SECURITY: A PRAGMATIC CONCEPTUALIST'S RESPONSE

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INTRODUCTION

Professor David Allan's thought-provoking (not to say provocative!) article on the nature of security[1] raises a number of fundamental questions which neither of us is likely to be able to solve, either with or without the aid of philosophers. Indeed, it is in the nature of conceptual issues, like that of ethical questions, that they are incapable of definitive solution. We are agreed that concepts are essential. We must be realistic enough to accept, like the physical scientist, that a formulation of a principle or rule is no more than a working hypothesis, capable of being falsified but not of being verified, strengthened by each failure of refutation, modified or abandoned when it ceases to respond to known phenomena. This does not mean that the formulation is worthless, merely that it is at best provisional.

Much has been made of the contrast between the civil law method of reasoning from the general to the particular and the common law method of reasoning from the particular to the general. Surely this should now be consigned to history. Over the centuries, through an accumulation of case law reduced to order by a combination of judicial decision and the writings of scholars, the common law now possesses a framework of principle and rule every whit as sophisticated as that of the civil law, and common law judges reason deductively from the general to the particular as naturally as their civilian counterparts. The distinction between the common law and the civil law approach is no longer that between the deductive and the inductive method, neither of which possesses any innate superiority, but is to be found primarily in the lack of a codification of principle in common law systems and of a doctrine of *stare decisis* in civil law systems.

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[1] David E. Allan, "Security: Some Mysteries, Myths, & Monstrosities" (1989) 15 *Mon. L.R.* 337.

THE NATURE OF SECURITY

Let me now turn to Allan's discussion of the nature of security. In the development of real security[2] the common law, like Roman law, developed in phases: from possession (lien and pledge) to ownership (mortgage) and thence to contractual appropriation (equitable charge). This development was inevitably influenced by commercial and legal practice. As difficulties arose with one form of security practitioners resorted to another and, finding it worked better, adopted it. The evolution of security law thus reflects the practitioner's response to judicial decisions and in turn the attitude of the courts towards the new instrument prompted by that response. As it seems to me, though the circumstances in which a security interest may arise are infinitely varied, there are four and only four types of consensual security known to the common law: lien, pledge, mortgage and charge. This is disputed by Allan, who argues that the common law, unlike the civil law, possesses no *numerus clausus* of security interests. This argument derives from his basic proposition that:

> "the criterion to be applied to determine whether a transaction is a security, after its incidents have been determined, is its ability to fulfil the function of security. Anything that performs the function of security must be security."[3]

Whatever may be said *de lege ferenda* this certainly does not represent the present state of the law either in Australia or in England. Reservation of title, which is plainly intended to fulfil a security function, is not recognised outside North America as security in law. This stems from the basic principle of the common law, which it should be noted is retained and indeed emphasised in Article 9 of the *Uniform Commercial Code*,[4] that the debtor can only give security in an asset in which he has an interest.[5] It is not necessary that the debtor's title to the interest should be indefeasible; it may be the relative title of one who possesses *animo domini*. But it is self-evident that one who has neither an interest in an asset nor a power to dispose of it cannot give it in security.[6] And it goes without saying that since real security is by definition security in a *res*,[7] anything which fulfils a security function but does not involve rights over a *res* is not security for our purposes. It follows that we can exclude from the definition of security such quasi-security devices as contractual set-off, subordination, the flawed asset[8] and the pure subordination

[2] I shall not discuss personal security, i.e. a personal right against the debtor or a third party under a bond, guarantee, indemnity or similar undertaking.
[3] Allan, op. cit. 345.
[4] Section 9-203(1)(c).
[5] To which one might add "or of which he has a power of disposal."
[6] The difference between the U.C.C. and the common law lies not in this requirement but in the fact that under s. 2-401(1) of the Code the conditional buyer's economic ownership is recognised by treating him as the owner and restricting the seller's interest to a security interest. A lessee may or may not be treated in the same way, depending on the circumstances.
[7] A point to which I shall return shortly.
[8] I.e. cash deposit withdrawable only on terms that obligations owed to the depositee by the depositor and/or a third party are first discharged.

agreement. This is true not only of the common law but of Article 9, which adopts a wider concept of security than any system in the world. How, then, is the existence of a security interest to be determined? Allan answers this question in the following way:

> "The particular rights which would justify the classification of the transaction as a security are sometimes known as rights of preference and pursuit in respect of specified assets or classes of asset . . . These two rights of preference and pursuit are at the very heart of the matter. If one is trying to create or establish a security, or if one is trying to characterise a transaction as a security, these are the rights one seeks. It should follow that a form of transaction which confers these rights on the creditor is a security; and a transaction which does not (given the premise in this section) is not a security."[9]

With this should be read Allan's separate proposition that the concept of attachment, in the sense of creation of a security interest effective as between the parties, is meaningless.

Now I agree that every security interest carries with it a right of preference and a right of pursuit. What I find difficult to accept is the notion that parties to a contract can, independently of any creation of real rights *inter se*, confer on one of them rights against strangers to the contract. If, in the relation between myself and my debtor, the security agreement merely confers on me a personal right to restrict the use of the debtor's asset, not a real right in the asset, how is it possible for the two of us by private contract to say that I shall be able to follow the asset into the hands of third parties and to claim the proceeds in priority to the debtor's general creditors?

The explanation for the rights of pursuit and preference is, of course, that they derive from the grant of real rights as between debtor and creditor. This, too, is denied by Allan, who contends that the essence of real rights is that they are available against persons generally, not merely against the grantor, so that to speak of a security interest arising as between debtor and creditor is a contradiction in terms. Such an argument overlooks the crucial point that the creditor has real rights to assert against third parties only because he has in the first instance been granted them against the debtor himself. The creation of real rights as between creditor and debtor is a necessary springboard for the assertion of real rights against third parties, which certainly cannot derive from purely personal contractual rights against the debtor.

Moreover, the concept of transfer of ownership or other real rights as between transferor and transferee is not merely a logical one, it possesses independent justification. First, it responds to the psychological need of human beings to translate personal rights of acquisition into ownership. So long as their rights rest purely in contract they feel uneasy, they lack control and the ability to take pride in being an owner. This feeling is not dependent on the existence of a range of third parties against whom ownership could be asserted; it exists even when the only person in contemplation is the intended transferor. If A and B are stranded on a desert island thousands of miles from

[9] Allan, op. cit. 346.

civilisation and prior to the shipwreck A sold his watch to B without handing it over, B will want to be able to say to A:"That watch is mine." To be told that he has a purely personal right to delivery of A's watch is not at all the same. Secondly, ownership is sometimes fixed upon by the law as a convenient focus for determining the incidence of liability caused by a thing. For example, the owner of an aircraft is by statute liable for surface damage caused by the aircraft; liability for pollution caused by a tanker is generally imposed on the owner. So irrespective of rights against third parties the law finds it convenient to determine whether B has acquired ownership from A or merely a personal right to delivery. Some jurisprudes have, of course, contended that there are no such things as real rights, and that even ownership is merely an aggregation of the separate personal rights available against a large collection of individuals. But this seems to me to be playing with words; the labels real and personal, which Allan appears to dislike, have no magical significance, they are merely convenient tools to distinguish rights which inhere in a *res*, and therefore are exercisable against persons generally,[10] from rights which are available only against a specific person or persons.

CREATION OF A SECURITY INTEREST

I come, then, to the crucial question of how the creation of a security interest is to be determined. As it seems to me, two elements must be conjoined, an intention to create security and an agreement in a form which effectuates this intention. I am rebuked for saying, in Allan's words, that "a declaration by the parties that they do not intend to create a security" will be effective *tout court*. If I had made such a statement I would have been rightly taken to task; but I did not. What I actually said was:

> "In its negative aspect the proposition signifies that a transaction which is not intended as security will not be treated as such by the law even if it may appear at first sight to have an affinity with security."

I gave as an example the genuine sale and lease back. I agree with Allan that intention must be gleaned from the whole transaction; I have never suggested otherwise.

However, as I have sought to show above, mere intention is not sufficient. The parties must by their agreement have given effect to that intention in accordance with legal requirements. They cannot do this where the party intending to confer security has no interest in or power to dispose of the asset to which the intended security interest is to relate. What should constitute a sufficient interest for this purpose is a question of policy, not of metaphysical reasoning. At common law a conditional buyer is not regarded as having an

[10] Here I follow W. Markby, *Elements of Law*, (6th ed., Oxford, Clarendon Press, 1905), 99, fn. 1, who correctly distinguishes real rights from rights *in rem*. The latter, as Allan correctly states, are rights against persons generally, not rights in a thing; the former are rights in a thing and as such are available against persons generally and therefore operate *in rem*, a characteristic which they share with some personal rights, e.g. those arising in tort.

interest beyond his actual possession; under Article 9 of the *Uniform Commercial Code* and the Canadian Personal Property Security Acts adopting Article 9 such a buyer is treated as the owner subject only to a security interest in favour of the seller. Allan and I are agreed that the Article 9 approach is greatly to be preferred, but it does not solve all the problems. The strength of Article 9 is that it provides a unified concept of security, so that we need no longer distinguish *for security purposes* between a mortgage, a charge and a reservation of title under a hire-purchase or conditional sale agreement. But the distinction may still be relevant for other purposes, e.g. in resolving a priority dispute between the holder of an Article 9 security interest and a party claiming an equitable tracing right as bailor of goods wrongfully disposed of by his bailee. Moreover, even Article 9 finds it necessary to maintain a distinction between possessory and non-possessory security.

Allan's basic premise is that one should not say: this is a security interest, therefore there are rights of pursuit and preference; one should instead say: this transaction confers rights of pursuit and preference, therefore it is a security transaction. But how is one to know whether the transaction does create such rights before we have ascertained its legal nature? Imagine a contract for security over a motor car in the following terms:

> "By way of security for the payment of sums advanced and to be advanced by Creditor, Debtor agrees:
> (1) that he shall not dispose of or part with possession of his motor car without Creditor's consent;
> (2) that Creditor shall be at liberty to follow the said motor car into the hands of any third party to whom Debtor transfers it in breach of this agreement;
> (3) that Creditor shall have a preferential right to the proceeds of any such transfer in priority to Debtor's other creditors."

Such an agreement meets in every particular Allan's suggested requirements for the creation of a security interest. It restricts the debtor's dealing powers and it confers expressly the rights of pursuit and preference which are the hallmark of a security interest. But what would a court make of such a odd-looking contract? Debtor has not purported to confer on Creditor any proprietary interest or other real right; he has merely accepted a restriction on his own dominion. How can Debtor's agreement to (2) and (3) be effective to impose liabilities and subordinations on third parties? What right have Debtor and Creditor to prescribe by private treaty the manner in which conflicts involving third parties, strangers to the contract, are to be resolved? Professor Sykes is surely correct in saying that rights of pursuit and preference are the *consequences* of the grant of a security interest and cannot be used to determine whether it exists. This, of course, is why no practising lawyer would ever dream of drafting a security instrument in the above terms. The agreement would be expressed to create a mortgage or charge of the motor car, or to appropriate the proceeds of the car to satisfaction of Creditor's claims, thus constituting the security interest, and the rights of pursuit and preference would then follow as a matter of law. Merely to prescribe such rights in the

agreement achieves nothing; so far as third parties are concerned it is *res inter alios acta.*

So Allan's approach, ingenious though it is, corresponds neither to existing law nor to existing legal practice and documentation. That, of course, does not conclude the issue against him as to what the law *should* be; but it is not clear to me that for the law to give effect to the odd-looking contract formulation set out above would be an advantage. Indeed, it is likely to create as many problems as it solves. Better surely for the law to require the parties to bargain for security as such and then itself prescribe the consequences of that bargain via-à-vis third parties.

THE NATURE OF A FLOATING CHARGE

In my book *Legal Problems of Credit and Security*[11] I essayed a new approach to the description of a floating charge, in which I sought to explain the nature of the chargee's real rights as rights in a shifting fund of assets rather than in specific assets and demonstrated, with reference to decided cases, at least six consequences flowing from the real character of the security thus created. My reward for this is to be accused of being "bemused by the apparent logical inconsistency of a security interest that is a present security but which has not attached to any assets" and of sharing "the bewilderment of Civil lawyers with an institution that they can only describe as illogical and anomalous." If explanations are to be equated with bemusement and bewilderment then I am indeed in a state of total confusion, a fact to which several of my colleagues and students will no doubt readily testify!

I agree entirely with Allan that a chargee, whether fixed or floating, is not an owner, merely an incumbrancer and have said so in terms elsewhere.[12] Where we part company is in Allan's assertion that it does not matter whether the chargee has rights *in rem* or only *in personam*, because we all know the significance in law of the fact that an uncrystallised charge creates a present security. The short answer to this is that we know *now*, because of an accumulation of case law, what consequences flow from the real character of a floating charge, but those consequences were all deduced by the courts from the initial premise that a floating charge constitutes a present security, not a mere contract for future security.

What happens when a floating charge crystallizes and the debtor then grants a fixed security to another creditor who takes it with notice of the existence of the floating charge but without notice of its crystallization? The conventional answer to this question is that once the floating charge has crystallized it takes effect thereafter like any other fixed charge and thus has priority over a subsequent security interest in accordance with the maxim that as between equitable interests the first in time prevails. In the above work I sought to show that this analysis, which appears to produce effects unfair to the sub-

[11] R. M. Goode, *Legal Problems of Credit and Security* (2nd ed., London, Sweet and Maxwell, 1988).
[12] Id. 14–15.

sequent creditor, is faulty because it fails to take into account the grant of dealing powers by the floating chargee under the terms of the floating charge. By taking a charge which is floating rather than fixed the debenture holder assents to the chargor's continued management of the assets and their disposition free from the floating charge if disposed of in the ordinary course of business. The debenture holder thereby holds out the debtor as authorised to make such dispositions, and (as I have argued) the termination of the debtor's actual authority resulting from crystallization of the charge does not by itself bring to an end the continuance of his ostensible authority. This estops the debenture holder from asserting the priority of his interest over a subsequent bona fide incumbrancer taking with notice of the debtor's initial actual authority (i.e. of the existence of the floating charge) but not of its termination through crystallization.

Allan challenges this reasoning on the ground that the debtor, having granted a floating charge, remains the owner of the charged assets and deals with them as owner, not as agent of the debenture holder. I agree that this is so and have never sought to contend otherwise. The question is one of authortiy rather than agency in the strict sense but the principles applicable are the same. The debtor may be the owner of the assets but he is not the unincumbered owner; he is always free to dispose of the charged assets subject to the security interest but if he wishes to dispose of them free from the security interest he must first obtain the assent of the chargee. This is as true of the floating charge as of the fixed charge; the only difference is that in the case of a floating charge the assent is given in general terms in advance. That the chargor's dealing powers depend on the assent of the debenture holder cannot be doubted; it is provided by the express terms of any properly drawn debenture, which will typically incorporate certain restrictions and/or provide that certain types of disposition (e.g. factoring of book debts) are not to be considered dispositions in the ordinary course of business.

The question then arises whether the debenture holder, having thus authorised the debtor to dispose of its assets free from the charge, can assert the termination of that authority against a party who takes his interest after such termination but in the reasonable belief that the debtor's authority was still current. Well established principles of agency law tell us that he cannot. Hence injustice is avoided. The difficulty Allan experiences in according priority to the erstwhile floating chargee disappears, for in truth he has no such priority.

CHARGES OVER A DEBTOR'S CREDIT BALANCE WITH THE CREDITOR

In *Re Charge Card Services Ltd.*[13] Millett J. held that it was conceptually impossible for a bank or other depositee to take a charge over its own customer's credit balance, a conclusion reached by the writer some years earlier

[13] [1986] 3 All E.R. 289.

in the first edition of the work cited above. The decision has caused controversy and Allan is obviously numbered among its opponents. They argue that the debt created by a deposit is an assignable claim, and if it can be transferred to a third party then why cannot it be transferred or charged back to the debtor bank itself? The short answer to this point is that a debt is a species of property only as between the creditor and a third party taking an assignment or charge. In the relationship between creditor and debtor the debt is merely an obligation. As creditor I do not *own* the debt, I am *owed* it. Accordingly as against the debtor I have nothing to assign or charge back to him. If I purport to give him security over my credit balance I am in truth doing no more than conferring a contractual right of set-off disguised as a security interest. A personal claim against a debtor cannot be elevated into a species of property vis-à-vis the debtor by waving a magic wand or by appealing to commercial convenience, nor can a creditor acquire by assignment or charge rights against himself. Everyone is agreed that a person cannot sue himself. What, therefore, are to we make of a claim by a debtor that he is simultaneously his creditor's assignee?

It is interesting that whereas Allan considers my reasoning harder to apply in the case of an assignment of a deposit rather than a charge, the English opponents of *Charge Card* take exactly the opposite position! They accept that an assignment is conceptually impossible but argue that in the case of a charge the result is different. In my view there is no escape from the basic proposition that *vis-à-vis the debtor* the creditor is a mere claimant, not the owner of an asset, from which it inevitably follows that there is no *res* which he can offer back in security.

CONCLUSIONS

Professor Allan has performed a signal service in focusing attention on some of the conceptual problems underlying security interests and in generating a debate of a kind which ought to feature more vibrantly in academic circles than it does. On many matters we are *ad idem*. Where we differ is in the proposition that by some process of divination not clear to me the legal incidents of a transaction are deducible before the character of the transaction is known and, being deduced, tell us what type of transaction it is in law. I remain impenitently of the view that the process is quite the reverse; first, the transaction is characterized, then its legal incidents are deduced. Of course it is true that at the end of the day it is a question of policy, that can only be answered by reference to non-legal considerations, whether in a given situation a creditor *should* have rights of preference and pursuit against third parties, and it is that question which has had to be answered before deciding whether to treat a transaction as creating a security interest. But the question *has* been answered, and long ago. It is open to the courts to find new cases in which rights of preference and pursuit should be given and to characterize

these as real rights rather than personal rights;[14] but even if they do it is hard to see how such an interest could fail to be either a mortgage or a charge, or what new form of security can be visualized by merely human imagination in addition to the four types of security currently known to the common law.

[14] The characterization would be important in cases where the third party defendant became insolvent.