699 are disapplied to financial collateral. 700 Thus, even if the charge is recharacterised, there is no risk that it will be void for lack of registration as a floating charge.

B. No-authority agency theory of a fixed charge

Drawing parallels between agency and a fixed charge helps to clarify how dealings with collateral work under a fixed charge and also aids the understanding of claims to proceeds of dealings with assets subject to a fixed charge. We will also use the parallels with agency in discussing the floating charge, which will allow us to see that the mechanism of dealings with assets under a fixed charge and a floating charge is similar. Agency is a relationship between an agent and a principal whereby the agent has authority to bind the principal. 701 This is sometimes expressed in terms of power-liability correlation as the agent has the power to affect the principal’s legal position and the principal is liable to see that his legal position is so altered. 702 This

696 Ibid. para 3.39.
698 See discussion in Ibid. para 3.42. See also recent discussion in Lehman (n 137) (Briggs J).
699 Companies Act 2006, s860.
700 FCAR, reg4. Contrast with the Scottish Law Commission Discussion Paper 151 on Moveable Transactions (2011) para 2.23, which states that floating charges fall outside the scope of the Financial Collateral Directive “because an unregistered floating charge confers on the creditor no ‘control’ over the assets in question”.
702 F Dowrick, 'The Relationship of Principal and Agent' (1954) 17 MLR 24, 37.
section shows that the relationship between the secured creditor and the grantor of security can also be viewed in this way. Fiduciary obligations, characteristic of an agent, should not, however, be imputed into the relationship between the secured creditor and the debtor.

(a) Basic elements of agency

To understand the relationship of the grantor and the holder of non-possessor security we need to distinguish between the power to act and the authority to act. These concepts were shown not to be synonymous in the law of agency. 703

(i) Power to act and authority to act

The distinction between power and authority, originally developed by German jurists in the nineteenth century 704 in the course of development of the modern Civilian approach to the doctrine of agency, influenced thinking of scholars throughout the Common Law world. The original distinction, made by Rudolf von Jhering, between action and competence to act, 705 was taken further and formed the basis for the studies of Paul Laband, who proposed to distinguish between power (Vollmacht) and mandate (Auftrag). 706 Power can be defined as

703 Ibid. 37 fn 69.
704 The difference between acting for other’s behalf but in one’s own name was remarked also earlier see R Pothier, Traité Des Obligations (Paris 1777) I.1.5§4 no 82 (p81).
705 R von Jhering, Mitwirkung Für Fremde Rechtsgeschäfte. Jahrbuch 1 (Fischer, 1857) 313 and R von Jhering, Mitwirkung Für Fremde Rechtsgeschäfte. Jahrbuch 2 (Fischer, 1858) 84 (arguing that mandatary and the agent were two sides of the same legal relation: the relationship between Mandatar and Mandant reflected the internal side whilst the relationship between Stellvertreter and Prinzipal was its external expression; this was a conclusion which Laband disagreed with).
706 P Laband, ‘Die Stellvertretung Bei Dem Abschluß Von Rechtsgeschäften Nach Dem Allgemeinen Deutschen Handelsgesetzbuch’ (1866) 10 Zeitschrift für das Gesamte Handelsrecht 183, 204: “Allein man muß sich darüber klar werden, daß Auftrag und Vollmacht nur zufällig, nicht notwendig zusammen treffen; daß sie keineswegs als die innere und äußere Seite desselben Verhältnisses aufzufassen sind, sondern daß sie zwei an sich verschiedene Verhältnisse sind, die nur tatsächlich in vielen Fällen sich decken.” (One has to be clear here that the mandate and the power may occur together but are not essential for one another; by no means are they to be understood as two sides of the same legal relationship but as two different legal relationships which may actually be covered in many situations; transl. MR). This distinction has been labelled “one of the major achievements of nineteenth century European legal science”, see W Müller-Freienfels, ‘Legal Relations in the Law of Agency: Power of Agency and Commercial Certainty’ (1964) 13 Am J Comp L 193, 196 and see 197-202 (discussing Laband’s doctrine and its impact) and W Müller-Freienfels, ‘Book Reviews of
the ability of an agent to conclude a legal transaction with another, thereby altering legal relations of another; it delineates the sphere of one’s ability to act, irrespective of how it arises. This power exists even if it is inconsistent with the internal directions given to the agent. By contrast, “mandate” refers to the bilateral relationship between the agent and the principal inter se. It comprises the privilege or duty of the agent (A) to act on behalf of the principal (P). It arises not only on the basis of an explicit contract between A and P where A promises to act on behalf of P but it can also be present impliedly as part of other relationships such as employment or partnership, whereby the authority to act on behalf of P is incidental to the relationship between A and P. Authority to act on behalf of a principal can be narrow or wide. The extent of authority depends on express instructions of the principal or the nature of relationship in which it is implied.

It should be noted that in literature the term “authority” is sometimes used to denote what we call here “power to conclude a legal transaction” while “mandate” is used in a sense in which we use “authority”. The terminology preferred here is “power to act” — “authority” instead of “authority” — “mandate”.

(ii) Non-fiduciary agency

The concept of agency is far from uncontroversial. The idea of a non-fiduciary agency may seem a contradiction in terms. Yet an agency without fiduciary duties is conceivable under English law. First, we need to note that in English law agency has been described as (a) a special kind of contract; (b) a fiduciary relation and (c) a grant of authority. The prevailing view is that agency is a fiduciary relation.

707 See also A Corbin, 'The 'Authority' of an Agent - Definition' (1925) 34 Yale L J 788, 794.
708 For agency to arise a contract is not needed; Dowrick (n 702) 26-27.
709 See e.g. Müller-Freienfels, 'Legal Relations in the Law of Agency: Power of Agency and Commercial Certainty' (n 706) 193, 199.
710 Re Hallett's Estate (1880) LR 13 Ch D 696, 709 (Jessel MR); Regal (Hastings) Ltd v Gulliver [1942] 1 All ER 378, 392 (Wright LJ); Bowstead and Reynolds on Agency
Dowrick explains that the doctrine of fiduciary relations historically developed as an extension of the law of trusts.711 Nowadays duties and disabilities of the trustees are imposed on agents by the courts and do not arise as a result of any actual or presumed common intention of the parties. Yet, Dowrick argues, where the parties expressly or impliedly agree that their relationship is to be governed by different rules, the agreement prevails. Dowrick also observes that not every agent is in a fiduciary position vis-à-vis his principal.712 For example, agents appointed to sign a memorandum have no fiduciary duties, as the principal places no particular trust in the agent.713 Another example of this unusual non-fiduciary agency is the receivership, where the receiver, appointed under a debenture714, acts as the company’s agent.715 In such cases it has been perceived that common law offers sufficient protection to the principal with respect to the obligations owed by the agent. This leads Dowrick to conclude that:

“the fiduciary element in agency, though key to much of the law governing this relation, is not the essential element in the relation”.716

What is key to the relationship between the principal and the agent is a power-liability relationship:

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711 Dowrick (n 702) 28 and cases cited there (at fn 20); see e.g. Burdett v Willett (1708) 2 Vern 628, 23 ER 1017; White v Lincoln (1803) 8 Ves 363, 32 ER 395; Burdick v Garrick (1870) LR 5 Ch App 233.
712 Dowrick (n 702) 31.
713 Ibid. 31.
714 Under English law this is now very limited, see n 221.
716 Dowrick (n 702) 32.
“[t]he essential characteristic of an agent is that he is invested with a legal power to alter his principal’s legal relations with this persons: the principal is under correlative liability to his legal relations altered”. 717

This is consistent with what we said above about the distinction between power and authority to act. In the quote the term “legal power” corresponds to what we termed earlier as “authority”: the direction granted by the principal to do an act on behalf on of the principal. We now turn to drawing parallels between agency understood as a grant of authority and non-possessory consensual security interests.

(b) Power to deal of the chargor

Like an agent, to whom title to an asset has been transferred, the grantor of equitable charge or mortgage has power to deal with the asset in the sense that he has ability to act and transfer title to third parties. Both the agent and the grantor have the power to alter another’s legal relations. If the chargor disposes of the legal title to collateral into the hands of a third party for value and without notice of the charge, the chargee’s equitable security is defeated. The chargor has a power to do so but no authority. It may not always be clear where the power to deal with the asset comes from. It will depend on the nature of the security.

(i) Source of the power to deal

In an equitable charge the power to transfer legal title flows from the chargor’s status as a legal owner of the property, or at least a person with a power to dispose of property granted by the owner. The chargee acquires no beneficial ownership.718 If the power to deal with the encumbered asset flows from one’s title to the asset, the next question is whether a mortgagor can also be seen as having a power to deal with mortgaged assets and if so, what is the basis for it.719 The distinction

717 Ibid. 36.
718 Text to n 161.
719 A question recently arose in a corresponding scenario whether a mortgagee has a power to dispose of assets while the mortgagor is performing its obligation: Citibank NA v MBIA Assurance SA [2006] EWHC 3215 (Ch) [43] (Mann J) (it is not inconsistent
between legal and equitable mortgage is important here. A legal mortgage (in the case of personal property) involves a transfer of legal title to the mortgagor subject to an obligation to retransfer asset upon repayment. Although “the mortgagor does not lose dominion over his land”, for as long as mortgage continues the mortgagor cannot transfer legal title twice over. The mortgagor has no power to pass legal title to third parties unless the legal title is re-conveyanced to him prior to dealing with a third party. A possible exception exists under section 24 of the Sale of Goods Act 1979. Under that section a seller in possession may pass legal title to the goods when dealing with a person in good faith and without notice of the previous sale on the basis that the seller is expressly authorised by the owner of the goods to transfer the legal title to the innocent buyer. Although mortgages are excluded from the scope of the Act an argument has been made that the exclusion only applies to two-party contract issues between buyer and seller and not where a third party issue arises in relation to a transfer of title. The policy argument is that there should be no difference between financiers who retain title to goods and who may lose title to good faith third party purchaser who take goods from the buyer in possession under section 25 of Sale of Goods Act and financiers who take a mortgage as security leaving the mortgagor in possession. Although the policy argument is convincing, it seems that the idea of drawing the distinction between two-party cases and three-party cases in order to bring mortgage within the scope of the Act is artificial.

with the nature of the mortgage if parties agree that steps of enforcement can be taken prior to default, from the day of the mortgage, affirmed by CA [2007] EWCA Civ 11, [2007] 1 CLC 113.

720 See Santley v Wilde [1899] 2 Ch 474 (CA). In the case of a mortgage of personal property where mortgage is by an outright transfer, the right to redeem is expressly or impliedly provided for in the mortgage agreement. See also Carter (n 117) 606 (Jessel MR): a legal mortgage involves an actual conveyance of the legal ownership but “the Court has interfered to prevent that from having its full effect, and when the ground of interference is gone by the non-payment of the debt, the Court simply removes the stop it has itself put on.”

721 Re Kingsbury Collieries, Ltd and Moore’s Contract [1907] 2 Ch 259, 261(Kekewich J).

722 Pilcher (n 11).


This is different in the case of a charge or equitable mortgage because the chargor or mortgagor continues to have a power to transfer legal title to third parties precisely because the legal title has not been transferred. A charge or equitable mortgage does not divest the chargor of the power to deal with the asset. For this reason parallels with agency can be drawn in relation to equitable charge (or mortgage) but not legal mortgage. It is important to understand the consequences of the exercise of this power on the holder of security.

(ii) Consequences of the exercise of the power to deal

Lloyd LJ in *Yorkshire Bank Finance Ltd v Mulhall*[^725^] characterised the limits of mortgagor’s and chargor’s ability to deal as follows:

“[the mortgage] needs to be cleared off the title if the mortgagor is to be able to deal with or dispose of the property free of the incumbrance. The same is true of an equitable mortgagee, and of a chargee, whether legal or equitable.”[^726^]

Thus, a mortgagor or chargor cannot exercise their power to dispose other than subject to the security. This means that buyers of collateral should be bound by security. We know this is not the case. Due to the lack of a registration system of all security, third parties cannot always check whether a security interest exists. This puts innocent third party buyers at risk of acquiring an asset with encumbrance without having a chance to learn about security. Such a system necessitates protection of third parties to address this risk. In English law this is done by means of a defence of bona fide purchaser of legal title without notice. Thus, the issue of whether the chargor can confer good title depends not only on the chargor’s title to the asset but also the notice of the third party. In English law where assets are subject to a fixed charge, the purchaser takes free of a charge if he is a bona fide purchaser of legal title without notice of the charge. Notice may exist where charges are publicised

[^726^]: *Yorkshire Bank Finance* (n 725) [27] (Lloyd LJ).
through registration. Where a fixed charge is granted by a company it may need to be registered if it falls within the scope of s860 of the Companies Act 2006.\textsuperscript{727} Purchasers expected to search the register take subject to the charge. It is not clear who is expected to search but a purchaser of an asset fixed enough to be subject to a charge or purchaser of receivables who financed as an outright purchaser would probably be expected to search.\textsuperscript{728} Thus, whilst it may be true that a legal mortgage must be “cleared off the title” if the debtor is to dispose free of the security, it is not so in the case of equitable security. If a third party may take the asset free of the encumbrance, the grantor of security clearly has a power to dispose of the asset free of security. The consequence of the exercise of this power is alteration of the position of the secured creditor, whose interest is extinguished in the asset disposed of. The power to extinguish one’s interest stems from the grantor’s interest in the asset. The exercise of power to deal is thus a matter between the debtor and a buyer. This does not mean that the grantor is \textit{authorised} by the holder of security to dispose of asset free from security.

\textbf{(c) Lack of chargor’s authority to deal}

In a fixed charge debtor’s power to deal is restricted. There is an analogy here with agency because a contract concluded by an agent outside of the agent’s authority may be valid vis-à-vis the third party but implicate the agent in a breach of contract. This depends on the extent of authority given to the grantor to deal with property.

\textsuperscript{727} Under Companies Act 2006 (Part 25 Amendment) Regulations 2013, to come into force on 6\textsuperscript{th} April 2013 (subject to Parliamentary approval), all charges, whether fixed or floating, are registrable (introducing s859A).

\textsuperscript{728} The Companies Act 2006 (Part 25 Amendment) Regulations 2013, to come into force on 6\textsuperscript{th} April 2013, do not clarify the extent of notice. An earlier version of draft regulations included s859R, which proposed that any subsequent chargee would have notice of any matter requiring registration and disclosed on the register. This would have excluded purchasers. A buyer of an asset, whether subject to a fixed or a floating charge, would have been considered to take the asset without notice of the charge. This provision was removed as its effect was rightly seen as controversial and probably wider than originally intended. The Department of Business, Innovation & Skills noted the need for further consultation in this area, explanatory notes for the revised draft regulations’ (January 2013) URN 13/568, available at www.gov.uk (last accessed 27 February 2013).
(i) Nature of the restriction

The grantor of security cannot deal with secured assets free of security. The nature of this restriction, which the secured creditor imposes on the grantor is not that “you cannot deal free from security” but “you ought not deal free from security”. The former would imply that any dealings leading to withdrawal of the asset from security would be ineffective. We know this is not the case because innocent third parties can purchase assets free from security. Third parties have immunity from the creditor’s claims against the asset and, by the same token, the creditor is disabled from resorting to that asset in the hands of an innocent.\(^{279}\) The restriction, which the secured creditor imposes on the grantor is “you ought not deal free from security”. The act of withdrawing the asset from security is valid but it violates internal instructions of the chargee. If the fixed chargee finds out that the chargor is to dispose of the assets without the chargee’s consent, he may apply to the court for an injunction to prevent disposition.\(^{730}\)

(ii) No-authority or limited-authority “agency”

We said above that the debtor has, like an agent, to whom title to an asset has been transferred, a power to deal with the asset in the sense that he has ability to act and to transfer title to third parties. Like an agent, the grantor has *the power to alter another’s* (the principal’s or the security holder’s) *legal relations*. By disposing of collateral to a bona fide purchaser the chargor may deprive the creditor of its security. The *authority* to do so is, however, very limited. Bearing in mind that a fixed chargee is restricted in giving consent to substitutions in advance,\(^{731}\) a fixed charge could be seen as an agency where the chargor has no general authority to deal free of encumbrance. By the same token, the chargor does have authority to deal with the asset subject to encumbrance. The chargee may grant authority to effectuate

\(^{279}\) On the concepts of disability/immunity see Hohfeld (n 4); WN Hohfeld, ‘Fundamental Legal Conceptions as Applied in Judicial Reasoning’ (1917) 26 Yale LJ 710.

\(^{730}\) Gullifer, ‘Will the Law Commission Sink the Floating Charge?’ (n 174) 130.

\(^{731}\) As discussed above, text to nn 683-691.
a specific disposition free of security if it is combined with a specific obligation to substitute. Subject to this, the chargor may be said to have a very limited authority to deal with the originally encumbered asset free of the security (but no general authority to deal free of security). This is different in the case of financial collateral because of the right of substitution under FCAR. The collateral-provider may therefore be seen to have been granted a wider authority to deal than in a fixed charge outside of FCAR. The authority to deal free of security is not general. It is delineated by the criteria of provision of the same or greater value of assets and be relative to the indebtedness.

(d) Charge as an agency without fiduciary duties

We said above that a non-fiduciary agency is conceivable albeit unorthodox. Before we draw a parallel with a non-fiduciary agency and a relationship between the secured creditor and the debtor, a question that ought to be posed is whether fiduciary duties exist, or ought to exist, between the parties and if so, who owes them to whom.

We have seen that the secured creditor sometimes holds property on trust for the debtor: following discharge of the secured obligation the secured creditor holds surplus for the debtor or other secured creditors of the debtor. Even if this means that the secured creditor owes fiduciary duties to the debtor, it is difficult to see that any analogous duties are owed from the debtor to the secured creditor. There is no discussion in cases prior to Buhr v Barclays Bank of fiduciary duties owed by the grantor of security to the secured creditor. The proposition is theoretically viable because it is possible in law to be in a fiduciary position only in respect of some duties owed to another. With this consideration in mind Arden LJ in Buhr v Barclays Bank said that:

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732 See text to nn 712-715.
733 See text to nn 118 (pledge), 151 (mortgage).
734 See text to nn 832-844 for discussion on whether fiduciary relationship is the underlying rationale for the duty to hold the surplus on trust for the mortgagor (and subsequent mortgagees).
735 (n 14).
“the mortgagor has no general duty to act in the interests of the mortgagee. But in the specific matter of accretions to or substitution of the mortgaged property equity has undoubtedly treated the mortgagor as a fiduciary: (see Re Biss [1903] 2 Ch 40).”

The proposition that the mortgagor owes some fiduciary duties to the mortgagee seems to be a development in the existing law, which should not be accepted without a significant debate. We have already discussed in chapter III the secured creditor’s right to accretions. Such a right is not dependent on the mortgagor owing a fiduciary duty to the mortgagee and it is difficult to see that Re Biss suggests otherwise.

It also seems that some arguments could be raised as to why a mortgagor should not be treated as a mortgagee’s fiduciary. It is a well-established rule that a fiduciary is “not allowed to put himself in a position where his interest and his duty conflict”. The relationship between the grantor of security and the secured creditor is one of conflicting interests. As discussed in chapter I, inherent in a secured transaction is the moral hazard posed by the risk of debtor’s “misbehaviour”. Secured transactions are rarely, if at all, mutually interested relations. Of course, one could argue that the creditor, as the principal, consented to this position of conflict between the debtor’s own interest and duty, and so there is no breach of fiduciary duty. If so, why impose a fiduciary duty at all? If we say that the creditor consents to some acts that would otherwise amount to a breach of a fiduciary duty and not others, where should the line be drawn? A

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737 Buhr (n 14) [47].
738 The proposition seems to have been followed without discussion in Dick v Harper [2006] BPIR 20 [40] (Kosmin QC sitting as a Deputy Judge), echoing Arden LJ’s dicta that “Equity treats the mortgagor as owing a fiduciary obligation to the mortgagee in this respect. An equitable chargee has a proprietary interest in the property and this is sufficient to give the mortgagee a proprietary interest in property which represents the property which was mortgaged.”
739 (n 459).
740 Bray v Ford [1896] AC 44 (HL) 51 (Herschell LJ); see also e.g. Parker v McKenna (1874) LR 10 Ch 96, 118 (Lord Cairns LC).
741 See text to nn 69-72.
742 See text to nn 79-82.
disposition free of encumbrance would probably count as a breach of fiduciary duty, but it is less clear how one should treat acts of the debtor regarding the collateral that lead to diminution of value of the collateral, for example where the debtor paints his encumbered car pink, thinking that he is improving its value but a year later pink cars go out of fashion and the market value of the collateral drops. The loss of value of the collateral is sometimes a result of market fluctuations. The question is who should bear the risk of loss in such cases. Making the mortgagor a fiduciary would place this risk on him. The detailed exploration of this issue is outside the scope of this work but it seems that that imposing fiduciary duties on the mortgagor may be going a step too far.

Furthermore, we normally say that a person is a fiduciary in order to impose on them a specific duty to act in a particular way (e.g. fair-dealing) or to impose a prohibition of a certain act (e.g. no self-dealing). In the case of a grantor of a fixed security we already know the scope of the specific prohibition imposed on the chargor: he has no permission to dispose of the asset at all without consent from the chargee. The view accepted in this thesis is therefore that there is no need to resort to the law of fiduciaries because what we are trying to achieve (enable the secured creditor to have a remedy when the chargor disposes without chargee’s consent) can be done without imposing a fiduciary duty on the chargor.

3.2 Rights to proceeds of authorised dispositions of assets under a floating charge

Similarly to a fixed charge, a floating charge can also be conceptualized in power and authority terms. Whilst in a fixed charge, the chargor’s

744 See generally Ibid. ch 7.
745 Tito v Waddell (No 2) [1977] Ch 106.
746 Campbell v Walker (1800) 5 Ves 678, 31 ER 801 (transaction voidable by the beneficiary if trustee purchases trust property); Tito (n 745).
747 We will also suggest in chapter V section 2.2.B that the duties which the mortgagee owes with respect to sale proceeds also need not be characterised in terms of a fiduciary relationship, see in particular text between nn 845-847.
authority to dispose free of security is very limited,\textsuperscript{748} in a floating charge the chargor (the company) has a much wider authority to dispose. A floating chargor is authorised to deal with assets in the ordinary course of business free from the charge. If the chargor then sells as an asset subject to a floating charge in the ordinary course of business, the chargee is bound by the legal action exercised by the person authorised (the company) and the sale binds the chargee.\textsuperscript{749} We have seen that the authority to dispose in the case of a fixed charge must be coupled with an obligation to substitute and that this authority cannot be given in advance.\textsuperscript{750} A right to substitutes arises in such cases on the basis of agreement between the parties, specifically modifying the previous bargain. In floating charge authority is not given specifically to a particular substitution and an obligation to substitute need not be present. Thus, the basis for a right to proceeds of authorised dispositions in the case of a floating charge is less clear. The problem posed in this section is whether a floating chargee (prior to crystallisation) is automatically entitled to proceeds of authorised dispositions and if so, on what basis. Answering this question requires investigation into the nature of the floating charge prior to crystallisation. A number of theories have emerged to deal with this issue.

\textbf{A. Theories of the floating charge}

Theories that have developed can be broadly divided into non-attachment theories and attachment theories, depending on whether the charge is considered to attach to any asset before it crystallises.\textsuperscript{751} They do not specifically refer to the chargee’s right to proceeds but a brief

\textsuperscript{748} The chargor has no general authority to dispose free of encumbrance but the chargee may grant authority specifically to a disposition coupled with a sufficiently specific obligation to substitute (unless the charge falls within FCAR), see text to and following n 731.

\textsuperscript{749} Goode on Commercial Law (n 115) 180, 733.

\textsuperscript{750} Text to nn 683-691.

\textsuperscript{751} Re Panama, New Zealand and Australian Royal Mail Company (1870) 5 Ch App 318 (CA) 322-323 (Giffard LJ): "the moment the company comes to be wound up, and the property has to be realized, that moment the rights of these parties, beyond all question attach".
outline will help to set the background for the rest of the analysis. It should be noted at the start that courts in England appear to be undecided on this point. Although on a number of occasions courts sported the view that the charge is unattached in specie to any asset until crystallisation\textsuperscript{752} and assets are assigned to the chargee on crystallisation,\textsuperscript{753} there are also views from the highest authority approving of the ‘defeasible fixed charge’ theory of the floating charge, which is an attachment theory.\textsuperscript{754}

\textbf{(a) No immediate interest, no attachment}

A floating charge is traditionally seen as not endowing the chargee with any immediate proprietary interest in any asset although the chargee has a present security interest before crystallisation.\textsuperscript{755} This view has been met with some approval in Australia.\textsuperscript{756} The chargor is free to deal with the assets because the charge is unattached. The interest becomes enforceable upon crystallisation but it relates back to the moment the charge was created. At the moment of crystallisation the charge becomes equivalent to a fixed charge. This theory does not explain why a disposition of assets subject to a floating charge outside the ordinary course of business, but still uncrystralised, binds a purchaser with

\textsuperscript{752} \textit{Re Benjamin Cope & Sons Ltd} [1914] 1 Ch 800, 806 (Sargant J); \textit{Agnew} (n 178); \textit{Casslett} (n 110) 509-510 (Millett LJ).

\textsuperscript{753} \textit{Biggerstaff v Rowatt’s Wharf Ltd} [1897] 2 Ch 93 (CA) 106 (Kay LJ); \textit{Evans Rival Granite Quarries Ltd} [1910] 2 KB 979 (CA) 1000 (Buckley LJ); \textit{Rother Iron Works Ltd v Canterbury Precision Engineers Ltd} [1974] QB 1 (CA) 5 (Russell LJ); \textit{Business Computers Ltd v Anglo-African Leasing Ltd} [1977] 2 All ER 741, 745 (Templeman J); \textit{Re ELS Ltd} [1995] Ch 11, 17 (Ferris J).

\textsuperscript{754} \textit{Spectrum} (n 181) [139] (Walker LJ), although this is immediately after Walker LJ also approved the ‘fund’ view of the floating charge (which is seen by some as a non-attachment theory, see text to n 770).


notice (where the disposition is outside the scope of apparent or actual authority). The lack of an immediate property interest does not explain why a floating chargee can appoint an administrator out of court or an administrative receiver in certain cases, both of which will lead to crystallisation of the charge.

An explanation of the floating charge as a power to acquire a persistent right and a fixed charge as an immediate persistent right proposed by McFarlane could also fit under this heading. The term “persistent right” has been coined to depict a right against a specific right held by another, which traditionally is referred to as an equitable property right. The chargor therefore is not under a duty to hold any specific rights as security for its debt owed to the bank.

(b) Immediate interest but unattached

Professor Goode, on the other hand, argues that the chargee has an immediate proprietary interest but not in each and every one of the charged assets but in the fund comprised of the charged assets. This conceptualisation shows that the lack of a chargee’s present ability to exercise rights over assets does not mean that a floating charge is a mere contract to give security at a future date on the occurrence of a designated uncertain event. Equally, however, until crystallisation the charge is unattached since:

“[the creditor] cannot exercise proprietary or possessory rights over the assets either as against the company or as against third parties, nor does he have a locus standi to obtain an injunction

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757 Ibid. paras 6.74, 15.06.
758 Insolvency Act 1986, Sch B1 para 14; Goode on Legal Problems of Credit and Security (n 1) para 4.37.
759 Hubbuck (n 410) (chargee entitled to an interlocutory injunction restraining dispositions other than in the ordinary course of business). For charges created prior to September 2003 or falling within statutory exceptions, Insolvency Act 1986, ss72B-72GA.
760 Goode on Legal Problems of Credit and Security (n 1) paras 4.41-4.42. Appointment of a receiver by the court will also crystallise the charge when the appointment takes effect (at 4.43).
761 McFarlane (n 338) 600.
762 Ibid. 23.
763 Goode on Legal Problems of Credit and Security (n 1) para 4-03.
against the company to restrain dealings with its assets in the ordinary course of business where the dealings are not in breach of the debenture or subject to the creditor’s veto and his security is not in jeopardy”.

Under this theory the charge is said to be an immediate security interest from the moment it is created. Although it does not attach to the encumbered assets, it “affects” them and, in that sense, it is a “present security”. Goode describes such interests as interests in a changeable fund of assets in the sense that the composition of fund changes from time to time but the interest in the fund remains the same. The changeability of the fund is not the charge’s pivotal feature. The hallmark is the freedom to deal. The fund itself may be closed and only reduce when the debtor pays over to the chargee the proceeds of the assets, or the floating charge may be even taken over a single identified asset. What matters is not the content of the fund but the power to deal with the assets contained in it, without the consent of the chargee, so long as the power continues.

The notion of a reified fund as a subject matter of a property right is controversial. Thus, the idea that a floating charge is an immediate proprietary interest in a pool of

764 Ibid. para 4-03, citing Re Borax Co [1901] 1 Ch 326 and Lawrence v West Somerset Mineral Ry Co [1918] 2 Ch 250.
765 Evans (n 753) 999 (Buckley LJ).
766 Goode on Legal Problems of Credit and Security (n 1) para 4-03; see also Yorkshire Woolcombers (n 173) 295 (Romer LJ). It should be borne in mind that fund is deemed to have an existence separate from that of its components.
767 Bond Worth (n 125) 267-268 (Slade J).
768 Spectrum (n 181) [107] (Scott LJ).
769 Goode on Legal Problems of Credit and Security (n 1) para 4-04.
assets and not in any specific asset caused concern among authors who thought that property rights can only be taken in specific assets, not in a fictional pool.

(c) Attached interest prior to crystallisation

Two theories appear to rely on the chargee’s proprietary interest in each of the charged assets throughout the life of the charge, not merely upon crystallisation. When assets are dealt with in an authorised way (in the ordinary course of business) the proprietary interest in the assets is said to be defeated (defeasible charge theory) or overreached (overreaching theory).

(i) Defeasible charge theory

Professor Worthington suggested that a proprietary interest of a floating chargee is the same as that of a fixed chargee, with the same equitable right to protect chargee’s interests, except that it defeases if a charged asset is dealt with in a permitted way. Thus, defeasance occurs whenever, and to the extent that, a third party acquires an interest in the charged asset in a transaction, which falls in the ambit of the chargor’s licence to deal. It seems therefore that on this theory the charge attaches to the assets from the moment of creation. Nolan has raised the following objections to this theory. First, he observes that although defeasance of a charge may explain why the charge ceases to affect an asset, it cannot explain why the chargee, whose rights in that

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771 See also Driver v Broad [1893] 1 QB 744 (CA); Wallace v Evershed [1899] 1 Ch 891; Re Dawson [1915] 1 Ch 626; Government Stock and other Securities Investment Co Ltd v Manila Railway Co Ltd [1897] AC 81 (HL) 86 (Macnaghten LJ); see also Sheehan, 'Property in a Fund, Tracing and Unjust Enrichment' (n 7) 229.


773 Worthington, 'Floating Charges: The Use and Abuse of Doctrinal Analysis' (n 192) 25, 39.

774 See Beale et al, The Law of Security and Title-Based Financing (n 2) para 6.75, who point that the defeasible theory is not consistent with dicta in cases such as Evans (n 753) 999 (Buckley LJ), where the floating charge was held not to attach until crystallisation.

775 Nolan (n 770) 129-130.
asset have been defeated by sale, has then *prima facie* equivalent rights to any substitute for the asset. Second, until a defeasible interest is defeated the floating charge seems to take full effect. Nolan noted that the floating charge defies that because it is not capable of taking a full effect and is not enforceable until it crystallises.

(ii) Overreaching theory

On Nolan’s overreaching theory, accepted by the leading text on Equity, the interest in the hands of the third party is overreached rather than defeated. A floating charge is an interest, which is *ab initio* limited by the immunities of the chargor and successors in title to the chargor’s assets. When the asset is disposed of in the ordinary course of business the disponee acquires good title to the asset, free of the charge, because the chargor had power to dispose of the assets at law with immunity from the action in equity by the chargee and so the disponee is similarly immune. Until crystallisation the chargee cannot exercise his rights of recourse to the assets because his rights are subordinated to the chargor’s power to deal with these assets in the ordinary course of business. The charge attaches to the assets from the moment of creation of the charge, but it is a “weak” attachment because, as Nolan says, it only takes place in the sense that the chargee can have recourse to the assets by way of security, when the charge crystallizes. A significant consequence of Nolan’s approach is that the explanation of the nature of the floating charge as an immediate property interest does not require the fund to be the subject matter of a property right, as suggested by Goode.

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776 Ibid. (n 775) 129.
777 *Snell’s Equity* (n 743) para 40-008.
779 Nolan (n 770) 129.
780 Ibid. 130.
781 Ibid. 130.
782 As described by Beale et al, *The Law of Security and Title-Based Financing* (n 2) para 6.76.
783 Nolan, (n 770) 129.
784 Text to nn 763-765.
The overreaching theory is said to better explain the nature of the floating charge than the defeasibility theory because it avoids the problem of the chargee’s interest being *prima facie* brought to the end upon a disposition to a third party, making it easier to explain why a chargee has *prima facie* rights in the substitute of an asset disposed of by the chargor. It is tempting to say that overreaching is an explanation of the secured creditor’s right to substitutes in a floating charge.\(^{785}\) The doctrine of overreaching explains why a purchaser acquires title to an asset free of charge when the chargor deals with the asset in the ordinary course of business. Yet, it is not clear whether the right to proceed is a necessary corollary of overreaching.\(^ {786}\) We explore the support for the right to substitutes below and suggest that even if overreaching theory is the correct explanation of the floating charge, we ought to be cautious in how the right to substitutes is conceived within that theory.

**B. The source of right to substitutes under a floating charge**

Nolan seems to say that the right to substitutes under an uncrystallised floating charge can be *implied* as an accepted though silent default rule. But he also talks about it as a “principle” that the floating charge automatically covers proceeds of disposition of the original asset:

“The principle that the proceeds of assets comprised in a security form part of that security unless they are released from it by the

\(^{785}\) Overreaching is, however, an explanation for right to substitutes in the context of trusts (and Nolan also uses overreaching to explain trust funds, Nolan, (n 770) 111-117), see C Harpum, ‘Overreaching, Trustees’ Powers and the Reform of the 1925 Legislation’ (1990) CLJ 277, 278: “overreaching is concerned to transfer trusts from the original subject matter of the trust to the actual proceeds after sale”; D Fox, ‘Overreaching’ in P Birks and A Pretto (eds), *Breach of Trust* (Hart, Oxford 2002) 95; C Rickett, ‘Old and New in the Law of Tracing’ in S Degeling and J Edelman (eds), *Equity in Commercial Law* (Lawbook Co, Sydney 2005) 119, 136.

\(^{786}\) Overreaching may take place even where there are no proceeds: in relation to trusts see Harpum (n 785) 282: “The exercise of a power which does not give rise to any capital monies-such as an exchange of land-overreaches just as much as a transaction which does. In other words, overreaching is the process whereby existing interests are subordinated to a later interest or estate created pursuant to a trust or power”, cited with approval in *State Bank of India v Sood* [1997] Ch 276 [281] (Peter Gibson LJ).
terms of the security or by the consent of the person who owns the security."\textsuperscript{787}

Nolan perceives the “principle” as one of two mechanisms of bringing after-acquired property into the scope of the floating charge, the other one being an after-acquired property clause, i.e. a clause stating that the security extends to proceeds, or a class of future assets which later happen to derive from the existing assets. In other words, according to Nolan, proceeds of authorised dispositions are automatically covered by the same floating charge. This is controversial. In \textit{The Law of Security and Title-based Financing} it is suggested that a holder of a floating charge does not always have an automatic right to proceeds of authorised dispositions:

“If an asset subject to a floating charge is disposed of within the permission [given by the charge], the chargor will receive proceeds of the disposition, either in the form of money, or receivables. These proceeds will often fall within the ambit of the floating charge anyway, but if they do not then they will not do so \textit{qua} proceeds, since the disposition was not for the chargee’s benefit but the chargor’s.”\textsuperscript{788}

It is argued in this thesis that the “principle” that would give the floating chargee an automatic right to proceeds as of right does not find support in English law. A preferred view is therefore the latter: that proceeds of authorised dispositions only inure for the benefit of the floating chargee if they are covered by the floating charge. Both points require a more detailed explanation.

\textsuperscript{787} Nolan (n 770) 125.
\textsuperscript{788} Beale et al, \textit{The Law of Security and Title-Based Financing} (n 2) para 15.05; also in the previous edition (H Beale, M Bridge, L Gullifer and E Lomnicka, \textit{The Law of Personal Property Security} (1st edn OUP, 2007) para 13.35; see also Goode on Legal Problems of Credit and Security (n 1) para 1-59 fn 232.
(a) Lack of support for a “principle” that proceeds are automatically captured by a floating charge

(i) Argument from authority

Nolan refers to three cases to support the “principle” that a floating charge automatically covers proceeds: *Barclays Bank Plc v Buhr*, 789 *Wickham v New Brunswick & Canada Railway Company* 790 and *Re Bond Worth Ltd.* 791 It is argued that none of these cases provides support for a “principle” that proceeds of authorised dispositions (dispositions in the ordinary course of business) are automatically covered by a floating charge. If true, it means that the only way for a floating chargee to ensure that proceeds fall within the scope of the floating charge is by way of an after-acquired property clause.

The first case, *Barclays Bank v Buhr*, contains references to a “principle of substitutions and accretions”. The existence of such a “principle” was questioned in chapter III in relation to agreements that are silent as to whether security extends to proceeds. *Barclays Bank v Buhr* itself was a case of an unauthorised disposition in the context of a fixed security. 792 The issue of proceeds of unauthorised dispositions is complex. It is not clear whether just because a sale was unauthorised, the creditor can automatically claim proceeds. We explore claims to proceeds of unauthorised sales in the next chapter. Pre-empting the conclusions reached in chapter V, we may note that it will be suggested that claims to proceeds of unauthorised dispositions are also better explained otherwise than by reference to the “principle”.

The case of *Wickham v New Brunswick & Canada Railway Company* similarly did not concern proceeds of an authorised disposition of collateral. In that case a railway company issued mortgage debentures on, among others, “the undertaking” and “all moneys to arise from the sale of the lands of the Company”. The question was whether the

789 (n 14) [39]-[50] (Arden LJ).
790 (1865-67) LR 1 PC 64.
791 (n 125).
792 See chapter V section 2.1.
debentures created an equitable mortgage on lands of the company. It was held that they did not because parties did not mean to include lands in the word “undertaking”\(^{793}\) As a result, the mortgagees were not able to restrain the sale of the land by judgment creditors and were not able to obtain a title to the proceeds of lands when sold. What seems important, however are the following dicta of Lord Chelmsford:

“if the word “undertaking” would \textit{ex vi termini} contain [lands], the Debenture-holders would not only have been entitled to, but would have had the complete control over, the proceeds of the sales of lands, as the Company could not have sold without their consent, and it would, therefore, have been quite unnecessary to provide specifically for their having the moneys to arise from the sales.”\(^{794}\)

If a debtor is not able to sell an asset without the secured creditor’s consent, this means that the authority to deal with the collateral is restricted and the security interest is likely to be fixed. It seems that what Lord Chelmsford meant was that proceeds of sale would have been covered by security automatically, whether or not there was a clause extending security to proceeds, because he assumed that mortgagees would have only consented to sale subject to an obligation to substitute. Mortgagees can of course also consent to withdrawal of an asset from security without anything being substituted for it\(^{795}\) but then there would have been no asset to claim. If this is a correct reading of these dicta, what Lord Chelmsford says is consistent with our analysis of rights of a fixed chargee to proceeds of an authorised disposition.\(^{796}\)

Finally, \textit{Re Bond Worth} also does not support the point that a floating charge automatically extends to proceeds of authorised dispositions.

\(^{793}\) \textit{Wickham} (n 790) 79 (Chelmsford LJ).
\(^{794}\) \textit{Wickham} (n 790) 79 (Chelmsford LJ).
\(^{795}\) It is within a right of a secured creditor to surrender their security interest and become an unsecured creditor. For a recent example see \textit{Kelly v Inflexion Fund 2 Ltd} [2010] EWHC 2850 (Ch), [2011] BCC 93.
\(^{796}\) Text to n 682.
The case concerned retention of title clause, whereby the seller purported to retain “equitable and beneficial ownership (…) until full payment (…) or until prior resale, in which case [the] beneficial entitlement [would] attach to the proceeds of resale or to the claim for such proceeds”. The floating charge that was held to arise covered proceeds on the basis of this express contractual term. Re Bond Worth cannot therefore provide support for the “principle”, which is meant to apply when the contract is silent as to proceeds. In older cases, as Nolan explains, parties apparently often avoided including the reference to proceeds but understood impliedly that it was contained therein.

(ii) Argument from principle

The main point advanced in this thesis is that rights of a secured creditor to proceeds of dispositions of the original collateral differ depending on whether dispositions were authorised or unauthorised. The right to proceeds is closely linked to the grant of authority to dispose in a fixed charge. The authority to dispose of assets subject to a fixed charge can only be granted if coupled with a specific obligation to substitute or, if the charge falls with FCAR, if the substitution preserves the value of the collateral in a way required by FCAR. In a floating charge the authority is wider. The chargor is given a general authority to dispose free of the charge so long as the dispositions are in the ordinary course of business. For a disposition to be within the authority given by the chargee the chargor need not provide a substitute (by contrast to the fixed charge). The nature of the floating charge does not require that the proceeds of authorised dispositions fall within the charge. Thus, unless the parties agree that the proceeds of an authorised disposition would fall within a floating charge, there is no reason why they should be automatically covered by the charge. The nature of the security is not sufficient to explain the automatic right to substitutes. This seems to be precisely where fixed and floating charges differ.

797 Bond Worth (n 125) (header).
798 Text to nn 692-694.
Beale, Bridge, Gullifer and Lomnicka seem to be saying the same by referring to debtor’s disposals being either for the benefit of the chargee (in a fixed charge) or for the benefit of the chargor (in a floating charge) unless parties decide otherwise.\(^{799}\) This is why a “principle of substitutions” does not exist.

(b) An express or implied bargain as the source of the right to proceeds

It seems that if parties intend for the charge to extend to proceeds of authorised dispositions, they ought to say so in the agreement, whether by way of a proceeds clause or by specifying classes of assets, within which proceeds will fall. It is clear that where parties expressly agree that proceeds are to be covered by a floating charge, the charge extends to proceeds of authorised dispositions (dispositions in the ordinary course of business).\(^{800}\) However, where there is no such express provision it may be possible that one can be implied. Examination of debenture documentation led Nolan to conclude that parties simply often understand that the charge would extend to proceeds of disposition without saying so expressly.\(^{801}\) In practice the difference between an “implied or default rule” and a “principle” may be negligible so long as one can modify both of them contractually. There is a danger, however, that by calling it a “principle” the implied default rule may become a key element defining the nature of a floating charge, which it is not. Terms in contract (in the security agreement) can be implied as a matter of law or as a matter of fact.\(^{802}\) What Nolan suggests seems to fall into the former category. Bearing in mind what we said earlier about the lack of support in case law for the rule that substitutes fall within the floating charge automatically, it is submitted that extension of the floating charge to substitutes could be implied as a matter of fact if the court were to perceive it as the unexpressed

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\(^{799}\) See Beale et al, *The Law of Security and Title-Based Financing* (n 2) para 15.05.

\(^{800}\) *Bond Worth* (n 125).

\(^{801}\) Nolan (n 770) 120-124.

\(^{802}\) *Scally v Southern Health and Social Services Board* [1992] 1 AC 294 (HL) 306-307 (Bridge LJ).
intention of the parties.\textsuperscript{803} It is suggested that the documentation examined by Nolan lacking the term extending the floating charge to substitutes could be understood as comprising a term implied as a matter of fact, so the proceeds could still be said to fall within the ambit of the charge. In other words, as well as on the basis of an express clause, the chargee may have a right to proceeds of authorised dispositions on the basis of an implied after-acquired property clause, not a “principle”. A right to proceeds is not a result of the floating chargee’s interests being overreached in the original asset. It is not correlated with whether or not third party buyers acquire title to the original asset unencumbered.

4 Conclusion

We saw in chapter III that security interests in fruits do not arise automatically by virtue of the secured creditor’s right to the original asset (with some exceptions where the creditor has possession of the original asset). If parties want a security interest to extend to fruits they need to say so in the security agreement. Such clauses take effect as security interests in after-acquired property. Security in an after-acquired asset does not attach until the asset is acquired, at which point it takes effect retrospectively from the moment the security agreement was entered into.\textsuperscript{804} This chapter examined the effect of such clauses, which led us to conclusion that they form not multiple security interests but a single, continuous security that extends to fruits when they arise.

As established in chapter II substitutes and fruits are different because substitutes are generated from an event that affects the original asset, usually a disposition, which is an act by the debtor or within the debtor’s control. This difference led us in chapter III to say that the secured creditor’s rights to substitutes, unlike fruits, necessarily depend


\textsuperscript{804} Lind (n 673).
on the authorised or unauthorised character of the disposition that produced substitutes. The basis for the right to substitutes had to, therefore, incorporate the factor of authority. In this chapter we argued that fixed and floating charges could be conveniently analysed by drawing parallels with agency that was understood as a grant of authority, not as a fiduciary relationship. It was argued that the distinction between power to act and authority to act, inherent in agency, could be useful in construing the analytical framework of fixed and floating charges. The chargor’s power to act stems from his legal title to the asset, or at least from the power to dispose of the legal title granted by the owner. This is different from the chargor’s authority to act. In a fixed charge the chargor has no general authority to dispose of assets free of encumbrance but may be given very limited authority to do so if coupled with a specific obligation to substitute or, if the charge falls with FCAR, if the substitution preserves the value of the collateral in a way required by FCAR.\textsuperscript{805} In a floating charge the authority is wider. The chargor is given general authority to dispose free of the charge so long as dispositions are in the ordinary course of business. For a disposition to be within the authority given by the chargee the floating chargor need not provide a substitute (by contrast to the fixed charge). It was suggested that the floating chargee does not have an automatic right to proceeds of authorised dispositions. The nature of the floating charge does not support this conclusion and the support in case law of such a rule is also questionable. For a floating charge to extend to proceeds of authorised dispositions, the parties must have provided for this in the agreement, so the floating charge in substitutes arise on the basis of an after-acquired property clause in the security agreement, although it is not clear whether such a clause must be express. It seems that it may also be implied. The right to substitutes in a fixed charge also arises on the basis of an agreement between the parties but it cannot be said that it arises on the basis of an after-acquired property clause. If such a clause amounted to chargee’s consent to substitution

\textsuperscript{805} Text to nn 692-694.
given in advance it would not be consistent with a fixed charge. For the fixed charge to arise in proceeds of an authorised disposition the creditor must have granted authority to a specific disposition and it must be coupled with the chargor’s obligation to provide a substitution must be very specific.

Finally, we may note that the analysis of fixed and floating charges proposed in this chapter has shown that the mechanisms of disposals under fixed and floating charge are analogous. Under a fixed charge the chargor has no authority to deal free of security unless the authority is granted specifically and unless it is accompanied by an obligation to substitute. Under a floating charge the chargor has general authority to deal free of security so long as the dealings are in the ordinary course of business, in which case there is no need for substitutes to fall within the scope of the charge unless the parties so agree. In both cases the chargor has a power to deal. If dispositions are outside of the authority, the creditor may have a right to proceeds of such dispositions but this is on a different basis than in the case of authorised dispositions.
CHAPTER V – Secured creditor’s right to proceeds of unauthorised dispositions

1 Introduction

The previous chapter examined security interest in proceeds generated in authorised dispositions. The basis of the secured creditor’s claim to proceeds of such dispositions was the parties’ agreement. The parties agreed that one asset substituted another whilst the same security interest was asserted to the new asset. The present chapter focuses on secured creditor’s proprietary rights to proceeds of unauthorised dispositions. The scope of analysis is therefore restricted threefold by (1) proceeds; (2) unauthorised dispositions and (3) proprietary claims. We need to elaborate on each of these.

First, we are interested in claiming proceeds, not original followed assets. Provided the creditor’s security interest was attached in the disposed asset, the creditor can follow the asset and enforce security interest against purchasers of the followed asset. The exigibility (enforceability) of the security interest in such cases is limited by the protection of good faith purchasers. A purchaser of a legal title may defeat (clear) the secured creditor’s equitable interest if the purchaser is bona fide and without notice of the interest.

Second, only proceeds of unauthorised dispositions are of interest; authorised dispositions were discussed in the previous chapter. In order to say that a disposition is, or is not, unauthorised, the act (the disposition) must be within the sphere of control of the debtor. The debtor must have the power to do the act that generates proceeds. Otherwise it is not possible to say whether or not the debtor had authority to do the act, and so whether the act was authorised or not. For example, payment of a dividend on a share does not count as a
disposition of the share, even if the value of the share were to drop considerably in the process, and so it would be illogical to talk about authorised or unauthorised dividend payment from the perspective of security interest. Thus, the term “unauthorised disposition” refers to any act within the debtor’s power to effectuate, which affects the original collateral but which is not within the authority given by the secured creditor. The chapter covers therefore not only proceeds of unauthorised sale by the debtor but also unauthorised manufacture using the original collateral into a completely new product (specificatio) or incorporating encumbered asset into another asset (accessio). That said, a sale of collateral without authority is treated as the paradigm case of an unauthorised disposition and sale proceeds as the paradigm case of proceeds of such a disposition.

Third, the scope of the chapter is limited to proprietary claims only, thus excluding personal claims to proceeds. By a “personal claim” we mean a claim, which - if successful - gives the secured creditor a remedy enforceable in personam and does not endow the claimant with protection in the defendant’s insolvency.

This chapter seeks answers to two major questions about the extent of the secured creditor’s right to proceeds of unauthorised dispositions: first, does the creditor acquire a new right to such proceeds or does the original security interest persist in the proceeds, and second, if it is a new right, how can this right be proprietary? The first question is asked because it is not clear to what extent the right to proceeds is correlated with the secured creditor’s right to assert the security interest in the followed asset in the hands of a third party. If the right to proceeds of unauthorised disposition is independent from the right to the original asset, the secured creditor ought to be able to assert his security in the proceeds irrespective of his persisting right to the original collateral. If, however, the right to proceeds is the same right as the secured creditor

806 Text to nn 340-342.
807 Text to n 300.
808 Text to n 265.
had in the original collateral, it cannot attach to the proceeds until the right has “detached” from the original collateral. We could explain this by borrowing a fishing line metaphor, which Peter Birks wielded in relation to real subrogation. Where the security agreement covers proceeds of an authorised disposition of the collateral, the security interest could be seen as a fishing line hooking on to proceeds as soon as the originally encumbered asset is disposed of and released off the hook. Where the disposition of collateral is unauthorised, the disposition itself does not release the asset from the hook. The secured creditor still holds the fishing rod with the asset attached to the hook but he may not be able to fish out that asset if the asset is with a bona fide purchaser. The question is whether in order to catch the proceeds of an unauthorised disposition the creditor needs a new fishing rod to hook on to the proceeds or whether he may still use the old fishing rod, even though the parties, in their bargain, did not contemplate that the creditor would do so. The second major question is whether, to continue with the metaphor and assuming that a new rod is needed, the secured creditor is able to use his new fishing rod and fish out the new asset (substitute) with priority to other creditors of the debtor. From the secured creditor’s perspective it would be preferable to assert a proprietary remedy to the proceeds and there may be compelling reasons to do so bearing in mind the rationale of security interests in the original collateral. The prevailing view is that proceeds of unauthorised disposition are held on constructive trust for the creditor. It is not clear, however, what constitutes the basis for this proprietary response. We must show that there is a causative event to warrant such a response.

The questions about the potential new right and its nature are interlinked. There are three potential explanations. First, if the right to the proceeds is the same right as the one in the original collateral (“the same fishing rod hooking on to different assets as they swim past”), the

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810 See chapter 1 section 2.
right to proceeds is clearly proprietary because it is the same right. Second, the right to proceeds could be a new right (“a new fishing rod”) and proprietary because the proprietary right in the collateral was interfered with. Third, the right to proceeds could be a new and a proprietary right arising on the basis of a causative event independent from the interference with property right in the original asset. The area is complex and it is better to state at the beginning that the preferred explanation is the third one with unjust enrichment as a causative event and lack of authority as an unjust factor. This view provides a more coherent analysis of unauthorised dispositions and it is consistent with the analysis of the authorised dispositions. For this explanation to work it is necessary to accept that unjust enrichment can lead to proprietary restitution, a view which is not free from controversy. Those commentators who reject it prefer the second view. The first view is the least tenable one because it amounts to accepting a principle that a security interest in an asset gives an automatic right to substitutes. It was suggested in *Buhr v Barclays Bank* that such an automatic right exists. We begin this chapter by discussion and a critique of the way in which the courts of both instances in that case treated rights to proceeds of an unauthorised disposition. We then go on to discuss the other two views.

### 2 Automatic right to proceeds - *Buhr v Barclays Bank*

The reasoning both by Judge Weeks QC in the first instance and by Lady Justice Arden, who delivered the judgment in the Court of Appeal in *Buhr v Barclays Bank*, 811 is based largely on policy arguments and analogies, which are aimed at showing that the secured creditor’s right to proceeds of unauthorised dispositions is an implicit part of the bargain between the grantor of security and the security holder. Right to proceeds of unauthorised dispositions is thus put on a par with a right to proceeds of collateral expressly bargained for. The creditor

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811 *Buhr* (n 14).
automatically has a right to proceeds of unauthorised disposition by
virtue of his security interest in the original asset, which was disposed
of. This seems to be a different approach to the one adopted in the
House of Lords decision in Foskett v McKeown,812 where trust
beneficiaries were given an election between a co-ownership share of
proceeds and a lien on traceable proceeds of the misappropriated trust
money. We discuss Foskett in greater detail later813 but it is useful to
note now that the election is usually considered to be a power in rem.
Although the nature of such a power is controversial, as seen below, it
is different from an automatic exchange right to proceeds championed
in Buhr v Barclays Bank.

The difference of solutions to the same problem posed in parallel
scenarios in cases decided by higher courts in the same year is hard to
explain. Given that Foskett v McKeown was decided a bare couple of
months before the Court of Appeal decision in Buhr v Barclays Bank, it
is perhaps not surprising to see only a single reference to the House of
Lords decision in Buhr.814 It is more difficult to understand, however,
why Buhr v Barclays Bank is bereft of references to the reasoning of
lower courts in Foskett v McKeown, in particular why it contains no
trace of the debate whether rights to traceable proceeds are based on
vindicatio of property rights or unjust enrichment. Before we embark
on a more detailed analysis of how Buhr v Barclays Bank fits with the
existing judicial and academic discussion of claims to traceable
proceeds, it is convenient to spell out why the disposition in that case
was unauthorised.

2.1 The unauthorised disposition in Buhr v Barclays Bank

Mr and Mrs Buhr executed a charge by way of legal mortgage in favour
of Barclays Bank over their farm, which was unregistered land. This
was a second charge. The bank gave notice of its interest to the first

812 Foskett (n 285).
813 Text to nn 904-906.
814 Buhr (n 14) [25].
mortgagee, UCB Home Loans Corporation Ltd (UCB). Barclays sought to protect the land charge by entry of a Class C(i) as a puisne mortgage under the Land Charges Act 1972.\textsuperscript{815} However, the registration could not take effect as the entry was in a wrong name. The Buhrs later granted an option to purchase the mortgaged property to prospective purchasers. The Buhrs made a proposal to Barclays for an individual voluntary agreement. Barclays Bank understood that it would obtain some repayment from the sale of the farm. The option was later exercised. The solicitors obtained the deeds from UCB and undertook to hold them until the debt to UCB could be discharged from the proceeds. Buhrs admitted to their solicitors that there was a second charge over the farm in favour of Barclays Bank. Buhrs’ solicitors were also informed about this by the purchaser’s solicitors, who noted the incorrect registration of that charge. The sale of the farm took place and the proceeds were paid to the solicitors account in November 1998. UCB was discharged. A balance of £27,500 remained. In January 1999 Mr Buhr went bankrupt. Barclays Bank sought to affirm that it had a proprietary interest in the proceeds of sale and that Buhrs’ solicitors held the money on constructive trust for Barclays, so that it would not have been available to satisfy unsecured creditors of Mr Buhr. Both the High Court and the Court of Appeal, led by Arden LJ, held that a trust existed in the Bank’s favour.

One curious aspect of the case is that factually it appears unclear whether Barclays consented to the sale of the farm free of their security. If they did, the sale would have been authorised and the legal effect would have been arguably different than if the sale was unauthorised. Even if Barclays agreed in the voluntary arrangement to the discharge of the mortgage when the farm was sold, they are unlikely to have agreed not to have an interest in the sale proceeds.\textsuperscript{816}

\textsuperscript{815} Land Charges Act 1972, s2(4). For the purposes of the Act a puisne mortgage is a legal mortgage not protected by a deposit of documents relating to the legal estate affected.

\textsuperscript{816} Cf the rather enigmatic statement by the counsel: “The effect of the sale was to crystallise their contractual obligation to repay Barclays”, \textit{Buhr} (n 14) [21].
is likely that Barclays consented to sale free of its security on the understanding that their interest would carry through to the proceeds so that Barclays would be able to apply them in the discharge of its loan. If this is true, the sale was authorised and either an express trust arose or the charge carried through to the proceeds of the disposition because the parties so agreed. As the facts are inconclusive, we assume, as the courts have done but contrary to one commentator’s view, that the sale of the farm was on the facts unauthorised.

Before examining the reasoning, we need to briefly explain the effect of lack of registration of a land charge in an unregistered land. A class C land charge is void against a third party purchaser if not registered. Lack of registration does not affect the validity of the charge as between the parties to the charge and remains enforceable against certain third parties, in particular the liquidators, trustee in bankruptcy or unsecured creditors. Thus an unregistered land charge in unregistered land remains protected in insolvency of the debtor. If the court ordered the land to be sold before Buhrs managed to sell the farm, the net proceeds of sale would be applied in repayment of the

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817 Buhr (n 14) [45] (Arden LJ): “the disposition by the Buhrs was not authorised: their authority from Barclays to sell the mortgaged property could not extend to selling Rectory Farm in a manner which destroyed Barclay’s security” and [49]: “Buhrs’ disposition was unauthorised. They purported to sell with full title guarantee and thus free from Barclays’ charge”.

818 L McMurtry, ‘The Extent of Security: Sale, Substitutions and Subsequent Mortgages’ (2002) Conv 407, 411 (emphasising that the sale was done with consent from Barclays Bank and could not therefore be treated as a wrongful sale).

819 Land Charges Act 1972, s4(5). See also K Gray and S Gray, Elements of Land Law (5th edn OUP, 2008) para 8.3.5 (noting that the term “purchaser” is defined under LCA 1972, s17(1), as a person, including a mortgagee or lessee, who gives valuable consideration).

820 An equitable chargee has no legal right to possession or legal right of property but can require that the property charged in his favour should be made available to discharge the debt due to him: see e.g. Charnley (n 166) 449-450 (Atkin LJ); Cosslett (n 110) 508 (Millett LJ).

821 By comparison, the sanction for non-registration is more severe under Companies Act 2006, s874 (previously Companies Act 1985, s395(1) and before then Companies Act 1948, s95). A charge registrable under Companies Act 2006, s 860(1), executed but not registered at Companies House is void as against a liquidator and an administrator of the company but not as against the company itself, which means that when a company-charger is wound up and debts payable in liquidation are satisfied, an unregistered charge will continue to encumber the company’s property because the lack of registration does not deprive the chargee of the enforceability of his interest against the company. See Independent Automatic Sales Ltd v Knowles & Foster [1962] 1 WLR 974, header and 979-980 (Buckley J); Buhr (n 14) [36] (Arden LJ).
monies owed to the mortgagees.\textsuperscript{822} Yet the fact that an unregistered land charge remains valid and enforceable against the chargor does not \textit{ipsa facto} explain why the chargee would be able to claim proceeds of sale of a charged asset.

\textbf{2.2 The right to proceeds as an implied bargain (High Court reasoning)}

The arguments accepted by Judge Weeks QC in the first instance were not accepted in the Court of Appeal, although Arden LJ agreed with the High Court as to the outcome.

\textbf{A. Implied clause of conveyance of all estate including proceeds}

An argument was made, and was successful in the High Court, that Buhrs were charging not only the legal estate in the farm but also their equitable interests in the proceeds of sale of the security for the loan.\textsuperscript{823} This argument essentially amounted to saying that a security in interest covers automatically proceeds of an unauthorised disposition. It was based on section 63 Law of Property Act 1925, according to which:

\begin{quote}
\textquote[caption={every conveyance (…) effectual to pass all the estate, right, title, interest, claim and demand which the conveying parties respectively have, in, to, or on the property conveyed”}]{“[e]very conveyance (...) effectual to pass all the estate, right, title, interest, claim and demand which the conveying parties respectively have, in, to, or on the property conveyed”}.
\end{quote}

It covers the passing of benefit of an equity with the land\textsuperscript{824} for example a right to break a lease.\textsuperscript{825} Section 63 LPA 1925 has been applied to protect secured creditors in matrimonial home cases to give effect to a legal charge by creating an equitable charge over the beneficial share in

\begin{footnotes}
\item[822] See argument by the counsel Buhr (n 14) [33].
\item[823] \textit{First National Security v Hegerty} [1985] QB 850.
\item[825] \textit{System Floors Ltd v Ruralpride Ltd} [1995] 1 EGLR 48; \textit{Harbour Estates Ltd v HSBC Bank plc} [2005] Ch 194 (an unusually framed clause allowing the first tenant and only a limited group of assigns, if permitted, to break the lease; the benefit passed to the assignee under s63 LPA 1925).
\end{footnotes}
land of a spouse who sought to create a legal charge. Since this “all estate” clause was not excluded by the Barclays’ charge, Judge Weeks QC accepted that it could also cover proceeds of the unauthorised sale of mortgaged property. Arden LJ rejected the reasoning of the High Court. McMurtry commenting on the case agreed with Arden LJ, arguing that a view that an equitable interest in land is represented by the proceeds of sale could be based on an analogy with a trust for sale whereby the equitable interest of co-owners was in the money, not in land. As McMurtry noted, following the Trusts of Land and Appointments of Trustees Act 1996 trusts for sale were reordered as trusts of land, so the analogy no longer exists and cannot support, if it ever would have supported, the claim to proceeds of sale of land, in which the claimant has an equitable interest other than under a trust.

B. Analogy with a statutory trust of proceeds of sale

Section 105 of the Law of Property Act 1925 provides that the proceeds of sale are to be held under a statutory trust and it states in what order they are to be applied to the discharge of mortgagees’ claims. The provision only applies if it is the mortgagee who sells the property. It has not been explained in the case if a parallel could be drawn between situations where the sale is made by one of the mortgagees and where it is made by the mortgagor. In the Court of Appeal Arden LJ said that relying on the parallel with section 105 LPA 1925 was not necessary because the right to proceeds of unauthorised disposition arose because “the principle of substitution” applied. We examine this “principle” in relation to proceeds of an unauthorised disposition later and we will argue that the “principle” does not exist. The question posed here is

827 Buhr (n 14) [52].
828 McMurtry (n 818) 413.
829 The proceeds are to be applied first to discharge superior mortgages; second, to discharge the claims, including the expenses of the selling mortgagor third, to discharge inferior mortgages of which the selling mortgagor has notice; and finally, any remaining proceeds are to be paid to the mortgagor.
830 Buhr (n 14) [53].
whether the parallel could exist at all and if so, whether it is on the basis of a fiduciary relationship. McMurtry, commenting on the case, seems to have thought that the parallel rested on the presence of a fiduciary relationship and since in McMurtry’s view the mortgagor did not owe any fiduciary duty to the mortgagee, she rejected the analogy. In this section it is argued that parallels between a selling mortgagee and a selling mortgagor could be drawn but with caveats. First, it is suggested that consideration of a fiduciary relationship is irrelevant to the parallel with section 105 LPA 1925. Second, the rationale for the statutory trust in favour of other mortgagees under section 105 LPA 1925 is to protect an already imposed duty of the mortgagee not to sell the property without consent from other mortgagees. In order to understand if the parallel could exist we need to ask whom the provisions of section 105 LPA 1925 are intended to protect and whether the mortgagee (Barclays) could be said to be in a position justifying such protection.

(a) Irrelevance of a fiduciary relationship

It is argued that it is not necessary to show that the selling mortgagee stands in a fiduciary relationship to the mortgagor or mortgagor’s other creditors for the statutory trust to arise. This is by no means obvious because it is not clear to what extent a fiduciary relationship can be said to underlie the rationale of section 105 LPA 1925, and even if it can, whether it justifies any parallel of a fiduciary relationship between the debtor selling the collateral and the secured creditor.

The principle now endorsed in section 105 LPA 1925 was previously found in the Conveyancing Act 1881 and prior to that in case law, of which Banner v Berridge is a good example. Banner v Berridge concerned a claim of a second mortgagee of a steamship against the

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831 McMurtry (n 818) 412.
832 Conveyancing Act 1881, s21(3).
833 (n 151).
834 See also Charles v Jones (1887) LR 35 Ch 544.
835 The action was brought by Banner, who was a trustee of the liquidation of the second mortgagee, who themselves had become insolvent.
first mortgagee Berridge, who had seized and sold the mortgaged vessel when the mortgagor (Lacy) became bankrupt. Kay J held that so long as the surplus of sale proceeds could be ascertained, the enforcing mortgagee held the surplus on constructive trust for the first mortgagee. On the facts, however, the claimant could not prove surplus because the action was only brought six years after the sale. It appears therefore to be settled law that a secured creditor is a fiduciary for the mortgagor and other mortgagees of his debtor. Because of this position the mortgagee has a duty to hold the sale proceeds separately “in such a way as to be fruitful for the benefit of the persons beneficially entitled to it”. The need to keep the scope of fiduciary duties of the mortgagee narrow was recognized early on. Thus, in Quarrell v Beckford it was held that the mortgagee stands in a fiduciary position to the persons entitled to the money only to the extent and in the manner that he holds the surplus of sale proceeds. In Downsview Nominees v First City Corporation it was also stressed that the secured creditor who decides to sell the debtor’s property owes the debtor and subsequent encumbrancers a specific duty to do so in good faith and with reasonable care. This duty, albeit narrow in scope, arises as a result of the debtor’s equity of redemption.

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836 Banner (n 151) 269.
837 Banner (n 151).
838 Similarly, a fiduciary relationship was found to award an interest in equity between pawnee and pawnor in relation to any surplus on the sale of pawned articles: Mathew (n 118) 1462 (Chadwick J); see also Rakestraw (n 454); Knight v Marjoribanks (1849) 2 Mac & G 10, 13-14; 42 ER 4, 5 (Cottenham LC).
839 Charles (n 834) 550 (Kay J).
840 (1816) 1 Madd 269, 56 ER 100.
841 Downsview (n 156) 314-315 (Templeman LJ). The mortgagee is for example obliged to obtain the best price: Cuckmere Brick Co Ltd v Mutual Finance Ltd [1971] Ch 949 (CA); Bishop v Bonham [1988] 1 WLR 742 (CA); Silven Properties Ltd v Royal Bank of Scotland Plc [2003] EWCA Civ 1409, [2004] 1 WLR 997 (as to the limits on what how far the mortgagee is expected to go in reasonably exercising the power of sale); see also Parker Tweedale v Dunbar Bank [1991] Ch 12 (CA); AIB Finance v Debtors [1998] 2 All ER 929; Medforth (n 514) 98-99 (Sir Richard Scott V-C); Mortgage Express v Marden [2004] EWCA Civ 1859; Felix McHugh v Union Bank of Canada [1913] AC 299 (PC) 311 (Lord Moulton).
842 The mortgagee does not owe any general duty of care to the mortgagor, for example with respect to whether or when to exercise a power of sale. For arguments against such a general duty of care, see K Loi, ‘Mortgagees Exercising Power of Sale: Nonfeasance, Privilege, Trusteeship and Duty of Care’ (2010) JBL 576.
If we say that the mortgagee holds the surplus on trust for the mortgagor because he owes fiduciary duties to the mortgagor, there must be a reason why these fiduciary duties are limited to the surplus only, and not in relation to the entire mortgaged asset. If we find a basis for the mortgagee’s “fiduciary duties” relating to surplus, perhaps we can also find a better way to describe such duties than by reference to the term “fiduciary”. It seems that the reason why the mortgagee holds the sale proceeds on trust for the mortgagor is the nature of the mortgagee’s interest. The mortgagee only holds the property for security purposes. Kay J in *Charles v Jones* illustrates the point well:

“[The creditor] takes his mortgage as a security for his debt, but, so soon as he has paid himself what is due, he has no right to be in possession of the estate, or of the balance of the purchase-money. He then holds them, to say the least, for the benefit of somebody else, of a second mortgagee, if there be one, or, if not, of the mortgagor. What, then, is he to do? Surely he has a duty cast upon him. His duty is to say, ‘I have paid my debt: this property which is pledged to me, and in respect of which I now hold this surplus in my hands, is not my property. I desire to get rid of this surplus, and hand it back to the person to whom it belongs’.”

The mortgagee must hold the proceeds for the mortgagor because the mortgagor never consented to the mortgagee having the entire asset over and above the outstanding secured claim. Lack of mortgagor’s consent to the mortgagee having the surplus is the basis for the trust. It is not necessary to make the mortgagee a fiduciary for the mortgagor to make him account for the surplus.

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843 *Charles* (n 834) 549; see also *Banner* (n 151) 262 (Kay J).
844 Foreclosure, where the creditor could take the property in satisfaction of the debt irrespective of its amounts and value of the property, is seen as a “traditional” though now “obsolescent” remedy, see *Cukurova Finance International Ltd v Alfa Telecom Turkey Ltd* [2009] UKPC 19 at [13] (Walker LJ); the mortgagee still has a right to take possession or to sell but he also has duty not to act in a way that unfairly prejudices the mortgagor: *Palk v Mortgage Services Funding* [1993] Ch 330 (CA) 337-338 (Sir Donald Nicholls V-C).
(b) Lack of consent as the triggering factor

The fact that a trust arises on the basis of a lack of consent, rather than presence of a fiduciary relationship, is further supported by the relationship between two mortgagees of the same debtor. If two mortgagees agree that one of them is to sell the mortgaged asset, an express trust of sale proceeds arises in favour of the other.⁸⁴⁵ This situation, where the first mortgagee sells a mortgaged asset with consent from the second mortgagee is different from a situation where a mortgagee sells without the mortgagee’s consent, as was the case in Banner v Berridge. Why does it matter that one of the mortgagees did not consent to the sale by another? Clearly a lack of consent to an action is not legally significant unless the consent was required in the first place. On the facts of Banner v Berridge the requirement of consent was imposed by the Merchant Shipping Act 1854⁸⁴⁶. Where the sale was conducted nevertheless without such consent, it was for the benefit of prior mortgagees and the first mortgagee was consequently a “fiduciary vendor”. In Banner v Berridge the mortgagee was held to be a fiduciary but only insofar as the mortgagee held the surplus of the proceeds of sale and only because the mortgagee was obliged by a statute to obtain consent of the other mortgagee, which he had not done. Therefore, the relationship between the two mortgagees was not inherently fiduciary. It was not the perceived existence of a fiduciary relationship that was the basis for the trust of surplus arising in favour one of the mortgagees. If that is true, and the rationale behind section 105 LPA 1925 and Banner v Berridge is the same, the presence of a fiduciary relationship is irrelevant for a statutory trust of sale proceeds to arise under section 105 LPA 1925.

⁸⁴⁵ Tanner v Heard (1857) 23 Beav 555, 557; 53 ER 219, 219 (Sir Romilly MR): “Being entitled, in the first place, to the amount due on his mortgage and the expenses of the sale of the ship, and there being a surplus, he was bound to account to the Plaintiff in the character of trustee”; (the first mortgagee selling with the consent of the second mortgagee was accountable to the second mortgagee as a trustee). See also Banner (n 151) 262 (Kay J).

⁸⁴⁶ Merchant Shipping Act 1854, s71, which provided that where there were more mortgages than one, any registered mortgagee could exercise a power of sale to enforce the mortgage so long as the enforcing mortgagee obtained the consent (“concurrence”) of the prior mortgagees.
Therefore, section 105 LPA 1925 does not require that the selling mortgagee owes fiduciary duties to other mortgagees and to the mortgagor. To draw a parallel between section 105 LPA 1925 and the selling mortgagors in *Buhr v Barclays Bank* it was not necessary to show that the mortgagor owed any fiduciary duties to the mortgagee. If a parallel is to be drawn we need to show that there was an obligation on the mortgagor to obtain consent of the mortgagee, just like one mortgagee had to obtain consent of another mortgagee under the Merchant Shipping Act 1854 in *Banner v Berridge*. This is consistent with the notion of a fixed charge advanced in this work. A fixed security is security whereby the chargor only undertakes to dispose of charged asset with consent of the chargee and consent must be given specifically for each substitution, not in advance,\(^{847}\) unless the charge falls within FCAR.\(^{848}\) Saying that the mortgagor is a fiduciary when he sells without consent in that respect for the mortgagee is redundant.\(^{849}\)

It follows that an analogy with section 105 LPA 1925 is not necessary to establish that the mortgagor holds proceeds of an unauthorised disposition on trust for the mortgagee. The mortgagee’s claim to proceeds of unauthorised disposition has its own legal basis, which involves the triggering factor of lack of consent. Lack of consent on its own is *not* an event that leads to a legal response. We will show later that it is best to think of it as an unjust factor of lack of authority in establishing the event of an unjust enrichment. In *Buhr v Barclays Bank*, however, Arden LJ rejected the analogy with section 105 LPA 1925 for a different reason. She thought it was because a “principle of substitutions” applies.\(^{850}\) The following section examines why Arden LJ so held.

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\(^{847}\) Text to nn 683-691.  
\(^{848}\) Text to nn 692-700.  
\(^{849}\) For discussion of the mortgagor as a fiduciary see text to nn 732-747.  
\(^{850}\) *Buhr* (n 14) [53].
2.3 The right to proceeds arising as a matter of law (Court of Appeal reasoning)

A. The “principle of substitutions” in unauthorised dispositions

In Arden LJ’s view the right to proceeds of an unauthorised disposition arose on the basis of the chargee’s proprietary right in the original property. Her Ladyship first held that a chargee (or a mortgagee) has a proprietary interest in the asset, thus rejecting an argument made by the counsel that an equitable charge was insufficient to give an interest in land.\(^{851}\) It is undoubtedly correct that a holder of a charge or mortgage has a proprietary interest in the subject matter of the charge.\(^{852}\) Arden LJ went on to say that this proprietary interest in an asset originally subject to the security “is sufficient to give the chargee a proprietary interest in an asset, which represents the property originally mortgaged following completion of an unauthorised disposition by the mortgagor.”\(^{853}\) Arden LJ further held that if the “principle of substitutions (and accretions\(^{854}\))” did not apply, there would have been a “significant lacuna in the law of mortgages”.\(^{855}\) Thus, the chargee would have a right to proceeds of an unauthorised disposition by operation of law, that is by virtue of his or her interest in the original asset. Yet, there is no explanation in the case why this was so or why it was better to explain the chargee’s interest in the proceeds of an unauthorised disposition by virtue of the chargee’s interest in the original property than, for example, by way of reversal of unjust enrichment of the defendant. This section aims to explore the rationale for and evaluate the “principle of substitutions” as an explanation of proceeds of unauthorised disposition.

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\(^{851}\) Buhr (n 14) [47] citing Bland v Ingrams Estate (No 1) [2001] 1 WLR 1638 (CA) 1645 (Nourse LJ) (an equitable chargee obtains a proprietary interest in the property).

\(^{852}\) See above chapter I sections 3.3 and 3.4.

\(^{853}\) Buhr (n 14) [47]

\(^{854}\) The right to accretions was discussed in chapter III section 2.

\(^{855}\) Buhr (n 14) [50].
(a) Rationale for the “principle”

Perhaps it was the appearance of “simplicity and eminent fairness” of the proposition that a mortgagee should be entitled to substitutes as well as accretions to the mortgaged property that appealed. If so, it will be argued that the basis of unjust enrichment promotes fairness to a greater extent than the “principle” explanation because it ensures a better balance of interests of the secured creditor and innocent third party recipients of substitutes enabling the latter to raise the change of position defence if the secured creditor came to claim traceable proceeds from them.

(b) Scope of application of the “principle”

Arden LJ suggests that a mortgagee automatically has a right to substitutes of (and accretions to) the subject matter of the security. The automatic right to substitutes arises purely because a secured creditor has a proprietary interest in an asset. The principle was meant to apply in the same way in the case of the disposition being authorised or unauthorised in the sense that the right to proceeds arises automatically. We explained in chapter III that such a principle does not exist in relation to substitutes and we discussed in chapter IV that if parties wish for the security to extend to substitutes they should say so in the agreement.

Although Arden LJ admitted that a distinction existed between authorised and unauthorised dispositions, this distinction did not seem to be relevant to the secured creditor’s right to substitutes because that right in both authorised and unauthorised dispositions was held to arise in the same way: automatically as a matter of principle. The distinction between authorised and unauthorised disposition only appears to have been relevant in relation to the remedy, not the basis for the right to

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856 Buhr (n 14) [41].
857 See Buhr (n 14) [47] (Arden LJ): “the equitable chargee obtains a proprietary interest in the property (…) This is sufficient to give the mortgagee a proprietary interest in property which represents the property originally mortgaged following completion of an unauthorised disposition by the mortgagor.”
substitutes. It is not clear whether by using the reference to “adoption” of an unauthorised transaction, Arden LJ meant to say that the mortgagee had an election or whether the mortgagee had an immediate right to proceeds. It seems, however, that since the “principle” was meant to apply automatically it applied as an immediate right, analogous to the “exchange product theory” known in the trust context, whereby the beneficiaries’ rights to traceable proceeds were considered to arise automatically.  

B. Explanations of the automatic security interest in substitutes

(a) Fraud prevention

Lara McMurtry, who commented on Buhr v Barclays Bank doubted that the “substitutions and accretions principle” could fully explain the proprietary interest of a mortgagee in the proceeds of sale. Nevertheless, referring to the same section of Fisher & Lightwood on Mortgage as Arden LJ did, McMurtry did not question the existence of the principle and noted that the purpose of these rules was initially to prevent fraud but has later been adapted to promote commercial expediency. In this section we evaluate prevention of fraud as an explanation for the mortgagee’s right to proceeds of unauthorised dispositions. It is argued that prevention of fraud cannot be, if it ever were, a valid justification for secured creditor’s right to proceeds.

First, fraud is based on a proof of wrongdoing and would necessarily require investigation into the state of mind of the grantor of security disposing of collateral. The secured creditor would not be able to claim proceeds of dispositions done innocently even if they were unauthorised, which is an absurd result.

858 For discussion of the “exchange product theory” see text to nn 872-879.
859 McMurtry (n 818) 410.
Second, given that fraud is “brought into play whenever one party has acted unconscionably in exploiting the power to direct the conduct of another which is derived from the relationship between them”, it only makes sense to talk about fraud if the victim was capable of behaving in a way influenced by the exploitation of the power. The victim must have herself done the act that had particular undesirable legal consequences. If another person has done that act whilst the victim remained inactive, then the act itself should be attacked. Thus, it is difficult to say that a secured creditor claiming proceeds of unauthorised disposition of collateral was a victim of fraud because he was not fraudulently influenced to do anything. He did nothing to effectuate the disposition. By disposing of the collateral in an unauthorised way, the grantor of security exploited the power derived from the relationship between the secured creditor and grantor, but he did not exploit the power to direct the conduct of the secured creditor.

If the exploitation of the power (disposition of the collateral) was itself a wrong, then fraudulent or innocent intentions of the disponor should not matter. All that matters is that the disposition occurred and that it was not authorised by the creditor.

Third, if fraud were the basis for a claim there would be no reason why liability of the mortgagor and the corresponding right of the mortgagee would relate to an asset – the proceeds. There is no proprietary restitution for wrongs, although until recently this was contentious.

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862 Etridge (CA) (n 861) 712.
Arden LJ did not herself consider fraud as a basis for the operation of the “principle of substitutions”. What Arden LJ did consider as relevant, however, as mentioned above, was the fiduciary duty owed by the mortgagor to the mortgagee and the retrospective agency imposed on the mortgagor following an unauthorised disposition of the collateral when the mortgagee chose to adopt the transaction. We established earlier that the possible reading of the Arden LJ dicta is that the claim to proceeds arose automatically as a result of a breach of a fiduciary duty. It is this fiduciary duty that we now turn to.

(b) Breach of a fiduciary duty

It is not clear that a mortgagor owes or ought to owe fiduciary duties to the mortgagee. Although the idea that a mortgagor owes fiduciary obligations to the mortgagee is controversial,\textsuperscript{864} for the purposes of this section we will assume that a mortgagor could be a fiduciary because we focus on how Arden LJ understood the relationship between the “principle of substitutions” and the imposition of fiduciary duties on the mortgagor. It is not clear whether the “principle of substitutions” applies \textit{because} the mortgagor owes fiduciary duties to the mortgagee (the fiduciary relationship would be a pre-requisite for the principle to apply) or whether the “principle of substitutions” \textit{is a result} of the existing fiduciary relationship between the mortgagor and the mortgagee. There is very little by way of analysis in the case report.

Arden LJ does not explain why it was important that the mortgagor was a fiduciary with respect to the substituted assets while the “principle of substitutions (and accretions)” applied. Two alternate conjectures can be made: first, the “principle” depends on the existence of a fiduciary relationship; and, second, the “principle” exists independently of the fiduciary relationship. To see what Arden LJ meant to say it is useful to cite the following passage:

“[Once the unauthorised sale took place] Barclays (if indeed it

\textsuperscript{864} See text to nn 732-747.
has already done so by commencing these proceedings) could adopt this transaction and thus retrospectively make the Buhrs its agent. In the context of this transaction, the Buhrs would (…) then be bound to keep the proceeds of sale separate from their other assets and would hold them (subject to prior charges) on trust for Barclays and so would be bound to account to Barclays for the amount secured by its charge”.

If the “principle of substitutions” applies because the mortgagor owes fiduciary duties to the mortgagee the situation resembles the law prior to *Foskett v McKeown*. A fiduciary relationship was a pre-requisite to making the claim. It was at one point clear that a fiduciary relationship must be established before a claim to traceable proceeds could be made but following *Foskett v McKeown* the requirement appears to be redundant.

If Arden LJ meant to say that the fiduciary relationship between the parties enabled the mortgagee to assert a right to proceeds, it is difficult to understand why it was necessary to say that the mortgagor became retrospectively the mortgagee’s agent. As a fiduciary, the mortgagor is liable to account for proceeds; he does not need to be made retrospectively an agent. Imposition of agency retrospectively on the mortgagor makes more sense on a different interpretation of Arden LJ dicta: that the “principle” was meant to apply without there being a fiduciary relationship in the first place, so that the mortgagor never owed any fiduciary duties to the mortgagee and it is only through the application of the “principle” that the mortgagor becomes an agent of the mortgagee and as a result of the retrospective agency, the mortgagor is said to owe fiduciary duties to the mortgagee with respect to substitutes. The position would resemble *Chase Manhattan NA v*

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865 Buhr (n 14) [49].
866 Foskett (n 285).
868 See also Smith, *The Law of Tracing* (n 7) 120-132 (arguing that the pre-requisite of a fiduciary relationship is not relevant to the exercise of tracing but to the ability of the claimant to assert equitable proprietary rights in traceable proceeds).
Israel-British Bank (London) Ltd, where the payment itself was sufficient to give rise to a fiduciary relationship.

Unlike on the latter view, on the former view, which involves a prerequisite of a fiduciary relationship, the “principle of substitutions” is not really a principle. It is simply a right to traceable proceeds of an asset arising because the defendant owed fiduciary duties to the claimant with respect to that asset and because of that fiduciary duty he must account for the traceable proceeds. Neither view explains why a constructive trust of traceable proceeds would be a response to adoption of the unauthorised disposition of an asset in which the mortgagee had a security interest and not a beneficial ownership. Even if the mortgagor were a fiduciary, it does not automatically mean that the Buhrs would hold the proceeds on trust. As Smith noted, duties of good faith imposed by a fiduciary relationship are also found in the trust context as trustees are also fiduciaries but the trust analogy should not be extended too far because fiduciaries only have a duty to account, not to hold property on trust. Moreover, a person cannot acquire greater rights by adopting a transaction, which he did not authorise, than he would have acquired had the same transaction been authorised. A beneficiary of a constructive trust has greater rights to the subject matter of the trust than a secured creditor (mortgagee or chargee) has in relation to the subject matter of charge or mortgage.

Arden LJ seems to be saying, therefore, that (i) a secured creditor is automatically entitled to substitutions and accretions; (ii) because of this automatic right the secured creditor can adopt an unauthorised transaction and (iii) because of the adoption the grantor of security is a fiduciary and holds the proceeds on trust for the secured creditor.

C. Critique of the “principle”

This section critiques the view that a right to proceeds of unauthorised dispositions arises automatically and by operation of law.

(a) Rejection of the “exchange product theory”

Since the “principle” was meant to apply automatically it might have been intended to work on the basis of the “exchange product theory”\(^{871}\), that was thought to have developed in the trust context. If so, we should note that the support for this theory in relation to trusts has been undermined. The authority for the view that a legal owner has an immediate claim to exchange proceeds has been questioned and this view, once prevailing,\(^{872}\) is no longer seen as well-founded.\(^{873}\) Taylor v Plumer,\(^{874}\) traditionally cited as support for “exchange product theory” in the context of legal claims,\(^{875}\) is said to have been decided on equitable principles, and cannot therefore be an authority that a legal owner has an immediate right to traceable proceeds.\(^{876}\) Similarly, a Court of Appeal “exchange product theory” case of Banque Belge pour l’Etranger v Hambrouck\(^{877}\) is seen as better explained in terms of a power in rem to acquire proceeds.\(^{878}\) In a trust context, a beneficiary’s automatic right to proceeds is inconsistent with the beneficiary’s choice\(^{879}\) between an ownership share and lien. Rejection of the

\(^{871}\) For discussion of the “automatic exchange product theory” see further S Worthington, 'Justifying Claims to Secondary Profits' in E Schrage (ed) Unjust Enrichment and the Law of Contract (Kluwer Law International, The Hague, London, New York 2001) 462. Professor Worthington, it should be made clear, was far from adopting that theory, pointing out that there are too many cases where an exchange, even with the intention to deliver title is ineffective.

\(^{872}\) Cave v Cave (1880) 15 Ch D 639. See e.g. W Swadling, ‘A Claim in Restitution?’ (1996) 1 LMCLQ 63; E Bant, 'Ignorance as a Ground for Restitution - Can It Survive?' (1998) LMCLQ 18.


\(^{875}\) Taylor (n 874) 574 (Ellenborough LJ): “no change of that state and form can divest [the property covered with a trust] of such trust”. See also Scott v Surman (1743) Willes 400, 404; 125 ER 1235, 1239 per Lord Willes CJ “the thing produced ought to follow the nature of the thing out of which it is produced” (although this did not apply to money since money was not distinguishable), cited with authority recently in Triffit Nurseries (a Firm) v Salads Etcetera Ltd (in administrative receivership) [2001] BCC 457, 461 (Robert Walker LJ).


\(^{877}\) [1921] 1 KB 321.

\(^{878}\) Khurshid and Matthews (n 876).

\(^{879}\) Foskett (n 285) 131 (Lord Millet); Hallett’s Estate (n 710) 709 (Sir George Jessel MR).
“exchange product theory” means that the claim to proceeds must be restitutionary.

(b) Absence of a fiduciary duty

We already questioned above the view that that the grantor of security could owe fiduciary duties to the secured creditor.\footnote{See text to nn 732-747.} If the “fiduciary duty” is so limited in scope as to say that the mortgagor is obliged to account to the mortgagee for the proceeds of an unauthorised disposition then there are better ways of explaining this than by way of a fiduciary duty. The imposition of a fiduciary duty on a mortgagor does not by itself ensure a proprietary response (i.e. it does not necessarily lead to imposition of a constructive trust). Crucially, a person is liable for a benefit \textit{because} they are fiduciaries, not vice versa.\footnote{Although this seems to be the reasoning adopted by Arden LJ, who seems to have thought that because a “principle of substitutions and accretions” operated the debtor became a fiduciary for the creditor, see text following n 870.} McMurtry was right to say that if the mortgagee was found in a vulnerable position, it was due to its lack of care in dealing with the Buhrs not because of any “inherent weakness of its position as holder of a security interest”.\footnote{McMurtry (n 818) 412.}

(c) Adoption of an unauthorised transaction

Arden LJ said that as a result of the mortgagee’s adoption of the unauthorised disposition the mortgagor holds the proceeds on constructive trust for the mortgagee. We do not discuss here whether a constructive trust is the appropriate remedy.\footnote{This is discussed below, see text to nn 1029-1057.} What we question now is whether a mortgagee can ever be said to have a right to proceeds by adopting a transaction. The language of “adoption” of a transaction stems from the doctrine of ratification of an act performed without authority by an agent in the name of the principal.\footnote{Munday (n 701) para 6.01.} In \textit{Bowstead & Reynolds on Agency} we read that:

\begin{quote}
“Ratification (…) involves the idea that in certain circumstances
\end{quote}
a person can by expression of will adopt a transaction entered into by another on his behalf on which he is not liable or entitled so as to become liable and/or entitled as if he had made it at the time."  

The would-be principal may ratify a transaction effected in his name by another because that other person either (i) exceeds his actual or apparent authority or any other authority conferred by operation of law, or (ii) was never employed by as the principal’s agent in the first place. It is argued that the parallel with the doctrine of ratification is insufficient to explain the rights to proceeds an unauthorised disposition.

(i) Insufficiency of the parallel with ratification of an agent’s unauthorised act

First, the debtor makes disposition of an encumbered asset in his own name, not in the name of the secured creditor. The debtor is the one with the power to dispose of the asset. That power does not stem from the security holder’s right to the asset. It stems from the debtor’s title to the asset. The secured creditor is seen as a principal only in a very narrow sense: the secured creditor’s right to the asset merely limits the debtor in disposing of the asset free of security. The debtor therefore lacks general authority to dispose of the asset free of security.

Second, only a disposition, of which we can say that it is unauthorised, can be adopted. Here the relevant transaction is the transfer of the originally encumbered asset free of security without the secured creditor’s consent. In agency law the doctrine of ratification is normally justified on the basis of what the parties originally intended.

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885 Bowstead and Reynolds on Agency (n 701) para 2-050.
886 Munday (n 701) para 6.01.
887 See chapter IV section 3.1.B(b).
888 See text to nn 718-722.
889 See Yona International Ltd v Law Réunion Française SA [1996] 2 Lloyd’s Rep 84, 106 (Moore-Bick J): “The essence of ratification is a decision by the principal to adopt the unauthorized act as his own”.
890 Munday (n 701) para 6.02.
Adoption of a transaction makes it authorised *ab initio*. A person who ratifies an act of his agent is usually “seeking to *extend* his rights”. Therefore, in order to establish what the secured creditor would obtain if he were to adopt the unauthorised transaction, we must first examine in what position the secured creditor would have been had the transaction been authorised. This question was explored in the previous chapter. We concluded that an authorised disposition necessarily leads to extension of the same security interest to proceeds in cases of a fixed charge, but for the substitution to be consistent with a fixed charge (other than a charge falling under FCAR) the chargee must have consented to the specific substitution and the debtor must have had a specific obligation to substitute. Authorised dispositions also lead to extension of the same security to proceeds in the case of a floating charge if proceeds, or a class of assets which proceeds fall into, are covered by a security agreement expressly or impliedly (which they are likely to be). If an authorised disposition is to withdraw an asset from security, adoption of an unauthorised disposition would mean the secured creditor antecedently agreed to the disposition free of security. An authorised disposition can of course also lead to the security interest being enforceable against a new party – the transferee – but a secured creditor cannot adopt an unauthorised transaction by enforcing a security interest against a third party if the third party can raise a defence clearing the asset of a security interest. But, by analogy to agency law, a principal is restricted in ratifying an

891 *Koenigsblatt v Sweet* [1923] 2 Ch 314, 325 (Lord Sterndale MR); *Wilson v Tumman and Fretson* (1843) 6 M & G 236, 242 (Tindal CJ) (adoption of an unauthorised act by the principal results in a situation as if the act had been antecedently authorised); *Bird v Brown* (1850) 4 Exch 786, 154 ER 1433.


893 Such cases of fixed charges with substitution are rare because of the likelihood of recharacterisation as floating charges.

894 See chapter IV section 3.1.A.

895 See text to n 800.

896 If a third party cannot raise a defence that clears the asset of a security interest, the secured creditor can still follow the original collateral and assert a security interest in it.
act that would constitute an unfair prejudice to third parties. 897

There are problems, however, with explaining rights to proceeds through an adoption of an unauthorised disposition. In a fixed charge the right to proceeds explained by adoption of an unauthorised disposition does not seem to be consistent with the character of the charge as fixed. It is true that for the disposition to be authorised the secured creditor must give consent to specific disposition. However, there must also be an obligation to substitute. This is not for the creditor to allow but for the debtor to undertake. By ratification the creditor cannot, it seems, impose an obligation on the debtor to substitute. Furthermore, if the chargee gained a right to a substitute by adopting the unauthorised disposition this could be seen as giving consent retrospectively to a disposition free of security and would be similar to giving consent in advance to a disposition. If so, the result would not be consistent with a fixed charge where the creditor must give consent to each specific substitution.

Ratification of unauthorised dispositions in the case of a floating charge also poses problems because of the possibility that an unauthorised disposition might automatically crystallise the charge. 898 If a disposition without authority from the creditor (e.g. outside of the ordinary course of business) crystallises a floating charge, the chargee can only assert a right to proceeds by adopting the disposition if adopting the transaction automatically decrystallises the charge. A charge agreement may contain a clause that the charge can be decrystallised in a unilateral act.

897 Bowstead and Reynolds on Agency (n 701) para 2-087 citing Lord Audley v Pollard (1597) Cro Eliz 561; see also The Owners of the 'Borvigilant' [2003] 2 Lloyd’s Rep 520 [70] (Clarke LJ): “ratification is not effective where to permit it would unfairly prejudice a third party”; Smith v Henniker-Major & Co [2003] Ch 182 [71] (Robert Walker LJ). The strongest example of exception to ability of a principal to ratify concerns property rights: Bolton Partners v Lambert (1889) 41 Ch D 295, 307: “an estate once vested cannot be divested by the doctrine of ratification”; Bird (n 891) cf consideration of that case in Keighley Maxstead & v Durant [1901] AC 240 (HL) 247-249 (Macnaghten LJ); see also Bowstead and Reynolds on Agency (n 701) para 2-089. This area of agency law is, however, complex and controversial. See generally Munday (n 701) para 6.36; C Tan, 'The Principle in Bird v Brown Revisited' (2001) 117 LQR 626, 630-634

898 Beale et al, The Law of Security and Title-Based Financing (n 2) para 6.84.
such notice given by the chargee.\textsuperscript{899} It is conceivable that an act constituting adoption of an unauthorised disposition could also be a notice of decrystallisation, in which case the chargee would end up with the same floating charge over the proceeds. Decrystallisation is, however, controversial.\textsuperscript{900} If by adopting the disposition the creditor cannot cause a crystallised charge to decrystallise, the creditor also cannot extend the rights to proceeds, which she otherwise would have had if the charge did not crystallised (i.e. adoption would not lead to a right to proceeds and the creditor would need to claim them as proceeds of authorised disposition). In cases where an unauthorised disposition does not automatically crystallise a floating charge, the creditor may adopt the disposition and extend the floating charge to proceeds of unauthorised disposition so long as she would have had a floating charge over proceeds if disposition was authorised. Whether a floating chargee automatically has a floating charge over proceeds is not a question of overreaching but – as was argued in the previous chapter – of an express or implied term, and is not inherent in the nature of the floating charge.\textsuperscript{901}

Ratification does not seem to explain the right to proceeds of an unauthorised disposition. In \textit{Buhr v Barclays Bank} the security was fixed. Although Barclays Bank could be seen to retrospectively grant authority to the disposition free of security, it seems that they could not, due to the fixed character of security, impose an obligation to acquire a substitute by way of ratification. Therefore, Barclays Bank could not be said to claim proceeds as a result of adoption (ratification) of the unauthorised sale of collateral.

\textbf{(ii) Power in rem or election}

Assuming that there are cases, where a secured creditor may claim

\textsuperscript{899} Ibid. para 6.88 citing \textit{Covacich v Riordan} [1994] 2 NZLR 502 (NZ HC).
\textsuperscript{900} R Grantham, 'Refloating a Floating Charge' (1997) CFILR 53; C Tan, 'Automatic Crystallization, De-Crystallization and Convertability of Charges' (1998) CFILR 41 (both suggesting that once crystallised, a fixed charge cannot turn into a floating charge).
\textsuperscript{901} Text to n 800.
proceeds by adopting an unauthorised transaction, a question arises whether the right arises automatically or not. The support for the view that the right to traceable proceeds arises automatically\(^902\) has been questioned as already mentioned.\(^903\) Moreover, if the claim were to arise automatically the number of assets subject to the original title would be multiplied by the number of proceeds resulting from unauthorised transactions. The claimant would own all these assets \textit{prima facie} so in order to prevent her from recovering more than once the law would need to find a mechanism of refusing the claimant the ownership (problem of geometrical multiplication).\(^904\) There are two ways of explaining why the claimant’s right to proceeds does not arise automatically upon the unauthorised disposition: a power or an election.\(^905\) If we say that the claimant has a “power”, we indicate that he has no right to the proceeds from the moment of the substitution and it is only by somehow asserting the claim that he acquires the right to proceeds.\(^906\) By contrast, if we say that the claimant has an “election” (a view preferred, for example, by Professor Smith) this means that the claimant already holds rights in the traceable proceeds from the moment of substitution and so he may pick between claiming proceeds and the original asset.\(^907\) This would be similar to an election by an innocent party to a breach of contract between treating the contract as discharged or continuing.\(^908\) Whether the claimant has an “election” or a “power” depends on whether we think the claimant (here: the secured

\(^{902}\) Cave (n 872); with respect to legal claims to traceable assets see nn 874-875.

\(^{903}\) See n 876.

\(^{904}\) See Smith, \textit{The Law of Tracing}\ (n 7) 358-361; Worthington, 'Justifying Claims to Secondary Profits' (n 871) 462.

\(^{905}\) Smith, \textit{The Law of Tracing}\ (n 7) 380 (pointing out that this is a way of dealing with the problem of ‘geometrical multiplication’ of claims).

\(^{906}\) Ibid. 380.

\(^{907}\) Ibid. 380. There are in fact two kinds of election: between different kinds of assets (traceable proceeds and original asset) and between personal and proprietary claims, as Professor Smith pointed out (Smith, \textit{The Law of Tracing}\ (n 7) 375-383). We are not interested here in the latter election because we are not interested in establishing personal claims. As stated at the beginning, the purpose of this chapter is to establish a proprietary claim to proceeds, which would be aimed at preserving the proprietary bargain the creditor made when a security interest was created.

\(^{908}\) Photo Production Ltd v Securicor Transport Ltd [1980] AC 827 (HL), 849 (Diplock LJ); election as part of the general contract law – see Ultraframe (UK) Ltd v Fielding [2005] EWHC 1638 (Ch) [1417].
The creditor) has a claim to proceeds arising from the moment of unauthorised disposition of the collateral or not. The issue of “election” or “power” is secondary. The first and foremost issue is when the right to proceeds is thought to arise. The rights, which the claimant holds in the substitutes from the moment of substitution, are easier to explain if we accept the rei vindicatio basis for the claim.

Following the unauthorised disposition the secured creditor could choose to adopt the unauthorised transaction or not. If the parallel with agency is consequently to be drawn, adoption of the transaction ought to put the parties in a situation they would have been had the transaction been authorised ab initio. But ratification only gets us at most to the point where the creditor authorises disposition of the old asset free of security. It cannot explain the acquisition of the new asset by the debtor.

3 A new right to proceeds of unauthorised dispositions

Claims to traceable proceeds raise numerous problems in general law, not just in relation to secured transactions. The difficulties can be roughly divided into two groups. The first is the legal basis, or theoretical justification, for such claims. The issue is not purely of academic interest. The results may differ in practice depending on which justification of such claims is accepted. Moreover, a rationalization of the conflicting case-law would improve the certainty of law in this area. The second issue, inevitably intertwined with the first one, is whether the claims are proprietary, to what extent they are proprietary and what their nature is. These questions have been widely explored in the context of misappropriation of trust property by a trustee but less so in the case of dispositions of property encumbered with a security interest. Parallels can be drawn between security interests and a beneficiary’s interest in trust property. A beneficiary’s interest under a trust can be seen as a proprietary interest in the

909 See Goode on Legal Problems of Credit and Security (n 1) para 1-60.
individual assets within the trust fund.\textsuperscript{910} This is controversial\textsuperscript{911} but we assume so here. A secured creditor’s right, whether under a mortgage or a charge, can also be seen as a property right in individual asset where the charge is fixed but it is controversial to say so of a floating charge prior to crystallisation. For the purposes of this work, a more useful way of thinking of a floating charge is as a charge with authority to deal and of a fixed charge as an interest in property removing from the grantor of security the authority to deal with the asset, as was suggested in the previous chapter.\textsuperscript{912} Assets encumbered with a security interest, just like trust assets, are held by another (a trustee, a chargor) who has a power to dispose of them. Unlike a trustee, a chargor under a fixed charge is not to exercise this power. He is not to invest or otherwise manage the property if managing involves dispositions. A chargor’s position resembles most closely the position of a trustee under a bare trust since the obligation of the latter is limited to merely holding the property.\textsuperscript{913} The difference between a charge and any type of trust is that in the latter the property right holder is a beneficial owner. A chargee is not. He only has an equitable interest in the property. Even a mortgagee, who holds legal or equitable title to property, does not have the beneficial ownership of an asset that a beneficiary does. A mortgagee only holds title to the property insofar as he may resort to it to discharge the secured debt when the debtor defaults; his title is in a sense contingent on a condition subsequent, the condition being the non-discharge of the obligation by the debtor.\textsuperscript{914} Despite these differences between the nature of a trust interest and a security interest, parallels with beneficiary’s claims to traceable proceeds will help us shed light on secured creditor’s claims to proceeds.

\textsuperscript{910} Nolan (n 770); Sheehan, ‘Property in a Fund, Tracing and Unjust Enrichment’ (n 7).
\textsuperscript{911} For a view that a beneficiary has a property right in the reified fund, not individual assets, see Penner, ‘Value, Property and Unjust Enrichment: Trusts of Traceable Proceeds’ (n 770). For a view that the beneficiary has a right against the trustee’s right (so-called “persistent” right) see McFarlane (n 338).
\textsuperscript{912} See Chapter IV section 3.1.B.
\textsuperscript{914} See also text to 147.
The discussion on proceeds is necessarily limited and outside of its scope are some important questions such as whether it is logically and conceptually possible that a right *in rem* is an event giving rise to other rights, or whether a right *in rem* itself can only be a response to other events such as unjust enrichment.\(^{915}\) Associated with these difficulties is the question about the nature of tracing, which we do not explore here. The prevailing view is accepted here, namely that tracing is neither a claim nor a remedy.\(^{916}\) The contrary view, questioning tracing as a neutral process disassociated from the proprietary claim,\(^{917}\) is not followed.

### 3.1 Debate over the legal basis of a new right

The question that we now address is why a creditor who has a security interest in asset 1 should have a property interest in asset 2 if asset 2 is an identifiable substitute of asset 1. There are two major explanations, discussed primarily in a trust context.

#### A. Unjust enrichment and *vindicatio* as the primary sources of the new right

Rights contingent on tracing are said to arise either to reverse unjust enrichment of the defendant\(^ {918}\) or as a vindication of existing property

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\(^{915}\) See the debate between e.g. R Grantham and C Rickett, 'Property Rights as a Legally Significant Event' (2003) CLJ 717 (arguing that property is an event) and P Birks, 'Receipt' in P Birks and A Pretto (eds), *Breach of Trust* (Hart Publishing, Oxford 2002) 216-222; P Birks, 'Property, Unjust Enrichment and Tracing' (2001) 54 CLP 231 (arguing that property is a response). For refinement of Grantham and Rickett’s thesis see L Smith, 'Unjust Enrichment, Property and the Structure of Trusts' (2000) 116 LQR 412, 412, 421-422 (instead of treating property as the event, he suggests that it is the 'non-wrongful interference with property rights' that is the event).

\(^{916}\) *Foskett* (n 285) 128-129 (Millett LJ quoting Smith, *The Law of Tracing* (n 7) 120-130, 277-289, 342-347; the issue of whether or not there are two separate rules)


\(^{918}\) Birks, *Unjust Enrichment* (n 809) 35; Birks, 'Receipt' (n 915) 216-222; P Birks, 'On Taking Seriously the Difference between Tracing and Claiming' (1997) 11 Trust Law
interest in the original asset (as proprietary restitutionary claims). Some authors have also suggested a third basis for claiming, based on wrongs, whilst others have altogether denied a need for a doctrinal justification for the claims based on tracing. However, it seems that the last two views have not gained much support in practice or academia, so we shall focus our analysis on the first two. The skeleton of the unjust enrichment explanation of beneficiary’s claims to traceable proceeds is as follows. A claimant has a new proprietary


921 Such as wrong of misappropriation, or a wrongful interference; WH Kelke, An Epitome of Leading Cases in Equity (3rd edn Sweet&Maxwell, London 1913) 22. For a recent revival see Worthington, 'Justifying Claims to Secondary Profits' (n 871) 451, 455 (rejecting property and unjust enrichment analyses). If the basis were to be the law of tort, the claimant would need to show that they suffered a loss that the defendant is under a duty to compensate. See S Hedley, Restitution: Its Division and Ordering (Sweet&Maxwell, London 2001) 150-153 (comparing different causes of action); Chambers (n 918) 265-279. Cf Smith, 'Transfers' (rejecting the "wrongs" basis).

922 Rickett (n 785) 138 considering tracing rules to be simply just arbitrary problem solvers, without any doctrinal explanation.

923 This is based on the summary in Smith, 'Unravelling Proprietary Restitution' (n 918) 327-328.
interest in the traceable proceeds, which did not exist before the disposition. The new interest must have a source. Consent or a wrong are not suitable sources, leaving unjust enrichment and a category of “miscellany”. Unjust enrichment fits as an explanation since the trustee is enriched unless a new interest arises; the beneficiary is disenriched because of the misappropriation of the trust property, even though there is no transfer in the normal sense; and the enrichment is unjust. By contrast, the proponents of the vindicatio explanation begin with the premise that the law protects property, understood widely to include all assets in one’s patrimony. One of the methods of that protection is by giving rights in substitutes. The source of new right is, therefore, the interference with the defendant’s property rights. On either explanation, it is accepted that the beneficiary has an election or a power, which he must exercise before a proprietary right in the substitute is granted. This means that a right to a new asset is not immediate in the sense that it does not arise automatically upon disposition.

B. Distinction between unjust enrichment and vindicatio view

The distinction between the unjust enrichment view and the vindicatio view is not purely academic. Choosing one over another has an impact on what the claimant must prove, what defences the defendant may raise and how robust the claimant’s claim is vis-à-vis third parties. On the rei vindicatio view the claimant’s right to traceable proceeds flows from the property right he holds in the original asset. While a claimant on the vindicatio view must show that he had a property right

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924 In a trust context this was so decided in Foskett (n 285) where the claimant was given an election between a beneficial co-ownership share and a lien.  
925 See Penner, The Law of Trusts (n 873) para 11.132.  
926 See, however, P Jaffey, The Nature and Scope of Restitution. Vitiated Transfers, Imputed Contracts and Disgorgement (Hart, Oxford 2000) 300 (suggesting that once it is agreed that the claim is a power in rem very little turns on classifying the claim as based on property law or unjust enrichment).  
927 This appears to be contrary to Cave (n 872).  
928 This is the so-called “automatic exchange product” theory; see Worthington, ‘Justifying Claims to Secondary Profits’ (n 871) 462. Professor Worthington, it should be made clear, was far from adopting that theory, pointing out that there are too many cases where an exchange, even with the intention to deliver title is ineffective. For rejection of this theory see text to nn 872-879.  
929 Foskett (n 285) 129 (Millett LJ).
to an asset and that the asset in the hands of the defendant is the traceable proceeds of the original asset, on the unjust enrichment view the claimant must show that the defendant has been enriched at his expense and that the enrichment was unjust. If unjust enrichment is the explanation, the defendant (other than the trustee or the chargor) may raise a change of position defence. If the defence is understood as based on disenrichment, it is not likely to be available on the *vindicatio* view because the claimant is not disenriched as the title was not transferred. Although it has been suggested that change of position may arise even on the *vindicatio* view, as it protects defendant’s reasonable reliance interest, the prevailing view seems to be that the third party defendant (i.e. other than the chargor or the trustee) would be left only with the defence of a bona fide purchaser of legal title to the proceeds without notice. That defence – if successful – will clear the asset of the claimant’s title. If the purchaser is of equitable title, the person who had equitable interest in the asset first prevails.

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931 Foskett (n 285) 108 (Browne-Wilkinson), 127 (Millett LJ).
932 Millett, 'Proprietary Restitution' (n 919) 318; W Swadling, *The Limits of Restitutionary Claims: A Comparative Analysis* (UKNCL, BIICL, 1997) 79 showing that these two defences perform two different functions; P Millett, 'Restitution and Constructive Trusts' (1998) 114 LQR 399, 409 agreeing with W Swadling and revoking his previous view that the bona fide purchaser defence is a paradigm change of position defence in P Millett, 'Tracing the Proceeds of Fraud' (1991) 107 LQR 71, 82.
933 Smith, 'Unravelling Proprietary Restitution' (n 918) 331.
934 The issue of “bona fides” is separate from “without notice” although if the defendant had notice, there is no need to consider whether he was in good faith: Nelson v Larholt [1948] 1 KB 339; *Midland Bank Trust Co Ltd v Green* [1981] AC 513, 528 (Wilberforce LJ), also noted in Dietrich and Ridge, (n 917) 53 fn 35.
935 Foskett (n 285) 129; Millett, 'Proprietary Restitution' (n 919) 309, 315.
936 See generally Cloutte v Storey [1911] 1 Ch 18 (CA) 31 (Farwell LJ): “a purchaser for value without notice but without the legal title can only rely on such equitable defences as are open to purchasers without the legal title who are subsequent in time against prior equitable titles”. See also Meagher, Heydon and Leeming *Meagher, Gummow & Lehane's Equity Doctrines and Remedies* (n 715) 339: “There is no general doctrine of “bona fide purchaser of an equitable estate for value without notice””. See also Dietrich and Ridge (n 917) 54.
3.2 Inadequacy of the *vindicatio* view

It is argued that the *rei vindicatio* explanation is not consistent with the view of non-possessory security interests advanced in this work and that the secured creditor’s right to proceeds of unauthorised disposition should be based on unjust enrichment. It is not clear to whether the *vindicatio* view could be consistent with the view expressed above that adoption of an unauthorised disposition may be insufficient to explain the right to proceeds.\(^{937}\) Moreover, as Virgo says, a claimant wishing to vindicate his proprietary rights must show that the defendant received an asset, in which the claimant has an interest, either legal or equitable.\(^{938}\) The true difficulty rests with determining that the claimant still has his proprietary interest in the transformed new asset. This step is controversial in the context of owners, whether legal or equitable, and it is even more difficult in the context of secured creditors, as we shall see. We begin by looking at cases seen as supporting the view of *vindicatio* justifications of rights to traceable proceeds. It will be seen that considerations supporting the *vindicatio* view are either not likely to apply in the context of security interests or they are better seen as authority for unjust enrichment view.

**A. Reasons based on authorities for *rei vindicatio* view**

(a) Cases where the claimant remains equitable owner

The seminal case on claims to traceable proceeds is *Foskett v McKeown*.\(^{939}\) It arose in the context of beneficiaries’ claims following misappropriation of trust property. It will be recalled that a trustee (Murphy) held money on trust for a number of purchasers of land. Murphy breached the trust by paying £20,000 trust money for two out of five premiums towards his own life insurance (fourth and fifth premiums). After Murphy’s suicide the insurers paid to the trustees of the policy monies (about £1m) as the death benefit held for the benefit

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937 See text to nn 887-901.
939 *Foskett* (n 285).
of the policy beneficiaries – Murphy’s children. The purchasers claimed the proceeds of the policy. The question was whether they were entitled to a beneficial co-ownership share (which amounted to about £500k) of the insurance proceeds proportionate to their contribution to the money used to pay insurance premiums, or merely to a lien on the proceeds of the policy for the amount of money paid as premiums (£20k). The Court of Appeal held by majority\(^{941}\) that the beneficiaries could only claim a lien on the proceeds of the policy, but the House of Lords, by a bare majority, decided they had an election between the proportionate share and a lien. Lord Millett famously rejected the unjust enrichment explanation in favour of the property law basis but he did so by focusing on reasons why unjust enrichment justification does not work, not why interference with property law does work.

(b) The authority involving legal title

Cases, where the claimant purportedly retains legal title to the asset are more difficult than the trust beneficiary cases because, unlike with *Foskett v McKeown*, it is not clear on what legal basis they were decided. *Lipkin Gorman (a firm) v Karpnale*\(^{942}\) is a case of primary interest here. In *Lipkin Gorman (a firm) v Karpnale* a partner in a claimant firm of solicitors misappropriated client money, which he gambled away at the defendant’s casino. The claimant brought a restitutionary claim to recover the value of money received by the defendant. Although the House of Lords agreed that all restitutionary claims are based on unjust enrichment\(^{943}\) it has been argued that the term “unjust enrichment” has only been used in the broadest,

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\(^{940}\) This was after they obtained already a compensation from the bank from whose accounts the money had been misappropriated.

\(^{941}\) [1998] Ch 265 (Sir Richard Scott V-C, Hobhouse LJ; Morritt LJ dissenting): purchasers were entitled only insofar as they could trace their money into the premiums.

\(^{942}\) [1991] 2 AC 548 (HL).

\(^{943}\) See e.g. *Lipkin* (n 942) 572 (Goff LJ).
descriptive sense and that the true basis was *vindicatio*.\textsuperscript{944} Since the House of Lords did not identify the elements of the defendant’s unjust enrichment it can be argued that the ground for restitution was the *vindicatio* of property rights if it can be shown that the claimant firm retained title to cash.\textsuperscript{945} Both Lord Goff and Lord Templeman spoke of the claimant’s continuing proprietary interest in the money from the moment it was stolen by the partner until its traceable proceeds were received by the defendant.\textsuperscript{946} This interpretation of *Lipkin Gorman* prevailed in *Armstrong DLW GmbH v Winnington Networks Ltd.*\textsuperscript{947} Morris QC sitting as a deputy judge held that the firm had legal title to cash, thus characterizing the case as one of proprietary restitution but not unjust enrichment.

However, this interpretation overlooks Lord Goff’s reliance\textsuperscript{948} on two Privy Council decisions,\textsuperscript{949} according to which where a partner draws on partnership account without authority, he alone and not the partnership obtains legal title to the money so obtained. Sheehan\textsuperscript{950} rightly argued that what the firm had was a legal power to re-vest title in the money, akin to cases of rescission of contracts for fraud.

\textsuperscript{944} Virgo, *The Principles of the Law of Restitution* (n 919) 13 and 571 (finding it ironic that a case, which in his view has nothing to do with unjust enrichment, stands as authority for its recognition in English law); cf E McKendrick, ‘Restitution, Misdirected Funds and Change of Position’ (1992) 55 MLR 377; P Birks, ‘The English Recognition of Unjust Enrichment’ (1991) LMCLQ 473.
\textsuperscript{945} Virgo, *The Principles of the Law of Restitution* (n 919) 13. See also L Smith, ‘Simplifying Claims to Traceable Proceeds’ (2009) 125 LQR 338, 341 and 348 (arguing that the firm had a “strange innominate interest”, behaving like the beneficial interest in a trust and concluding that this interest must have been a legal interest since the claim was a common law claim in money had and received, and that the claim was a common law claim to vindicate equitable interest under a trust, not a proprietary common law claim to traceable proceeds of unauthorised disposition).
\textsuperscript{946} Lipkin (n 942) 560 (Lord Templeman), 572 (Lord Goff).
\textsuperscript{947} [2012] EWHC 10 (Ch), [2012] 3 All ER 425; Morris QC also held that *FC Jones v Jones* [1997] Ch 159 was further support for this proprietary restitutionary claim. For further support see the interpretation of *Macmillan v Bishopsgate Investment Trust plc* (No 3) (CA) [1996] 1 WLR 387 (see in particular Auld LJ at 409 seeing unjust enrichment as difficult to find) by G Virgo, ‘Reconstrucing the Law of Restitution’ (1996) 10 TLI 20 and Swadling, ‘A Claim in Restitution?’ (n 872); Virgo, *The Principles of the Law of Restitution* (n 919) 12.
\textsuperscript{948} Lipkin (n 942) 573 (Lord Goff).
\textsuperscript{949} Union Bank of Australia Ltd v McClintock [1922] 1 AC 240 (PC) and Commercial Banking Co of Sydney Ltd v Mann [1961] AC 1 (PC).
This argument, it is suggested, can be further strengthened. Lord Goff said that the “difficulty” posed by the Privy Council authority could be surmounted by viewing the cash in the bank account as a species of legal property.\(^{951}\) When a bank account is in credit the bank is the account holder’s debtor with respect to the amount represented by the bank balance. This does not raise problems. But then Lord Goff said:

> “since the debt was enforceable at common law, the chose in action was legal property belonging to the solicitors at common law. There is (...) no reason why the solicitors should not be able to trace their property at common law in that chose in action (...) into its product, i.e. cash drawn by Cass from their client account”.\(^{952}\)

The error committed in this reasoning is the divorcing of legal title from the subject matter of the title (the legal property – the debt). The debt in the account was enforceable at common law by the firm so long as the bank owed the sum to the firm. The debt was the firm’s property (the firm “owned” the debt) in the sense that the firm was able to transfer the debt to third parties, so that the bank would owe the debt to a third party. Debt owed by a bank is a chose in action. When Cass drew on the client account the debt owed by the bank to the firm was reduced. The bank cannot be said to owe the withdrawn sum to the firm. The firm therefore did not own the money withdrawn by Cass because Cass had power to draw on the account. It was not correct to extrapolate the legal title to the property so until the firm exercised their power to assert legal title to the traced money, the firm had no legal title to it. To support the solicitors’ right to trace their property Lord Goff cited _Marsh v Keating_.\(^{953}\) It is suggested that this case ought to be distinguished because Cass, unlike Fauntleroy in _Marsh v Keating_, had

\(^{951}\) _Lipkin_ (n 942) 573-574 (Lord Goff).

\(^{952}\) _Lipkin_ (n 942) 574 (Lord Goff).

\(^{953}\) (1834) 1 Bing (NC) 198 (HL), 131 ER 1094.
power (ability) to draw on the account (but no authority). Fauntleroy forged Mrs Keating’s signature so she did not confer on him power to transfer her share in the stock. The legal title to money in Lipkin Gorman vested in Cass and the case is better explained by a power to vest legal title by the firm.

A parallel can be drawn between Cass withdrawing cash from the firm’s client account with power to do so (but no authority) and a debtor disposing of his asset encumbered with a security interest. The debtor selling an encumbered asset, just like a solicitor drawing on an account, has the power to dispose of the asset but their authority to do so may be limited. In the case of a fixed charge, as we have seen in chapter IV, authority to deal is very limited. If Lipkin Gorman can be explained in terms of an unjust enrichment claim with the unjust fact of lack of authority, a similar claim must be available where a secured creditor sues the debtor who disposed of an asset within his power to dispose but in breach of the granted authority.

**B. Argument from principle**

Birks accepted that when the claimant seeks to recover an asset that belonged to her from the start, i.e. an asset to which she has title, the claim falls within the law of property. However, when the claimant seeks to recover a different asset than the one which originally belonged to the claimant, she must first show a right to it. Birks said that this cannot take place by a mere assertion of a property right to the traceable proceeds but requires a separate cause of action - unjust enrichment of the defendant.

We could say that the concept of ownership comprises, among its various incidents, also the right to retransfer property or its traceable proceeds when the exercise of the power to transfer was flawed in some way. This is in fact Peter Jaffey’s argument. He says that unjust

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954 We have seen a parallel split between power to dispose and authority earlier, see text to nn 706-707.
955 See text below n 731.
956 Birks, Unjust Enrichment (n 809) 33-36
enrichment can be dispensed with because the claims that purport to be made in unjust enrichment can be subsumed to other areas of law. If an asset belonged to the claimant, Jaffey argues:

“it is implicit in his or her right of ownership that he or she should be able to recover the money (or its value) from anyone who received it other than through a valid exercise of his or her power as owner to transfer it”. 957

Jaffey’s argument depends on a premise that issues of transferability and modes of acquisition of property are part of property law. As a result, the questions of consequences of mistransfers are also within the ambit of property law. A counterargument was put forward by Klimchuk, who said that including among the incidents of ownership the rules that govern the consequence of mistransfer “overburdens the concept of ownership”. 958 This is because the concept of ownership would have to include the effects of mistransfer of ownership rather than mistransfer of the asset itself. Exclusion of others from interference with the asset is the essence of ownership. An owner, whose asset was mistransferred ought to be able to recover the asset or obtain some other a remedy for the mistransfer. It does not necessarily follow that the owner ought to be able to recover the ownership of the asset automatically, as Jaffey seems to suggest. It seems that if Jaffey’s argument were to be correct, an owner whose asset had been mistransferred would prima facie be able to recover it from anyone on the basis of exercise of his power to recover, rather than by way of making a claim. This would arguably leave the state of the defence of a bona fide purchaser of legal title uncertain because there would be no reason why a bona fide purchaser should be able to raise a defence against the exercise of a power by the owner. No third party would be able to show that they are purchasers of legal title if ownership of every

957 P Jaffey, ‘Two Theories of Unjust Enrichment’ in J Neyers, M McInnes and S Pitel (eds), Understanding Unjust Enrichment (Hart, Oxford 2004) 139, 147.
958 D Klimchuk, ‘The Scope and Structure of Unjust Enrichment’ (2007) 57 U Toronto LJ 795, 804 fn 25, indicating also that Lionel Smith expressed the view that it seems be asking too much of the concept of ownership.
asset mistransferred asset fell with the transferor. Moreover, Honoré who famously listed a number of incidents of ownership did not include a right to retransfer among them. Honoré’s list of incidents concerns the thing, not rights to the thing. Honoré does of course talk about protection of ownership. He lists as one of the attributes of ownership the right to security of possession or ownership (right to prevent others from use of the asset). This incident, however does not go as far as Jaffey’s argument that ownership encompasses the right to retransfer the thing or the thing’s value.

Penner also argues that a right to give (right to transfer) is part of property rights. Unlike Jaffey, Penner argues that a power to sell (with sale being one of the main modes of conveyance of property) exists because people have the power to make contracts to exploit our resources, including property rights. Sheehan agrees that the right to sale is dependent on the right to contract. It must be true that a power to sell cannot exist without a right to contract. A comparative law argument could be added. In civilian jurisdictions transfers of property in sales or exchanges are always considered in the context of contracts to sell or to exchange. Even if transfer of property is seen as separate and independent from contract, like in German law, it cannot take place without a contract of sale having taken place. In French law, on the other hand, property is considered to pass solo consensu, so contract and conveyance are one act but with clearly distinguishable effects in contract law and property law. We will also draw on this

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959 Honoré, ‘Ownership’ (n 4) 108.
961 Ibid. 91-92.
962 D Sheehan, ‘The Property Principle and the Structure of Unjust Enrichment’ (2011) RLR 138, 152 (noting that this argument does not depend on accepting Penner’s justification for property so it can be accepted even if Penner’s justification for property is thought to give insufficient weight to policy or instrumental concerns).
963 In German law the act of conveyance and act of contract to convey are two separate acts (this is known as the Trennungsprinzip); the separation of the acts opens door to discussion whether conveyance depends on contract. German law views the two acts as separate – Abstraktionsprinzip.
964 French law accepts the principle of “consensualism”, which means that the property is transferred solo consensu, without an act of conveyance.
point later in our analysis when we discuss the inability of the secured creditor to have a power to dispose of (sell) encumbered asset without having the right to contract to sell that asset.

If a power to sell were not to be inherent in a property right to an asset, *a maiori ad minus*, consequences of the exercise of power to sell also cannot be a part of it.⁹⁶⁶ Chambers builds on this his argument that even if rights based on tracing were inherently part of the right of ownership, that would not make them continuing rights.⁹⁶⁷ Another event must cause these rights to arise.

(a) The defendant’s gain of an unencumbered title

This point was discussed in relation to mistaken payments in relation to the so-called liability mistake, where the claimant paid a sum of money to the defendant because he had mistakenly thought he owed it. It has been noted that in relation to such mistaken payments unjust enrichment explanation is indispensable. The claimant makes a claim not to an asset that belongs to him but to the value realised by the defendant when the asset transferred became the defendant’s property.⁹⁶⁸ The heart of the unjust enrichment claim is that the defendant has gained the title to the asset, not that the defendant has received value without the transfer of asset. Similar considerations apply to claims by a secured creditor to proceeds of unauthorised dispositions. Title to the original asset passes to a third party. That transfer is not vitiated but it is nevertheless “defective” because it was conducted without authority from the secured creditor. When the claimant-secured creditor makes a claim to the value realised by the defendant he complains that the defendant gained unencumbered title to the asset.

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⁹⁶⁶ See also Sheehan, ‘The Property Principle and the Structure of Unjust Enrichment’ (n 962) 151: “[on Penner’s view] property does not justify sale, even if it justifies other ways to exploit the resource”; Chambers (n 918) 277: “ownership of an asset does not include ownership of any proceeds of sale of that asset”.
⁹⁶⁷ Chambers (n 918) 277-278.
⁹⁶⁸ Klimchuk (n 958) 804.
(b) Inability to adopt what cannot have been authorised

If a right to proceeds of an unauthorised disposition arises by virtue of a property right (rei vindicatio basis), it must also be true that the claimant would have a right to proceeds of an authorised disposition unless he agreed to forego that right. If a person entitled to a property right in the original asset does not have a right to proceeds of authorised dispositions unless he contracts for that right, that person cannot similarly have a right to proceeds just because the disposition is unauthorised disposition. The distinction therefore concerns the scope of property rights. Some property rights are limited by their nature. The limitation might concern the scope of the powers over the asset or the type of assets. A secured creditor does not have a right to resort to proceeds of authorised dispositions unless he bargains for it. He does not have a right to proceeds without the bargain. Any right to proceeds outside of that bargain cannot arise on the basis of the very property right he bargained for. This seems to be more straightforward in the case of the floating charge because the holder of a floating charge does not have a right to proceeds unless there is an express or implied bargain that proceeds fall within the scope of the charge, although this is controversial. The mechanism of claiming proceeds in a fixed charge is more complex. A fixed chargee only has a right to proceeds if the chargor undertakes an obligation to substitute collateral specifically unless the charge falls within FCAR. It is questionable, as suggested above, whether acquisition of a right to proceeds by adoption of an unauthorised disposition of assets subject to a fixed charge would be consistent with the fixed character of the charge.

969 See text to nn 791-797.
970 See text to nn 679-683.
971 See text to nn 692-700.
972 See text to nn 887-901.
3.3 Unjust enrichment as the basis for the new right

It is useful to begin this section by addressing some of the fundamental issues raised by Lord Millett’s analysis in *Foskett v McKeown*. Lord Millett is seen as expressing a clear preference for vindication view as the legal basis for claims contingent on tracing. He said:

“the transmission of property rights from one asset to its traceable proceeds is part of our law of property, not the law of unjust enrichment.”

There are difficulties with this statement. First, property law and unjust enrichment are not mutually exclusive concepts in some authors’ views. Second, if unjust enrichment can lead to a proprietary response it is not necessarily because the unjust factor is “want of title”. A proprietary response may be justified on other grounds. The first difficulty leads to the analysis of the relationship between “property law” and “unjust enrichment”. There are some general considerations which we need to address first before discussing the unjust factor problem.

A. Proprietary response to an unjust enrichment event

(a) Argument from principle

This is a well-known Birksian argument. To say that a right is a “property right” refers to a kind of right, whilst unjust enrichment is a source of rights. There are different sources of rights (“events”), which apart from unjust enrichment include also consent, wrongs and

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973 *Foskett* (n 285) 119, see also 127, 132; similarly Lord Browne-Wilkinson 108-109, also at 110: “this windfall is enjoyed because of the rights which the purchasers enjoy under the law of property”; Lord Hoffmann at 115; Lord Steyn (in the minority) rejected unjust enrichment because he did not think that the payment of premiums constituted enrichment – at 112; Lord Hope thought it was not shown that the misappropriated money contributed to any extent to, or increased the value of, the amount paid out by the insurers as death benefit – at 122.

974 Birks, *Unjust Enrichment* (n 809).

975 Birks, 'Property, Unjust Enrichment and Tracing' (n 915) 238-241; Birks, 'Property and Unjust Enrichment: Categorical Truths' (n 918) 627-628; Smith, 'Unjust Enrichment, Property and the Structure of Trusts' (n 915) 413; Chambers (n 918) 265.

other events. “Responses” to these events are rights realisable in court and can be either personal (exigible in personam) or proprietary (rights in rem). To say that restitution is “proprietary” merely points to the response being a proprietary right but says nothing about its source. The controversial statement is that the event of unjust enrichment can attract either personal or a proprietary response (i.e. trigger either rights in personam or in rem). This view has been advocated by Birks, who said that personal or proprietary response was a matter of choice or policy, not logic. Civilian jurisdictions opted for a personal response to the event of unjust enrichment. Swadling said it was preferable for English law to follow suit.

Virgo, however, argued that property rights can never arise from unjust enrichment. Lord Millett was clearly influenced by Virgo’s view when juxtaposing property law and unjust enrichment. Virgo’s point raises a fundamental question that cannot be comprehensively addressed in this thesis. The extent of the debate over this point in England suggests that it is far from clear that Virgo is correct. We proceed on the assumption that Birksian view is correct so that, as a matter of logic, a secured creditor can assert a right in rem to traceable proceeds of an unauthorised disposition of collateral by the debtor as a response to unjust enrichment. The next question is, however, whether there are any policy arguments for adopting a proprietary rather than a personal response.

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977 Ibid. 33; P Birks, 'Equity in the Modern Law: An Exercise in Taxonomy' (1996) 26 Univ of Western Australia L Rev 1; Birks, 'Property, Unjust Enrichment and Tracing' (n 915).
978 Birks, Unjust Enrichment (n 809) 28.
980 Swadling, 'Property and Unjust Enrichment' (n 919).
981 Virgo, The Principles of the Law of Restitution (n 919) 11-12 and ch 20, especially 569-574.
(b) Policy arguments for a proprietary response to unjust enrichment

As already mentioned, Birks viewed a proprietary response to unjust enrichment as a matter of choice. Choices in law are often made for policy reasons and should not be made lightly.\(^983\) The State decides whether a particular consequence of a legal rule is preferable. The question is essentially one of a competition of claims between the unjust enrichment claimant and other creditors of the defendant. For obvious reasons the outcome of the competition becomes particularly relevant in the defendant’s insolvency. The arguments advanced in favour of proprietary protection of unjust enrichment claimants have been encountered before in the context of protection of certain categories of unsecured creditors, such as tort claimants.\(^984\) It is useful to reiterate these arguments here.\(^985\)

Unjust enrichment claimants have no opportunity to bargain for a stronger position.\(^986\) The enrichment in the insolvent’s estate represents an undeserved windfall to other creditors\(^987\) and so unjust enrichment claimants ought to occupy a position analogous to secured creditors.\(^988\) Swadling argued forcefully against the courts’ acceptance of policy arguments for a number of reasons, first, because the defendant’s insolvency is not the only area on which proprietary awards have

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\(^984\) See text to nn 88-100.

\(^985\) Also summarised in Swadling, 'Policy Arguments for Proprietary Restitution' (n 979) 507.


\(^987\) Birks, *Unjust Enrichment* (n 809) 181. This argument is also made by saying that the assets of the defendant become 'swollen'. Cf E Sherwin, 'Constructive Trusts in Bankruptcy' (1989) U of Ill LR 297, 317 (arguing that a proprietary should only be made if the competing creditors were unjustly enriched); A Kull, 'Rationalising Restitution' (1995) 83 Cal LR 1191, 1217.

\(^988\) Or possibly better position than secured creditors so that they would take prior to secured creditors rather than share *pax passu* with the secured creditors. See A Burrows, *The Law of Restitution* (2nd edn Butterworths, London 2002) 70-72 (only unjust enrichment claimants who can demonstrate analogy with secured creditors can obtain a proprietary award).
impact; second, because it is for the legislature to decide what policy should be. There is no reason, Swadling says, why unjust enrichment creditors should be given priority before other categories of unsecured creditors such as tort claimants. Thus, creditors who have an opportunity to bargain for protection in debtor’s insolvency, but do not take it, should be barred from proprietary rights. These arguments do not apply, however, in relation to the secured creditor’s right to proceeds.

A secured creditor, who makes an unjust enrichment claim to traceable proceeds of unauthorised substitution, deserves proprietary response precisely because he bargained for priority above other categories of creditors of the debtor and of any other third party who would hold the asset subject to the creditor’s original interest. He purposfully bargained to shield himself from the risk of non-payment of the problems of moral hazard, which the debtor poses. He agreed with the grantor of security that he would resort to an asset to discharge debt owed to him with priority to other creditors. A security interest is a measure of protection against the debtor’s non-payment. That measure would be worthless if the debtor (or a third party grantor) could single-handedly destroy the security by disposing of the asset in an unauthorised way, for example by transferring to a bona fide purchaser of legal title without giving the secured creditor a proprietary response. Thus, in cases where parties to a security agreement allocated risk

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989 Whether the award is personal or proprietary impacts on e.g. interest accruing (simple or compound) or conflicts-of-law issues; see Swadling, ‘Policy Arguments for Proprietary Restitution’ (n 979) 514, 519-520.
990 Ibid.; see also V Finch and S Worthington, 'The Pari Passu Principle and Ranking of Restitutionary Rights' in F Rose Restitution and Insolvency (Mansfield Press, Oxford 2000) 1-20 (arguing that preferential status should be awarded to claims in unjust enrichment and this can only be done through legislation).
991 Swadling, ‘Policy Arguments for Proprietary Restitution’ (n 979) 517.
992 Ibid. 516.
993 They do apply, however, in other contexts, for example a response to wrongs, such as a breach of a fiduciary duty, should not be proprietary restitution. See n 863.
994 Text to nn 74-78.
contractually, the proprietary response would not give the claimant secured creditor any greater rights than he bargained for.\textsuperscript{995}

Similarly, the argument that the defendant’s other creditors would receive an undeserved windfall holds in relation to secured creditors claiming proceeds, even if it is questionable in other contexts.\textsuperscript{996} Secured creditors bargained for a right to resort to an asset, leaving the grantor of security with equity of redemption. If the secured creditors are not given priority with respect to proceeds, their security becomes worthless whilst the equity of redemption of the grantor of security is enlarged. Thus, in the grantor’s insolvency, the pool of assets distributed to other creditors is enlarged. This enlargement is “undeserved” because the secured creditor did bargaining for protection in insolvency, thus withdrawing an asset from the pool available to general creditors. Unless the secured debt is paid, or the security interest otherwise discharged, there is no reason why the other creditors should “deserve” the access to the value represented by the traceable proceeds of a disposition, which the secured creditor explicitly or implicitly prohibited.

Finally, it may be added that Burrows argued\textsuperscript{997} that a proprietary right can be a response to unjust enrichment if there is an analogy with a secured creditor’s position. There is no need for drawing such an analogy where a chargee or mortgagee claims unauthorised proceeds purely because he is the secured creditor.

\textbf{B. Lack of authority as the unjust factor}

The major problem with unjust enrichment explanation seems to be the ground of restitution.\textsuperscript{998}

\textsuperscript{995} For an identical argument but in a context of subrogation see \textit{Banque Financiere de la Cite v Parc (Battersea) Ltd} [1999] 1 AC 221 (HL) 237 (Hoffman LJ).
\textsuperscript{996} Swadling, 'Policy Arguments for Proprietary Restitution' (n 979) 527.
\textsuperscript{997} Burrows, \textit{The Law of Restitution} (n 988) 71.
\textsuperscript{998} Foskett (n 285) 119 (Millett LJ): “There is no ‘unjust factor’ to justify restitution (unless ‘want of title’ be one, which makes the point). The claimant succeeds if at all by virtue of his own title, not to reverse unjust enrichment”; see also at 127, 132 (Millett LJ); similarly 108-109 (Browne-Wilkinson LJ) and 115 (Hoffmann LJ).
(a) Overview of the difficulties with unjust factors

The ground must be present to show that the receipt of property by the defendant was unjust. This is traditionally demonstrated by the presence of one of the unjust factors. Birks in his later writings altered his approach and suggested that the reason for recovery was the absence of basis for retaining the received asset by the claimant.999 This view was criticised by some authors1000 and defended by others.1001 It is assumed that the correct approach is the traditional position focusing on unjust factors.

When the claimant knows nothing of the transfer the unjust factor is ignorance.1002 According to Birks’ original thesis, this is a fortiori from a mistake.1003 If a claimant can recover money when he made a mistaken payment as he did not mean to make that payment, he should also be able to recover if he did not know anything of the transfer. The unjust factor of ignorance is rightly criticised. It may be that the claimant is aware of the transfer but is unable to prevent the transfer. To deal with the latter criticism an unjust factor of "powerlessness"1004 was suggested. The claimant is fully aware of the transfer but is unable to stop it. The problem with “powerlessness” in the context of security interests is that the secured creditor is not

999 Birks, Unjust Enrichment (n 809) ch 5.
1002 Birks, An Introduction to the Law of Restitution (n 930) 140-146; Birks, 'Property, Unjust Enrichment and Tracing' (n 915) 246; but see Swadling, 'A Claim in Restitution?' (n 872).
1003 Birks, An Introduction to the Law of Restitution (n 930) 141.
entirely helpless. He may be able to apply for a freezing injunction to prevent the debtor from dealing with assets and so prevent the dissipation of assets prior to execution of judgment. The creditor may also be able to inform the third party transferee of the encumbrance. This will put the third party on notice and deprive her of the bona fide purchaser without notice defence should the creditor try to enforce the security interest in the asset in her hands. Yet even if the secured creditor knows of the transfer and does nothing to preserve his interest in the asset, he should not be deprived of a remedy against the debtor who effected the unauthorised transfer. In addition, neither ignorance nor powerlessness gained judicial support and for that reason the usefulness of the analysis based on unjust factors has been criticised by the High Court of Australia.

(b) Lack of authority

A better explanation has been suggested by Peter Jaffey. He argued that a transfer is defective if the claimant did not authorise such a transfer. The debtor may well have the power to transfer assets to third parties free from security but such transfers are in breach of the bargain between the secured creditor and the debtor. In the context of trusts, Jaffey says that when the trustee breaches the trust he acts outside of his authority conferred by the trust instrument and the very fact of the unauthorised exchange confers on trust beneficiaries a title to substitute assets.

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1005 Formerly known as Mareva injunction.
1006 Snell's Equity (n 743) para 18-071. A freezing order may be granted where the claimant can make a good arguable case, Ninemia Maritime Corp v Trave Schiffartsgesellschaft mbH unde Co KG [1983] 1 WLR 1412.
1008 Jaffey, The Nature and Scope of Restitution. Vitiating Transfers, Imputed Contracts and Disgorgement (n 926) 161-162, citing the following as support for “lack of authority” being a vitiating factor with respect to transfer: Nelson (n 934); Re Coltman (1881) Ch D 64; Blackburn & District Benefit BS v Cunliff, Brooks (1885) 29 Ch D 902.
1009 Ibid. 162. Jaffey adds a caveat that this cannot be misunderstood to imply that the trustee is an agent of the beneficiary with authority to bind him in contract.
The idea of lack of authority is not new, as Sheehan notes. In *Nelson v Larholt* an executor, Potts, fraudulently drew eight cheques on the banking account of his testator’s estate in favour of a turf accountant, Larholt (the defendant), receiving from Larholt money in cash, which he used for his own purposes. Larholt received the cheques for value and in good faith. However, this was not enough to raise the defence. It was held that the defendant also should have received the cheques without notice of the executor’s want of authority. On the facts, it was held that Larholt knew or ought to have known of the executor’s want of authority. Lord Denning in *Nelson v Larholt* held that

“[when an asset is taken from] the rightful owner, or, indeed, from the beneficial owner, without his authority, he can recover the amount from any person into whose hands it can be traced, unless and until it reaches one who receives it in good faith and for value and without notice of the want of authority”.

The language of the lack of authority is also found, as Sheehan says and as mentioned above, in *Lipkin Gorman*, where Lord Goff states that Cass received the cash from the client’s account by drawing on it “without authority”. Sheehan notes that the problem with both *Lipkin* and *Nelson* is that in both cases the actors were *authorised* signatories. Jaffey comments that this does not collide with the concept of “lack of authority” because the latter has nothing to do with agency law. It is about authority but not one found in agency cases. Watts attempted to explain this by using a concept of mismotivation. We may add that in some cases there will be an actual lack of authority. In the analysis adopted in this thesis, parallels with agency do apply if we consider agency to be a grant of authority. The presence of

1010 Sheehan, *The Principles of Personal Property Law* (n 482) 255.
1011 (n 934).
1012 (n 934) 342-343.
1014 Lipkin (n 942) 573.
1015 Sheehan, *The Principles of Personal Property Law* (n 482) 256.
“authority” in Lipkin and Nelson could be seen as the power to deal (which itself may be separately conferred from an owner and not, as in the case of a chargor, retained by him). The power to draw on an account would therefore be conceptually separate from the authority to do so.

(c) Suitability of the lack authority unjust factor in the security interest context

The grantor of a security interest limits his authority to dispose of assets in a particular way (free from the creditor’s security) in the security agreement concluded with the creditor. If the creditor consented to the substitution, his security interest cannot shift onto the proceeds of disposition by virtue of his consent only; an obligation to substitute is needed. The lack of consent to dispose free of encumbrance cannot explain why the creditor should be able to assert an interest over the asset against the third party.

Criterion Properties v Stratford Properties\textsuperscript{1018} concerned enforceability of the so-called “poison pill” contract. It imposed a duty on the claimant, at the defendant’s election, to buy for a punitive price the defendant’s interest in the company. This put option was to be triggered by an outside party gaining control of the claimant or by either of its two directors ceasing to be a director. It was intended to work, and did so effectively, as a deterrent to a bidder for the company’s shares to prevent a takeover of the claimant by a certain third party. A year later, however, the directors fell out. One of them (the defendant) was dismissed and sought to invoke the put option. Hart J at first instance\textsuperscript{1019} held that the enforcement of the agreement, designed to severely impoverish the claimant, was an abuse of power, notwithstanding the directors’ good faith when concluding the contract. By comparison with cases in the context of directors’ shares,\textsuperscript{1020} the enforcement of poison pill agreements is even more improper.

\textsuperscript{1018} [2004] UKHL 28, [2004] 1 WLR 1846.
\textsuperscript{1019} [2002] EWHC 496 (Ch).
\textsuperscript{1020} Howard Smith Ltd v Ampol Petroleum [1974] AC 821 (PC).
According to Hart J the defendant, in relation to the agreement, was in a position analogous to a recipient of assets misapplied in breach of a fiduciary duty. Because of that, Hart J thought that a test for unconscionability, set out in *BCCI v Akindele* in relation to knowing receipt cases, was applicable. The Court of Appeal agreed with most of the legal, but not factual, analysis. Abuse of power could exist because the agreement could not operate to injure the company irrespective of the circumstances. On the facts, however, the mere knowledge on the defendant’s part of the terms and purpose of the agreement was found to be insufficient to make the enforcement of the agreement in favour of the defendant “unconscionable”.

Lord Scott held that the question whether there was authorisation could extend beyond the act of authorisation, i.e. whether there was a directors’ resolution at a meeting properly convened, to matters concerning motivation. Therefore the question was whether the purpose (motivation) of the agreement (here: that the directors were entitled to exercise their powers to deter a takeover by signing a poison-pill agreement) could be subsumed within the authority issue. Watts notes that although this aspect of Lord Scott’s analysis is presented as orthodoxy, it is far from it. He indicates that it is the opposite of the view that agent’s motivations are altogether irrelevant to his authority.

On the theory that an agent’s authority is determined by consent, an express purpose attached to an agent’s authority confines it. Equity is said to further imply restrictions on the exercise of the powers, some of which entitle the person, in whose favour the restrictions are

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1021 *Bank of Credit and Commerce International (Overseas) Ltd v Akindele* [2001] Ch 437 (CA).
1023 Watts, ‘Authority and Mismotivation. Case Comment’ (n 1017) 7.
1024 Ibid. 7.
1025 *AL Underwood Ltd v Bank of Liverpool & Martins* [1924] 1 KB 775, 792 (Scrutton LJ); *Reckitt v Barnett, Pembroke & Slater Ltd* [1928] 2 KB 244, 257 (Scrutton LJ).
1026 *EBM Co Ltd v Dominion Bank* [1937] 3 All ER 555, 566-569.
imposed, to set the contract aside. It is not clear to what extent the promisee should have the knowledge of the relevant facts before the contract is deemed unenforceable.

The lack of authority to transfer collateral free from security by the debtor or a third party grantor is different from an *ultra vires* doctrine, which applies, for example, in the case of a company acting outside its objects clause laid down in its memorandum. A debtor disposing of encumbered property in an unauthorised way cannot be said to act outside of what he is able to do, unlike a company, which would be said to have acted without capacity to act. A grantor of security agrees to limit its authority to act but does not limit its capacity. By contrast, a company only has as much capacity to act as granted by the company’s memorandum.

C. Lien as a conceptually more suitable remedy than a constructive trust

It is said that proceeds of unauthorised disposition of an encumbered asset are held on constructive trust for the secured creditor. Yet, it is submitted, a more nuanced view should be adopted. First, as already shown, the trust does not arise automatically as an “exchange product” of the unauthorised disposition. The secured creditor has a power to vest an interest in the proceeds. The second question is what interest it is. In a trust context the beneficiaries elect between a trust and a lien depending on what is more preferential to them. It is not clear that a secured creditor claiming proceeds should get a similar choice.

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1027 Watts, 'Authority and Mismotivation. Case Comment' (n 1017) 7-8.
1028 Ibid. 8: “In an attack founded on a mere breach of equitable duty by an agent, the state of the outsider’s knowledge of that breach becomes critical in a way that is not the case where the outsider cannot establish that it dealt with someone with actual or apparent authority.”
1029 *Buhr* (n 14).
1030 Text to nn 872-879.
1031 Foskett (n 285).
(a) Liens

It is not difficult to show that a lien could arise in favour of the secured creditor, although Arden LJ in Buhr v Barclays Bank does not mention it.\textsuperscript{1032} Liens,\textsuperscript{1033} being non-possessory security interests in specific assets,\textsuperscript{1034} operate similarly to non-possessory consensual security interests.\textsuperscript{1035} Liens, like consensual security interests, are accessory (subordinate) to the obligation they secure. They are measured by the value of the claim, not the value of the asset, although they are limited by the latter.\textsuperscript{1036} Liens, unlike trusts, do not provide the claimant with a right to take the asset from the defendant but merely a right to resort to the specific asset if the personal right to restitution is not met.\textsuperscript{1037} A secured creditor, who was to be granted a lien over proceeds of an unauthorised disposition, would receive a functionally identical interest to the one he bargained for. The claimant may recover no more than the value of the secured amount of the unjust enrichment claim\textsuperscript{1038} and up to the value of the asset secured.

(b) Constructive trusts

It is more difficult to explain why a trust should arise in favour of a secured creditor.

(i) Overview of constructive trusts

The trust means that the trustee holds property and owes certain kinds of obligation with respect to that property. Constructive and resulting trusts arise by operation of law. It is generally thought that constructive trusts arise out of an obligation to remit property acquired in breach of a fiduciary duty, so the trust can be seen as a response to

\textsuperscript{1032} Arden LJ in Buhr (n 14) only considers a constructive trust.
\textsuperscript{1033} “Lien” refers to a non-possessory charge, not a common law lien. Birks, Unjust Enrichment (n 809) 184-185, 202.
\textsuperscript{1034} E.g. Hallett’s Estate (n 710).
\textsuperscript{1035} See text to nn 124-134.
\textsuperscript{1036} Chambers, ‘Tracing and Unjust Enrichment’ (n 918) 284.
\textsuperscript{1037} Ibid. 284.
\textsuperscript{1038} This amount may be smaller or equal to the amount of the originally secured loan.
wrongdoing\textsuperscript{1039} and as such dependent on the awareness of an innocent recipient of the misappropriation and the knowledge that affects the recipient’s conscience.\textsuperscript{1040} A debtor disposing of property subject to a security interest without authority from the secured creditor is not in breach of a fiduciary duty because, as we saw previously, it is questionable that the grantor of security owes fiduciary duties to the secured creditor\textsuperscript{1041} unless we accept the \textit{Chase Manhattan} logic that the unauthorised disposition makes him a fiduciary. Given that fiduciary duties arise voluntarily, there is no reason to say that the debtor owes fiduciary duties to the secured creditor. Since there is no breach of a fiduciary duty, no constructive trust can arise as a result of it. However, constructive trusts are also thought to arise out of unjust enrichment although some authors argue they are best described as resulting trusts.\textsuperscript{1042} The resulting trust explanation requires, depending on the preferred view, a presumed declaration of trust,\textsuperscript{1043} a common intention to create a trust\textsuperscript{1044} or simply a proof that the victim did not intend to make a gift.\textsuperscript{1045} If any of these views is correct, the trust arising in favour of the secured creditor cannot be resulting. A chargee or a mortgagee is not in a position to make a gift of the encumbered asset nor express an intention to transfer that property. If the secured creditor has no powers to dispose of the property beyond the enforcement of the secured obligation, \textit{a maiori ad minus} he cannot intend to dispose of that property. The trust arising to reverse unjust enrichment may not be “institutional” because unlike an express trust it

\textsuperscript{1039} \textit{Westdeutsche Landesbank Girozentrale v Islington London Borough Council} [1996] UKHL 12, [1996] AC 669, 716 (Browne-Wilkinson LJ): “when property is obtained by fraud equity imposes a constructive trust on the fraudulent recipient: the property is recoverable and traceable in equity”.

\textsuperscript{1040} \textit{Westdeutsche} (n 1039) 705 (Browne-Wilkinson LJ); problems arising when the trust is dependent on knowledge or notice were noted by Chambers, \textit{Resulting Trusts} (n 982) 201-212.

\textsuperscript{1041} See text to nn 732-747.

\textsuperscript{1042} Chambers, \textit{Resulting Trusts} (n 982) but see Chambers, ‘Trust and Theft’ (n 982) 223, where he seems to recognize problems with both constructive and resulting trusts, and citing (at 242); B Häcker, ‘Proprietary Restitution after Impaired Consent Transfers: A Generalised Power Model’ (2009) CLJ 324.

\textsuperscript{1043} Swadling, ‘Explaining Resulting Trusts’ (n 982).

\textsuperscript{1044} \textit{Westdeutsche} (n 1039) 708 (Browne-Wilkinson LJ).

\textsuperscript{1045} Chambers, ‘Trust and Theft’ (n 982) 239.
does not involve the imposition of fiduciary duties, duties to manage the property, e.g. to invest. Yet it is “institutional” rather than “remedial” in the sense that it arises by operation of law at the moment of the unauthorised disposition, rather than by “judicial fiat” at a later date. As Häcker noted, writing in the context of impaired consent transfers, that either type of trust creates more problems than it solves so a better solution is to treat the trust as “‘resulting’ in pattern and ‘constructive’ in the sense of arising irrespective of the transferee-trustee's consent”.

(ii) The specific position of the secured creditor

It may be that the secured creditor’s position is more akin to that of an insurer in Lord Napier & Ettrick v Hunter. In that case an insured person received money in diminution of a loss, for which he had already been indemnified by the insurer. The House of Lords held that the insurer held a personal claim for the money received secured by a lien. Similarly, the Court of Appeal in Foskett v McKeown held that the beneficiaries had no more than a lien for the amount of money actually used to pay premiums on the life policy. The Court of Appeal drew an analogy between paying premiums and making improvements on land. Birks found the cases difficult to reconcile, which lead him to say that there may be no principle underlying these cases that would help us decide when a lien only arises and when there is an election between beneficial interest and a lien.

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1046 Smith, ‘Unravelling Proprietary Restitution’ (n 918) 324.
1047 Ibid. 324 (in the context of mistaken payments).
1050 (n 941).
1051 Foskett (CA) (n 941) 278 (Scott VC); Foskett (HL) (n 285) 109 (Browne-Wilkinson); Unity Joint Stock Mutual Banking Association v King (1858) 25 Beav 72, 53 ER 563 but of Re Diplock [1948] Ch 465 (CA) 545-548. Courts have also awarded a lien over property owned by a defendant as unjustly enriched by a claimant performing services whose effect is to increase the value of the property Spencer v S Franses Ltd [2011] EWHC 1269 (QB).
1052 Birks, Unjust Enrichment (n 809) 202.
(iii) Critique of a constructive trust in the context of security interest

In the context of security interests, a distinction could helpfully be drawn between unauthorised disposition of collateral before and after the default of the debtor. After the debtor defaults the secured creditor can resort to the asset in order to discharge the outstanding secured debt. The range of remedies available to the creditor depends on the type of security interest but ultimately any equitable charge may be enforced by sale of the assets.\footnote{Diplock (n 1051) 546-547.} The creditor may also have a right to acquire ownership of the asset. Of course both lien and constructive trust provide the proprietary protection to the creditor. But unless the creditor can enforce the security by acquiring ownership of the asset, a constructive trust may lead to overcompensation of the secured creditor. The security interest extends only to the amount of the debt outstanding. A constructive trust would effectively give a beneficial ownership to the creditor, an interest that he did not have prior to the unauthorised disposition. Even if the value of the asset is presently below the value of the outstanding secured claim, the constructive trust should not arise because the creditor could receive a windfall of undeserved profit if the value of the asset were to go up the next day.

One could argue that the constructive trust is on the unauthorised proceeds only to the extent that the proceeds represent the debtor’s enrichment, i.e. to the extent the previously secured debt is now unsecured. The problem is that it does not take into account that the debtor, or indeed a third party, can start repaying the secured debt. To maintain the constructive trust we would need to say that that the subject matter of the trust automatically decreases to reflect the amount of the repaid debt. The effect of such a “trust” would be very similar to a lien.
In addition, if a constructive trust were admissible, the creditor would need to be able to collapse the trust under *Saunders v Vautier*\(^\text{1054}\) rule and so acquire absolute ownership of the asset. It is debatable whether trusts other than express trust are so collapsible\(^\text{1055}\) but we assume so here. This could lead to circumvention of policies underlying insolvency regulations where the secured creditor is only permitted to sell the encumbered asset and take the proceeds but is not allowed to take the asset as his own. In such cases the constructive trust would essentially amount to such a ‘prohibited’ remedy.

Rimer J in *Shalson v Russo* said that the proprietary response to unjust enrichment of the defendant “would not involve giving him any preferential rights over creditors: it would merely assert his right to recover property in which they can have no interest”.\(^\text{1056}\) Thus, the purpose of restitution is to put the claimant where he would have been had the unauthorised act not occurred, not to put him in any better position. A constructive trust would indeed put the secured creditor in a better position. For these reasons the lien, as a proprietary remedy to give the claimant rights *in rem* in the proceeds, seems to better balance interest of the parties involved. This analysis, it will be recalled, is not the analysis of the Court of Appeal in *Buhr v Barclays Bank*\(^\text{1057}\) where a constructive trust over sale proceeds held in the solicitors’ account was found in favour of the mortgagee, although in that case on the facts the type trust did not overcompensate the mortgagee who was expecting payment anyway. In many cases in practice it will probably not make a difference whether the remedy endows the creditor with a beneficial

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\(^{1054}\) (1841) 4 Beav 115, 49 ER 282; affirmed (1841) Cr & Ph 240 41 ER 482.

\(^{1055}\) See J Glistler, *The Nature of Quistclose Trusts: Classification and Reconciliation* (2004) 63 CLJ 632, 649 (suggesting that the *Saunders v Vautier* right might apply to an express trust but not a resulting trust if the purpose attached to the transfer of property is still capable of being carried out) and cf P Birks, *Retrieving Tied Money* in W Swadling (ed) *The Quistclose Trust* (OUP, 2004) 121, 126 (suggesting that even if there is no express contract, there may be an implied contract not to recall legal title so long as the purpose is in place). Where the trust arising is constructive, it is doubtful, however, that it could be argued that money was to be held for a particular purpose. If there was no intention in the first place for the money to be held on trust, arguably, there was also no intended purpose as to how the money was to be held.

\(^{1056}\) [2003] EWHC 1637 (Ch), [2005] Ch 281 [126].

\(^{1057}\) (\(n\) 14).
ownership (a constructive trust) or merely enables the creditor to resort to the asset in priority to others (a lien). However, to the extent that in some cases it will make such a difference, we ought to strive to achieve a coherent analytical framework, which this thesis has aimed to present.

4 Conclusion

This chapter has shown that a secured creditor does not have an automatic right to proceeds of unauthorised dispositions. He cannot acquire a right greater than he had if the transaction had been authorised. When the creditor contracts for security in proceeds the security interest in such proceeds will arise on the basis of the security agreement, so it is necessary to establish a right to the proceeds by operation of law (i.e. by virtue of the property right). Where a disposition is unauthorised and the creditor is faced with establishing a right to proceeds of such a disposition, the right arises on the basis of unjust enrichment, not vindicatio of the property interest which he had in the original asset. If vindicatio explanation depends on adoption of an unauthorised disposition by the creditor, it is questionable that vindicatio leads to acquisition of rights to proceeds of unauthorised disposition because adoption of an unauthorised disposition may not lead to a right to proceeds. This is so in the case of a floating charge. If a floating chargee has no right to proceeds of an authorised disposition unless bargained for, he also cannot acquire the right to proceeds by adopting an unauthorised disposition. He cannot have more than he would have had if the disposition were authorised. In the context of a fixed charge acquisition of a right to proceeds by way of adoption of an unauthorised disposition could be seen as inconsistent with the fixed character of the charge, where consent must be given to a specific disposition and not in advance.

The controversial element of establishing an unjust enrichment claim, the unjust factor, was established as the lack of authority. Even though the debtor has a power to dispose of the asset as the owner of the asset, his authority to do so vis-à-vis the creditor is limited. In the case of the
fixed charge the authority is limited almost entirely, unless a charge falls within FCAR. In a floating charge the authority to dispose of assets free of encumbrance is wider but also not unlimited. The unjust enrichment based on a factor of lack of authority enables the secured creditor to claim the proceeds. The claim to proceeds of unauthorised dispositions is proprietary for Birksian policy reasons. The *in rem* response is necessitated by the type of bargain the creditor struck when the original security interest was created.
CONCLUSION

This thesis dealt with a specific problem of security interests in property. Security interests are property rights taken in particular assets. Certain changes to the assets may lead to emergence of entirely new assets in the hands of the grantor of security. This happens when collateral is mixed with other asset into a new asset (product); when the debtor exchanges the originally encumbered asset for another asset (proceeds); and when new assets are generated without destruction of the originally encumbered subject matter (fruits). All three types of new assets were referred to as derived assets. The question asked in this thesis was how emergence of these new assets influences the rights of the secured creditor. The problem of rights to substitutes and fruits has attracted little interest in the specific context of security interests and this thesis aimed to fill this gap. The little that we know about security in derived assets stems from one Court of Appeal case, Barclays Bank v Buhr. The case suggests that the secured creditor has an automatic right to products, proceeds and fruits by operation of a “principle of substitutions and accretions”. It was argued that the “principle” is not supported in the current English law and that the understanding of security interests in derived assets based on this principle is flawed.

The thesis began by showing that there is a functional and conceptual difference between substitutes and fruits. We examined how security in substitutes and in fruits differ functionally first in the context of the rationale for security interests. The most convincing explanation of why lenders seek security interests was that it makes lending more efficient compared to unsecured lending as between the borrower and the lender. We said that taking security means that lenders’ costs diminish whilst the benefit to borrowers grows, not because the lenders ask for payment of a smaller interest rate but because they are able to lend more. Both lenders and the borrowers are better off. In economic terms, this was expressed as a more efficient way of achieving market equilibrium.
Applying the efficiency considerations to security in derived assets, we examined rules that automatically extend security to substitutes and fruits. We noted that there is a functional difference between them. Whilst a rule automatically extending security to substitutes promotes efficient credit market equilibrium, a rule that automatically extends security to additional collateral, without parties’ agreement, makes the equilibrium less efficient. This is because a substitute replaces an original asset whilst a fruit is a new additional collateral, which could be used by the borrower to obtain more financing. This is not a question of value of the assets but the ability to raise extra finance with additional assets. We also noted that giving security in one’s assets raises issues in fairness of asset distribution between secured and unsecured creditors. Rules that automatically extend security to additional collateral (i.e. to fruits) may be seen as affecting the already delicate balance of asset distribution. Having examined rationale for security, we have presented an overview of security in English law and under Article 9 UCC, which lead us to observe a difference in approach to security in the two legal systems and so set the background for the rest of the thesis.

The conceptual difference between substitutes and fruits was shown in Chapter II. We drew on Roman law to show how derived assets were classified. Whilst the Roman law of mixed assets remains of importance in the area of security interests, a new way of conceptualising fruits was suggested. Roman rules of accession and specification allow us to distinguish when mixing leads to emergence of a new asset (a product) from the perspective of the creditor. We followed Professor Smith’s view that confusion of assets does not lead to creation of a new asset and so it remains possible to follow the original asset. We suggested that it is useful to think of products and proceeds as assets generated by an event affecting the original asset, typically a disposition understood as either a physical act (e.g. manufacture) or a legal act (e.g. sale). By contrast, fruits were conceptualised as assets that arise on the basis of a pre-existing right,
not a disposition of the original asset. We also noted that it is not useful to use the principle of accession in relation to fruits because it suggests that improvements to assets are governed by the same rules as right to fruits and that both could be referred to as accretions. Such an approach is flawed and we suggested that for clarity purposes the term “accretion” should be used to cover improvements but not fruits.

The rest of the thesis examined two scenarios: first, where the security agreement is silent as to whether security extends to substitutes or fruits and, second, where derived assets are contemplated by the parties, whether expressly or impliedly. The question posed in Chapter III concerned the effect of an agreement, which does not extend the created security interest expressly to derived assets. It was argued that the secured creditor has no right to extend security to fruits unless the security agreement expressly says so. As established in Chapter II, rights to fruits are determined on the basis of a pre-existing right to fruits, attached to the original collateral. Such rights must be conferred expressly (or impliedly, if by possession) onto the creditor. However, where assets derive from a disposition of collateral by the debtor (i.e. proceeds and products) the creditor may be able to claim the substitutes even if they are not expressly stated as subject matter of security in the security agreement. This will take place where the creditor did not authorise the disposition free from security.

Chapter IV focused on the effect of a security agreement with a derived assets clause, i.e. automatically extending security to derived assets. We have seen that the effect of such a clause is similar to an after-acquired property clause. One continuous security interest is created, embracing every new asset as and when it arises. By contrasting such security with conditional security interests, we attempted to explain why security interests in the new assets take effect retrospectively and not at the moment when assets come into existence. The second set of problems relating to security agreements, where parties expressly agreed to extend security to derived assets relates to the character of security as fixed or floating. We built on the discussion of
characterisation of security interests from Chapter I to present a new way of conceptualising a fixed security. We suggested that parallels could be drawn between charges and agency without fiduciary duties. In a fixed charge the debtor can be seen as having power to deal with assets, which stems from his title to the assets, but no authority to deal with the assets free of encumbrance. Only where the creditor consents to a specific disposition and where this is coupled with a specific obligation to substitute does the debtor have authority to deal with the asset. In such cases the parties’ agreement gives the creditor a right to resort to substitutes. This right arises on the basis of the parties’ agreement, not operation of law. Any disposition outside the debtor’s authority to deal was classed as an unauthorised disposition. In the case of a floating charge the right to substitutes is sometimes said to arise automatically by virtue of the nature of the security. There are a number of theories of the floating charge, of which the overreaching theory was the preferred one. Although overreaching explains why the creditor no longer has security to the original asset, it was questioned whether the support for the view that overreaching explains the right of the chargee to substitutes. We have suggested that substitutes only fall within the scope of the floating charge where the debenture expressly covers substitutes or where it covers a class of assets, within which substitutes fall.

The final chapter considered claims of the secured creditor to assets resulting from an unauthorised disposition of the collateral. Such assets were collectively referred to as “proceeds of unauthorised disposition”, encompassing all assets resulting from mixed substitutions (products) and clean substitutions (proceeds sensu stricto). Claims to proceeds of unauthorised disposition were directly in question in the case of *Barclays Bank v Buhr*.\(^\text{1058}\) The view propounded in that case, and supported by a view expressed in *Foskett v McKeown*\(^\text{1059}\) in a parallel context of beneficiaries’ claims to proceeds of unauthorised

\(^{1058}\) (n 14).
\(^{1059}\) (n 285).
dispositions by a trustee, was that the creditor claims proceeds on the basis of vindication of his property right. This work suggested that this view is flawed and that the right to proceeds of unauthorised disposition arises on the basis of unjust enrichment. This means that the creditor does not assert the same property right (the same security interest) in the proceeds of an unauthorised disposition but a new right, which arises by operation of law. The work also rejected the view that the new right in proceeds could be a constructive trust and that the only right that arises in proceeds of an authorised disposition can be a lien. This thesis therefore presented a coherent analytical framework for rights to proceeds of authorised and unauthorised dispositions of assets subject to fixed and floating charges.

Although this thesis addressed a relatively narrow question of rights of a secured creditor following changes to the collateral that lead to emergence of new assets, the conclusions reached here can be seen as part of a wider question of extent of property rights. We know to what extent an absolute owner can mix assets and we know that he has a right to whatever he exchanged his assets for. We also know when ownership extends to fruits of the property. The basis for rights of the owner is the ownership itself. When the same questions are asked in relation to property rights, which are narrower in scope than absolute ownership, the answers become more difficult. It is particularly difficult to explain on what basis a person with a proprietary right in an asset should have a right to a substitute for that asset. It is not clear to what extent, if any at all, fiduciary duties can be imposed on debtors to enable secured creditors to claim such substitutes. This thesis suggested that the basis for such rights is the parties’ agreement. Security interests are property rights founded on a bargain between the parties and the secured creditor should not acquire security in assets he did not bargain for. Security interests extend to derived assets by express agreement or agreement implied as a matter of fact but not law. There is no “principle of substitutions and accretions”, which would resolve...
problems in this area by operation of law, i.e. by virtue of the property right.

In summary, the proposed analysis may prove to be a useful analytical tool, providing a coherent explanation of proprietary interests under fixed and floating charges and allowing disputes arising in the area of security in derived assets to be readily resolved. It may also be useful in determining the shape of the law to fruits, products and proceeds in the possible future reform of law of security interests.
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