KEY POINTS

- The Business Contract Terms (Assignment of Receivables) Regulations 2018 were published in draft in July 2018.
- The Regulations are expected to be made in the Autumn of 2018, once they have been approved by Parliament.
- They will override contractual restrictions on the assignment of receivables in many types of commercial contract entered into on or after 31 December 2018.

Feature

Author Richard Calnan

Restrictions on assignment

In this article, Richard Calnan discusses the way in which The Business Contract Terms (Assignment of Receivables) Regulations 2018 will affect the assignment of receivables under commercial contracts.

If a contract contains a restriction on the transfer of rights under the contract, any purported transfer in breach of the restriction is ineffective. That was decided by the House of Lords in *Linden Gardens Trust v Lenesta Sludge Disposals* [1994] 1 AC 85. The effect is that the purported transferee does not obtain any proprietary interest in the contract rights, whether or not it was aware of the restriction.

This conclusion is occasionally challenged. Sir Roy Goode has argued that a restriction on transfer operates only contractually, and does not prevent the transfer of the ownership of the contractual right to the transferee.[1] This approach has recently received some judicial support, albeit obiter, from Gloster LJ in *First Abu Dhabi Bank v BP Oil* [2018] EWCA Civ 14 (at [28]). But (as Gloster LJ recognised) it is inconsistent with the ratio of the decision of the House of Lords in the *Linden Gardens* case, and it is suggested that it is also wrong in principle.

The law recognises that the parties to a contract can create rights which would not otherwise exist. The extent of those rights depends on the parties' common intention, established from the terms of the contract. If the contract says that rights cannot be transferred, then that is the effect of the contract. To decide otherwise would be to subvert the common intention of the parties.

There is no doubt that this can create practical problems for those wanting to take assignments of, or security over, contract rights. It is a particular problem with smaller contracts. If security is being taken over the benefit of a major contract which is being financed, the contract will be drafted with the requirement for the financing in mind. But where security is taken over a large number of small receivables due under contracts entered into with a variety of counterparties, the underlying contracts will be in a variety of forms and it is much more difficult for the financier to get comfortable that they contain no relevant restrictions or to ensure that they are removed. This is a particular problem for the factoring industry, which relies on taking outright assignments of receivables owing from large numbers of counterparties.

The problem is exacerbated by the fact that the extent of the restriction is a matter of interpretation of the relevant provision in the light of the contract as a whole (and of any other transaction documents) and in the context of the admissible background facts at the time the contract was entered into. It follows that the meaning of a restriction on transfer used in a particular contract depends on the context in which it is used; and that judicial pronouncements on the meaning of particular formulations of words are at best presumptions as to the meaning the parties are likely to have intended. That simply adds to the uncertainty.

This issue was considered by the Financial Law Committee of the City of London Law Society when it produced its draft Secured Transactions Code in 2015.[2] It recognised the tension between, on the one hand, preserving the basic principle of freedom of contract in commercial transactions and, on the other, making it easier for security to be taken over receivables. It suggested that one way of squaring this particular circle would be to enable the purported transferee to obtain a proprietary interest in the receivable whilst, at the same time, ensuring that the contractual debtor did not suffer any adverse consequences as a result. But this approach was overtaken by legislation, and the latest draft of the Secured Transactions Code reflects that fact.[3]

The legislation was the Small Business, Enterprise and Employment Act 2015. Section 1 of that Act authorises the making of regulations to override contractual provisions that restrict the assignment of receivables without providing any countervailing protection for the counterparty. A flavour of the discussion during the consultation period can be seen by contrasting the views of the City of London Law Society[4] with those of Hugh Beale, Louise Gullifer and Sarah Paterson (in (2015) 8 JIBFL 463).

There the matter lay until September 2017, when the Department for Business, Energy and Industrial Strategy (BEIS) published draft regulations to give effect to the power contained in the Act. The City of London Law Society wrote to BEIS in October 2017 to express concern about the draft regulations.[5] The concerns were mainly about the width of the draft regulations, which it was concerned would have certain unintended consequences on financial transactions. BEIS were responsive to the criticisms in the letter, and consulted in detail on the terms of the regulations. In the result, The Business Contract Terms (Assignment of Receivables) Regulations 2018 were finally published in draft in July 2018 on the BEIS website. They are expected to be made in the autumn of 2018 once they have been approved by both Houses of Parliament. For the purpose of this article, it is assumed that the Regulations will be passed in the same form.

WHAT TYPES OF CONTRACTS DO THE REGULATIONS APPLY TO?

The Regulations apply to contracts for the supply of goods, services or intangible assets under which the supplier is entitled to be paid money. They do not say this in terms, but it is the effect of the definition of "receivable" in reg 1(3).

Feature

There are a large number of types of contract which are excluded from the scope of the Regulations. In the first place, they only apply to contracts entered into on or after 31 December 2018 (reg 1(2)).

Second, the Regulations only apply where the person who supplies the goods, services or intangible assets concerned, and is therefore entitled to the receivable (the supplier), is a small or medium-sized enterprise.

This restriction is the natural consequence of the purpose of the Regulations – which is to override freedom of contract in circumstances where the supplier is unlikely to have sufficient bargaining power to prevent the counterparty to the contract (the debtor) from imposing a restriction on assignment.

The definition of what is a small or medium-sized enterprise is contained in reg 3. It is complex, and it cross-refers to the relevant accounting provisions in the Companies Act 2006 and the equivalent regulations for LLPs. Whether or not an entity qualifies in any particular case requires a detailed examination of the facts in the light of reg 3 and of the relevant accounting provisions. But, in broad terms, the outcome can be summarised in three propositions:

- A supplier is a small or medium-sized enterprise if it is not a "large enterprise" or a "special purpose vehicle".
- It is not a "large enterprise" if:
  - it is an individual, a general partnership or an unincorporated association; or
  - it is a small or medium-sized company or LLP in accounting terms; or
  - it is incorporated outside the UK and, if it were a UK company, it would be a small or medium-sized enterprise.
- Even if the entity is not a "large enterprise", the regulations will not apply if it is a "special purpose vehicle". This essentially means a firm that carries out a primary purpose in relation to the holding of assets (other than trading stock) or the financing of commercial transactions, which in either case involves it incurring a liability under an agreement of £10m or more.

There are particular rules for members of groups and for entities which do not have to file accounts. Perhaps the most curious feature of the definition is that the test is not applied at the time the contract is entered into, but at the time the assignment takes place. This has the unfortunate effect that the parties to a contract will not be certain, at the time the contract is entered into, whether the Regulations will apply to it.

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Third, the Regulations exclude contacts "for, or entered into in connection with, prescribed financial services" (reg 4(a)), which are widely defined in s 2 of the principal Act to mean "any service of a financial nature", together with specific instances. The result is that loan agreements and other contracts used in the financial services industry are excluded from the scope of the Regulations.

Fourth, there are a large number of specific exclusions for other types of contract. They are set out in reg 4 and, again, a number of the definitions are complex. In brief, they concern:

- contracts outside of a trade, business or profession;
- contracts which concern an interest in land;
- certain types of contract concerning the acquisition of shares and businesses;
- certain types of project finance contract;
- certain types of derivative and similar contract;
- certain types of energy contract;
- operating leases; and
- contracts which concern national security interests.

Finally, the Regulations also exclude certain types of cross-border contract. It would seem that the Regulations generally only apply to contracts governed by English law (or the law of Northern Ireland, to which the Regulations also apply). They do not say so in terms, but this is implicit in reg 1(4) which provides that the Regulations will apply to a contract which is governed by a foreign law if that law has been used wholly or mainly to evade the Regulations. Nor do the Regulations apply to a contract where none of the parties to the contract have entered into it in the course of carrying on a business in the UK (reg 4(d)).

Even from this brief summary, it can be seen that establishing whether or not any particular contract falls within the scope of the Regulations is not straightforward.

WHAT IS THE EFFECT OF THE REGULATIONS?

If the contract concerned does fall within the scope of the Regulations, what effect do they have on the contract? Regulation 2(1) provides that a term in a relevant contract "… has no effect to the extent that it prohibits or imposes a condition, or other restriction, on the assignment of a receivable arising under that contract or any other contract between the same parties".

This raises three questions:

- What is a "receivable"?
- What is an "assignment"?
- What is meant by "prohibits or imposes a condition, or other restriction"?

The definition of "receivable" is straightforward. It is "a right (whether or not earned by performance) to be paid any amount under a contract … for the supply of goods, services or intangible assets".

To the extent that there is a restriction on the assignment of other contract rights, the Regulations do not apply.

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More difficult is to establish what is meant by "assignment". Receivables are transferred in various ways in practice. Sometimes the transfer is outright (for instance by way of sale); and sometimes it is by way of security (for instance to secure a loan). The transfer may be effected by a statutory assignment, an equitable assignment, a charge or a trust. "Assignment" is not defined in the Regulations or the Act. So which of these transactions does it apply to?

Although there is little commercial difference between a security assignment and a charge (or an outright assignment and a trust), lawyers do distinguish between assignments, charges and trusts; and, where an expression has a particular technical meaning, it is likely to be given that meaning.

There are nevertheless good reasons to suggest that the Regulations will apply to charges and trusts as well as to transactions which are strictly assignments. "Assignment" in the Regulations needs to be read in the context of legislation the purpose of which is to enable small and medium-sized enterprises to finance their receivables. Receivables are financed in a variety of ways, often by charge and sometimes by trust. The dictionary meaning of "assign" includes the transfer and making over of assets, both of which expressions are capable of extending to transactions effected by a charge or trust. It is grammatically open to a court to read the expression broadly, and to do so would give effect to the purpose of the legislation.

But there is still doubt and, until that doubt is resolved, the best course when taking security over receivables must be to take an assignment by way of security (rather than a charge) where there is, or might be, a restriction. That way it is clear that the Regulations do apply.

If the Regulations do apply, a term has no effect to the extent that it "prohibits or imposes a condition, or other restriction" on the assignment of a receivable. Regulations 2(2) and (3) describe certain types of information which the assignee must be able to obtain, failing which the provision which prevents that happening will fall foul of the Regulations.

Non-assignment clauses are common in commercial contracts, and they come in a variety of forms. An outright prohibition on assignment is clearly covered, as is a prohibition without the consent of the counterparty, because that has exactly the same legal effect as an outright prohibition. Clauses may prevent an assignment unless something is done (such as a payment of a fee) or they may prevent an assignment without consent, such consent not to be unreasonably withheld. Anything which restricts the ability of one of the parties to assign a receivable would seem to fall within the scope of the prohibition.

CONCLUSION

The Regulations will not be made until the autumn of 2018, and they will not affect contracts entered into before 31 December 2018. But we will need to consider in advance how they will affect transactions in practice.

The first question will be to consider whether the Regulations do actually apply to the particular type of contract concerned. There are a lot of exceptions from the scope of the Regulations, and the relevant definitions are often complex and frequently depend on accounting rules. And the problem is not made any easier by the fact that whether or not the supplier is a small or medium-sized enterprise is established at the date of the assignment, rather than at the date of the contract.

If the Regulations do apply, it will be sensible for anyone taking security over receivables to do so by means of a security assignment, rather than a charge, if they might want to take advantage of the Regulations.

The more difficult problem arises for the debtor under the contract – the person who will have to pay the receivable to the supplier. There are good commercial reasons why debtors want to restrict assignments, and the Regulations cut across these. What is particularly unfortunate about the Regulations is that they do nothing to protect the debtor from the consequences of overriding its contractual protections. A debtor will continue to be able to exercise against the assignee contractual rights of set-off and also independent rights of set-off which exist at the time it receives notice of assignment. But a debtor will no longer be able to exercise independent rights of set-off which are created after notice of assignment has been received.

Debtors need to consider whether their contracts can be redrafted in a way which avoids at least some of the adverse consequences of the Regulations. They prevent the parties from restricting their ability to assign a receivable created under the contract. What they do not do is to prevent the parties from agreeing the scope and extent of the obligations which they owe each other. The Regulations do not prevent the parties from agreeing when a receivable comes into being and what the amount of that receivable is to be.

The history of interference with freedom of contract in commercial transactions has not been a happy one. The question now is to establish how the parties can redraft their contracts to restore some degree of freedom in their dealings. ■

1 Goode, *Contractual Prohibitions Against Assignment* [2009] LMCLQ 300.
2 www.citysolicitors.org.uk; go to "Committees", then "Financial Law"; see the User Guide dated 22 July 2015.
3 The revised version of the Code is available at www.citysolicitors.org.uk; dated 26 July 2016.
4 Which are summarised in (2015) 3 JIBFL 136.
5 www.citysolicitors.org.uk; dated 13 October 2017.

Further Reading:

- Ban on assignment clauses: views from the coalface (2015) 8 JIBFL 463.
- Ban the ban: prohibiting restrictions on the assignment of receivables (2015) 3 JIBFL 136.
- LexisNexis Loan Ranger blog: Business Contract Terms (Assignment of Receivables) Regulations 2017: Unexpected consequences for lenders.