"Can Practitioners and the Courts Work in Tandem?"

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In a recent editorial in this Journal ((201) 1 JIBFL3), Hugh Pigott referred to the problems caused by the failure of successive legislatures substantially to amend and update key commercial statutes, many of which were more than a century old. He quoted extensively the remarks of Professor Sir Roy Goode QC in his COMBAR lecture, who pointed out that this legislative vacuum had been largely left to the courts to fill, so that, as Professor Goode remarked, "we now recognise that judges do not merely declare law, they also create it". However, as Professor Goode conceded, "there is a clear limit to what can be achieved through the common law, particularly where it is encumbered by archaic statute". A few relatively recent examples, one famous (or possibly infamous depending on your viewpoint) and the others less discussed (but in one case arguably more important to practitioners), are summarised in this article to illustrate the difficulties for judges in this respect. In one case (the Charge Card sage), the difficulty arose wholly from a judicial analysis of the validity of specific contractual provisions and ended some 11 years later with a contrary judgment based partly on a rejection of the intellectual argument underlying the earlier decision, but also partly an apparent reluctance to nullify "a practice of the commercial community". In another case (Brumark), the House of Lords overruled a decision of the Court of Appeal seven years earlier by finally rejecting a judicial interpretation with which some commentators had never been fully comfortable.

These examples, and others, raise important questions not only about the challenge for judges in the role of spearheading legal development, but, more broadly, as to whether there is some inherent contradiction between the traditional role of the courts as a source of legal reform and development through an interpretive and precedent-driven process and the need of the international financial community to work in an environment in which, as far as possible, contracts are given legal effect in a manner which is consistent with the commercial intention of the parties and which can be generally understood. On another level, they raise questions as to whether the philosophical gap between specialist practitioners and judges, which has always existed, has now become too wide and whether anything, and if so what, can practically be done to narrow it.

Charge Card and What Followed

We have found it impossible to resist the choice of the Charge Card (*Re Charge Card Services Ltd* (1986) 3 all ER 289) saga as the first study simply because it illustrates the issues referred to above so clearly. Consequently, and with apologies to readers (possibly a majority) who may have hoped to have read the last word on this sorry tale, it is necessary for the purposes of examining the issues briefly to record the differing analyses set out in Charge Card (which, although not the first case to address these issues, is generally recognised as a seminal decision on them) and subsequent decisions on the legal consequences of a credit provider (hereafter referred to for the sake of simplicity as a "bank") taking a charge over moneys deposited with it by the chargor.

The following propositions seem to have been generally accepted:

- that in depositing funds in a deposit account at a bank, the depositor in effect makes a loan of the amount of the deposit to the bank repayable and bearing interest in accordance with the terms of the deposit. Thus, the depositor"s title to its cash is replaced by a debt owed by the bank, which is a chose in action, ie a right to sue the bank for the amount of the deposit. The bank, in its turn, may freely employ the deposited cash, retaining for itself any profit it makes by such employment;
- that security over a bank account must be taken either in the form of a legal mortgage or an equitable charge, but that since a mortgage by a depositor of its credit balance held with the chargee is impossible, any security interest created must be in the form of an equitable charge;
- that the charge cannot be in the nature of an assignment because it is settled law that an assignment of a debt by a creditor to his debtor operates as a release of the debt so the secured asset is extinguished; and

- that in order to create a charge over property, it is necessary to give the chargee a proprietary interest by way of security in the relevant property in the form of the right to resort to the property and have it applied towards discharging the applicable secured obligations.

Thereafter, the legal analysis appeared to diverge along broadly the following lines:

- per Millett J (in Charge Card) that the benefit of a debt could not be "appropriated or made available to the debtor" because it is a chose in action, ie a right to sue the debtor, which can be assigned to a third party, but not the debtor itself, and accordingly a charge in favour of a debtor of his own indebtedness was "conceptually impossible";
- per Professor Goode (in commenting on the Charge Card decision in 1988) that a debt is a species of property as between a creditor and a third party assignee, but as between debtor and creditor it is a pure obligation owed to, but not owned by, the creditor and accordingly "there is no res which he (the creditor) can offer back in security"; and
- per Lord Hoffmann (some 11 years after the decision) in Morris that a charge over a debt owed by the chargee could subsist if its characteristics were consistent with the "normal characteristics" of an equitable charge, namely: (i) a grant of a proprietary interest by way of security, (ii) conferring rights in rem which are not affected by the chargor"s insolvency, (iii) exercisable only to satisfy the secured obligation (with an equity of redemption), (iv) exercisable by way of sale or foreclosure, (v) not involving any transfer of title or possession to the chargee and (vi) which can be created by an informal transaction for value over legal or equitable property.

Lord Hoffman concluded that the charge over the credit balance of an account held with the chargee exhibited all of these characteristics, save that it was exercisable by way of book entry which he, but not others, apparently regarded as not material.

Of course these are complex arguments and even Professor Goode admitted to having had different views with respect to the correct legal analysis of the chargor/chargee relationship at different times. The decision of Millett J in Charge Card was criticised by many as being uncommercial or out of touch with the market place, particularly by practitioners (who of course had a huge (and legitimate) vested interest in the outcome of the debate). In fact, even proponents of the Millett analysis were moved to defend it on commercial grounds by pointing out that if Charge Card had decided that the charges over cash deposits could be created, then a whole range of deposit arrangements—for example, the deposit of margin collateral by customers with their brokers—might be registrable as charges over book debts, so putting at risk all such arrangements already entered into and not registered within the requisite 21-day period. The Court of Appeal in Morris (which included Millett LJ) also remarked, in a judgment expressly affirming the Charge Card decision, that if no alternative practical methods of creating security had existed, they would have been prepared to "sacrifice doctrinal purity on the altar of commercial necessity". This defence was rejected by the House of Lords, which opined that it constituted "no reason for preventing banks and their customers from creating charges over deposits if, for reasons of their own, they want to do so" and determined that "charge backs", which posed no threat to the consistency of law and were not objectionable on the grounds of public policy, should be recognized (per Lord Hoffmann) on the basis that "the courts should be very slow to declare a practice of the commercial community to be conceptually impossible".

Effect of Charge Card on Banking Practice

Following Charge Card, banks, on the advise of their lawyers, adopted as a standard requirement the so-called "triple cocktail" of security comprising, first, a charge in substantially the same terms as before, secondly a contractual right to set off the charged deposit against, or combine it with, the relevant secured obligations (to underpin the right to set off which, as Millett J observed, equity would recognise as a consequence of the charge, whether valid or not) and, thirdly, a "flawed asset" provision whereby the borrower agreed that it could not withdraw, assign or deal in the chose in action represented by the credit balance until the relevant secured obligations had been discharged.

However, it seems that even after Morris banks are still requiring the "triple cocktail" of security, although there may be some independent justification for so doing (for example, to underpin the fixed nature of the charge). Understandable though this may be, in psychological if not entirely in legal terms, it seems a somewhat haphazard alternative to enacting legislation to validate charge backs, which the legislatures of Hong Kong, Singapore, Bermuda and the Cayman Islands had all managed to achieve after Charge Card and before Morris. It is also somewhat ironic that Lord Hoffmann felt compelled to come to the rescue of a banking community which had already dealt with the problem, albeit in a piecemeal fashion, and which did not feel obliged to express their gratitude by abandoning the alternative defences they had constructed.

Charge Card has also spawned other legal debates such as whether the presence or absence of valid charges over cash deposits has any practical effect on the right of banks to obtain enforceable security interests as opposed to simply having contractual rights of set off. Confusion also arose over whether bank account deposits constituted book debts, charges over which would be void against liquidators or administrators and third party creditors unless registered within 21 days of their creation with the Registrar of Companies, first reversing the practice of accepting such charges for registration following the Charge Card decision and later, in 1988, reversing that policy.

Even within the Morris judgment itself, there appears to be some inconsistency between the acknowledgement of commercial supremacy in relation to the charge back issue and the ruling in relation to another part of the decision, namely the application of r 4.90 of the Insolvency Rules to arrangements between BCCI and its depositors. Rule 4.90 provides for automatic set off of obligations owed to and by insolvent companies provided they are in respect of "mutual dealings", but in Morris the depositor was attempting to persuade the court that r 4.90 entitled it to set off the credit balance of the deposit account against obligations for borrowed moneys borrowed by its subsidiary, but guaranteed by it. Both the Court of Appeal and House of Lords rejected various arguments in favour of a finding of mutuality relying on the decision in *MS Fashions Ltd v BCCI* (No 2) (1993) Ch 425 that liability as principal debtor was required for mutuality and determining that, in the absence of the necessary language, such liability could not be inferred. However, Lord Hoffmann described the distinction between Morris and MS Fashions (where that language appeared) as "artificial" and "a trap for the unwary" and despite the fact that the "commercial community" in the guise of the depositor could not have intended such an outcome, had the insolvency of BCCI been contemplated. Possibly, the court was concerned with supporting an interpretation of guarantees which could effectively have turned all sureties into principal debtors or had regard to the fact that use of the terms "principal debtor" and "primary obligor" had become accepted practice (though frequently used, one suspects, without much thought being given to the merits or otherwise of converting sureties to principal debtors in the particular circumstances of the transaction). Nevertheless, there is an element of irony in the two approaches being juxtaposed in this way.

Recent Examples—Brumark

Since Morris, there have been other examples of the challenges facing judges in commercial courts. For example, the recent decision of the Court of Appeal in *On Demand Information plc v. Michael Gerson* (Finance) plc (2001) 1 WLR 155 (Walker LJ, Pill LJ and Sir Murray Stuart-Smith), a case which concerned an application for relief from forfeiture in relation to finance leases of equipment. In that case, the lessee, under four finance leases, went into administrative receivership, which under the terms of the leases constituted a repudiatory breach, by which time two of the four leases were in their secondary period, the third lease was near the end of its primary period and the fourth lease had about three months (out of a total of 18 months) of its primary period left to run. The lessor terminated all four leases and the lessees applied for relief from forfeiture of the equipment leases. The issues included whether the leases were in principle capable of attracting relief from forfeiture.

Professor Goode, for the lessor, argued that the rights conferred on the lessee under the finance lease were purely contractual in nature, as opposed to proprietary rights, and therefore outside the scope of relief for forfeiture. However, the Court of Appeal, hemmed in if not actually bound by a series of decisions extending the principle of relief against forfeiture from its nineteenth century real property origins through personal property, time charters of vessels to hire purchase contracts, found that relief against forfeiture could in principle be granted under a finance lease of equipment. In doing so, it also extended the application of the forfeiture principle from what was originally a proprietary right to a possessory right. It

might be interesting to ask the draftsmen of those particular leases to what extent he or she considered the possibility of the lessee being granted such relief or the lessee"s legal advisor to what extent he or she felt fortunate to be the beneficiary of such an interpretation!

The case of *Re Brumark Investments Ltd, IRC v. Agnew* (2001) UKPC 28 concerned another important issue for bankers and their lawyers, namely the creation of fixed charges over book debts and specifically whether a purported fixed change over book debts which, in the absence of contrary direction, leaves the chargor free to collect and deal with the proceeds in the ordinary course of its business is a fixed charge or a floating charge. The particular relevance of this decision to the issues discussed in this article is that the debenture which contained the charge was created in 1995 after the Court of Appeal decision in Re New Bullas Trading Ltd (1994) BCLC 449 and appeared possibly to have been drafted in a manner designed specifically to take advantage of that decision. Consequently, we shall concentrate on this aspect rather than comprehensively attempting to review the broader issues, which are nevertheless of considerable interest and have already been the subject of much debate. Modern cases prior to New Bullas Trading had been mainly concerned with the validity of provisions in documents purporting to create fixed charges over book debts which treated book debts and their proceeds as an indivisible asset for security purposes and addressed the issue of to what extent the chargor"s freedom to collect and deal with book debts might affect that validity. It had largely been settled that, broadly speaking, where the collection and disposition of proceeds were effectively restricted Left within the control of the debtor, the charge over the book debts might well be found to be a floating charge. In the New Bullas Trading case, however, the debenture purported to create separate and distinct charges, a fixed charge over book debts and a floating charge over their proceeds. The Court of Appeal, reversing the decision of Knox J at first instance, placed great emphasis on the freedom of the parties to make such arrangements as they might agree and found that the parties could, as they had intended, create both a fixed charge over book debts and a floating charge over the proceeds of collecting those debts.

The Court of Appeals" decision though controversial, gave judicial approval to the drafting approach adopted in the debenture which was the subject of that case and the draftsman in the Brumark Investments case essentially followed that approach. However, seven years later, the Privy Council found no conceptual or practical difficulty in rejecting the decision in New Bullas Trading and affirming the judgment of the New Zealand Court of Appeal in Brumark in very clear terms (per Lord Millett):"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".

They found that the charge over book debts was a floating charge and, of the New Bullas decision, commented quite bluntly that it was (as most commentators before them had argued) "wrongly decided". The New Zealand Court of Appeal, on that subject, said only marginally more tactfully of that decision (per GaultJ):

"it represents a perception that the particular facts of that case distinguished it from the general line of cases. We are unable to accept that they did so".

Thoughts and Issues

In his COMBAR lecture referred to above, Professor Goode pointed to a number of areas in which he believed the process of legislation and law reform in this country to be inadequate. As mentioned above, one of these areas is the reform and updating of core statutes beyond what he referred to as "minor tinkering". He also pointed to the failure to act on some recommendations in official reports intended to pave the way for new or modified legislation, such as the **Crowther Report** (1971), the **Cork Review** (1982), the **Diamond Report** (1988) and the inadequacies of the legislative process. Most of all, he bemoaned the lack of a law reform "infrastructure" and in particular review bodies which can look at reforms of a technical rather than political nature involving outside specialists. These are all issues requiring urgent attention and we hope that it is not too late to put in train the necessary remedial measures. However, this only takes care of one side of the equation, namely the "big picture" issues of major legislative reform.

More crucially, from the viewpoint of day-to-day practice, is the issue of how to harness a common law precedent-based system to the pressurised, deal-driven environment of commerce and finance in such a way that the fundamental requirements of predictability and consistency in judicial decision making can be maintained. It would be quite wrong in our view to assume, as the starting point for such a decision, that the problem is solely one of unpredictability and inconsistency in relation to specific decisions of the courts.

Instead, we should be appreciative of the efforts which some judges clearly make to live in the "real world" and acknowledge that an even greater burden in this respect than the archaic statutes to which Professor Goode referred can be the challenge of reversing or avoiding prior decisions within the narrow confines of the rules of precedent. The decisions referred to above were in part chosen in an attempt to illustrate different facets of the problem—an unwelcome, but intellectually persuasive, decision eventually overturned by intellectual brute force, a shotgun marriage of nineteenth century equitable property law principles and tax efficient lending to equipment purchasers and a decision which may have been influenced by an attempt to enable parties to fulfil their commercial objectives, but which was generally regarded as conceptually flawed.

The underlying and more worrying problem, however, is in our view in relation to the judicial process rather than the decisions themselves or, to be more precise, the interrelationship between the judicial process and the practice of law. In the case of both Charge Card and Brumark, the original decisions were hotly debated, widely critised (whether correctly or not) and in both cases eventually overturned after several years. In the meantime, and in the absence of an effective means of challenging the decisions, practitioners simply set about dealing with the practical implications of those decisions in ways which they perceived as most beneficial to their client"s interest, ie by taking the sting out of the decision (in the case of Charge Card) or taking advantage of the decision (in the case of New Bullas Trading). It could not be argued that this necessarily disadvantaged lawyers and their clients—indeed, for those banks whose charges over cash deposits were reinforced by the "triple cocktail" approach and for those lenders with "New Bullas style" charges whose charges were actually adhered to or even enforced in accordance with their terms prior to the Brumark judgment, real benefits have accrued. However, these are simply random consequences.

We believe that the most important lessons to be drawn are the following:

- the lack of guidance afforded by the decisions of the different courts in relation to the attitude of the courts to some vitally important issues such as the extent to which the courts will nowadays look outside the "four corners" of documents to give effect to the commercial intentions of the parties;
- the ability of judges to hold and apply over the years fundamentally different and contradictory conceptual analyses of issues unless and until fate creates the opportunity where one concept can defeat the other, and
- the fact that there is no certainty either that an opportunity for revisiting decisions will arise, and certainly not how quickly it will arise, or for determining how the constituent members of the subsequent court will view the matter.

Currently, there is no means other than "due process" available to practitioners, advocates or judges to determine these issues and so practitioners have no option but to play the hand with which they have been dealt as skillfully as they can.

In this respect, we should acknowledge that a change in emphasis occurred over the last 30 odd years. Practising law in an international financial marketplace has increasingly meant reconciling the lawyer"s instinct to achieve the best and most elegant legal solution to legal problems with the need to serve the clients" commercial requirements, which may be for speed rather than elegance, or for the most "saleable" rather than the best solution. Consequently, it may be that some of the intellectual energy which once went into persuading clients to accept the preferred legal solution might nowadays be more likely spent in devising ingenious ways of circumventing problems rather than solving them and mitigating defects rather than correcting them. Whilst wholly justifiable in commercial terms, this must logically serve to widen the philosophical gap between practitioners on the one hand and advocates and judges on the other.

Simple logic says there must be some way of tackling this issue and at least ameliorating the situation, if not remedying it (and it may no longer be capable of complete remedy). For example, would it help if there were a recognised forum for debate between practitioners and participants in the judicial process providing "continuing legal education" for all parties? Should there, for example, be an annual enactment of "sweeper" legislation containing definitive statutory solutions to perennial problems with "entries" selected by a cross-discipline panel from the submissions made by lawyers on both sides of the divide? If not, how else can we narrow the gap between those who "do the deals" and those who subsequently analyse and opine on what has been done, a gap which must inevitably otherwise widen given the pace of financial and commercial development relative to that of legal development?

We are frankly relieved that time and space allow us to pose these questions, but not to explore them further!

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