Tracing proceeds of unauthorised dispositions of assets subject to a charge

Proprietary interests have the advantage of binding third parties, which is particularly important where the defendant is insolvent. Where the claimant bargained for creation of a proprietary interest, for example a bank was granted a charge, it is important to protect that interest. English law, unlike many civilian jurisdictions, offers proprietary protection by way of proprietary tracing claims. This article outlines some of the difficulties of proprietary tracing claims in the context of charges.

It is well established that in English law a person who has a proprietary interest in one asset may in some circumstances assign a proprietary claim to another asset when the latter represents traceable proceeds of the original. Proprietary claims based on tracing are, however, difficult. One problematic area relates to claims which might arise when the proprietary interest over the original asset is a charge. To explain some of the issues, it is useful to start by considering the following scenario: B, an English company, borrows a sum of money from A. The loan is secured on B's fleet of vans by way of a fixed charge, which is duly registered at the Companies House. Subsequently, B sells one of its vans to C without A's consent. C knows nothing of A's charge over the van. The price is paid into B's account which at the time of payment does not contain other funds.

What proprietary claims does the chargee (A) have? One option is to assert a charge over the van against the third party (C). However, it may not be practicable to do so. Importantly, if C is a bona fide purchaser of legal title to the van without notice of A's charge, A's charge over the van is lost. Registration of the charge at the Companies House does not necessarily provide notice since registration constitutes notice only to those who have a duty to search the register and it is generally thought that purchasers of goods do not have such duty. The chargee may then wish to claim a proprietary interest in the new asset in the hands of the chargor (B): the sale proceeds, represented by a balance on the chargor's account. There are two possible bases for the chargee's claim to proceeds: one is a restitutionary proprietary tracing claim and the other is the charge agreement. The latter would seem to be a simpler solution but it is not without its risks.

CLAIMS TO PROCEEDS ARISING AS A MATTER OF LAW

In Foskett v McKeown the Court of Appeal held that the claimant's proprietary claim was ancillary to the mortgage. This decision was not without its critics and it prompted Lord Millett, the presiding judge, to remark that the decision was not a precedent.
outcome is not disputed; but it is important to identify the reasons for this result.

Lady Arden provided two different reasons. One was a suggestion that the chargor’s right to proceeds arises automatically, as soon as the charger becomes entitled to them, as a matter of a “[general] principle of substitutions”.

The second, was that the chargor was able to “adopt [the unauthorised] transaction and thus retrospectively make the [charger] its agent”.

There are some difficulties with the reasons in Buhr. If any charger is to have an automatic charge over a substitute, it is difficult to see why it would also need to ratify the unauthorised disposition. More importantly, there is little evidence, as a matter of authority, that any “principle of substitutions” exists in English law. As to the second reason, it is hard to see why the chargor could ratify. Principals can only ratify unauthorised acts of those who intended to act on the principal’s behalf, and only where the principal was disclosed. Generally, it is unlikely that the chargor would sell the asset ostensibly on behalf of the charger, and that the charger would wish to act on behalf of the charger. Typically, C knows nothing of the existence of the charger and thinks that B deals with the asset unencumbered, on its own behalf.

A possible alternative analysis is that the basis for the charger’s (A’s) proprietary claim to proceeds is unjust enrichment. Obtaining the proceeds (substitute) unencumbered, free of A’s security, would amount to B’s enrichment at A’s expense. In identifying the enrichment, it is not helpful to talk about tracing value, as Lord Millett does in Foskett. It is difficult to premise the process of identifying an asset (proceeds) on something which does not exist. Rather than tracing value, it is useful to think of how new assets derive from the initial assets by identifying legally relevant events that the initial asset is subject to and determining their outcome. Which events are relevant is a question prior to asserting a claim, but it is not a purely evidential exercise. It requires taking into account the nature of the claimant’s rights and making policy choices. For example, in relation to charges, the charger’s exercise of power to dispose of the charged asset is a relevant event as a matter of principle because the nature of the charge differs depending on whether the chargor has authority to exercise the power to dispose.

By contrast, to give a trivial example, it is not generally a relevant event that the charger might paint the charged asset a different colour.

In a given scenario it is important to ask whether the charger’s (B’s) exercise of a power to dispose of property in the initial asset was authorised or unauthorised. If authorised, the terms of the grant of authority (for example, authority to dispose of the asset free of the charge) will determine whether a proprietary interest is meant to extend to proceeds or not. If unauthorised, then the proceeds of the unauthorised disposition of the charged assets are the new derived asset which can now be claimed. On this analysis it is not necessary to, for example, look at the intention of the defendant. Unjust enrichment explanation of claims to traceable proceeds has been rejected in Foskett.

One of the key reasons was the difficulty of explaining why the enrichment of the defendant (B) was unjust: “want of title” to the asset was not a satisfactory reason. However, in the context of charges, enrichment is unjust not because of “want of title” (or, in this context, “want of security”) but because A provided no authority for B’s exercise of the power to dispose of the asset. The advantage of this explanation is that it is consistent with the principles underpinning the chargor’s consent retrospectively. Nothing stops the parties, of course, from agreeing to create a floating charge over the van and the proceeds. The lack of charger’s consent to the sale would not then usually matter.

CONCLUSION

Proprietary tracing claims are powerful tools in the charger’s armoury of claims. While the principles governing this area are very complex, it is important to develop an understanding of the law of tracing that does not undermine the current law of charges. A well drafted agreement may help avoid those complexities, although there exists a risk that the charge may be recharacterised as a floating charge.

Feature

TRACING PROCEEDS OF UNAUTHORISED DISPOSITIONS OF ASSETS SUBJECT TO A CHARGE

CLAIM TO PROCEEDS BASED ON AGREEMENT

There are various ways in which the charger and the charger could agree that the charge would extend to the proceeds of disposition of the charged asset even if the disposition is unauthorised. The parties (in the scenario above) could provide, for example, in the debenture that the charge extends to sale proceeds of the vans, or that the charge is over the charger’s bank accounts. The sale proceeds become subject to the charge on the basis of a term in the charge agreement. It is a matter of the interpretation of terms in the parties’ agreement whether the charge extends to the proceeds, and what constitutes proceeds. It is not a matter of any link between sale proceeds and the van which might exist as a matter of law.

However, there is a risk in such drafting: the parties may be understood to have intended that the charger would have the power to sell the charged asset without the charger’s consent, and so parties’ rights and duties created may not be consistent with a fixed charge, and so the charge could be characterised as floating. A similar risk exists were the chargor to obtain the charger’s consent retrospectively. Nothing stops the parties, of course, from agreeing to create a floating charge over the van and the proceeds. The lack of charger’s consent to the sale would not then usually matter.

1 [2001] 1 AC 102 (HL).
2 [2005] UKHL 41.
3 [2001] EWCA Civ 1223.
4 Land Charges Act 1972, s 4(5).
5 Ibid, at [39]-[44] and [53].
6 Ibid, at [49].
8 This approach ultimately might help address concerns identified, for example, by R Laville, Bankers take note: how the tracing process has become more complex (2015) 11 JIBFL 678 discussing The Federal Republic of Brazil v Durant International Corporation [2015] UKPC 35.
9 [2001] 1 AC 102 (HL) 115 (Lord Hoffmann) and 127 (Lord Millett).
10 [2001] 1 AC 102 (HL) 127 (Lord Millett).
12 Re Spectrum Ltd (in liquidation) [2005] UKHL 41.