

Security over Receivables

BACKGROUND

For both facilities, the financier will also require a qualifying floating charge and potentially other boot collateral.

Security over receivables is a key feature of many types of receivables finance transactions. For example:

- for a secured borrowing base facility (**BB Facility**), the financier will take security over the customer's whole book of receivables and the collection accounts into which the proceeds from those receivables are paid; and
- for a whole turnover receivables purchase facility (**RP Facility**), the financier commonly takes security over any receivables in respect of which title has not transferred to the financier for any reason (e.g. as a result of a prohibition on assignment) (**Non-Vesting Receivables**).

This publication focuses on the different types of security that can be granted over receivables and the issues to consider when taking such security.

In this publication, references to receivables are limited to trade receivables arising from contracts and not those evidenced by negotiable instruments.

TYPES OF SECURITY

Receivables are intangible assets due to the fact that they are choses in action (i.e. an asset that can only be claimed or enforced by action and not by taking physical possession) and therefore security can only be taken over receivables by way of a mortgage or a charge. A mortgage of receivables is commonly granted as an assignment by way of security.

(i) Assignment by way of security

In the case of an assignment by way of security, the customer expresses to transfer to the financier its rights, title and interests in the receivables subject to an equity of redemption (i.e. the customer has the right to have the receivables re-assigned to it if the secured liabilities are satisfied).

An assignment by way of security can be characterised as legal or equitable, but in most cases the assignment will relate to present and future receivables and an assignment over future receivables will result in the assignment being equitable.

Putting aside the effect of the service of notice on the debtors (which is another requirement for a legal assignment), the benefits of a legal assignment by way of security vs an equitable assignment by way of security has been negated in more recent times due to the requirement to register security at Companies House and the effects and protections afforded by such registration. Accordingly most financiers are very comfortable with an equitable assignment by way of security.

(ii) Charge

In the case of a charge over receivables, the customer's rights, title and interests to the receivables remain with the customer and instead the charge affords the financier the right to appropriate the monies raised from the charged receivables towards the payment of the secured liabilities.

PROHIBITIONS ON ASSIGNMENT

Assuming the Business Contract Terms (Assignment of Receivables) Regulations 2018 do not apply, if the contract from which the relevant receivables arise prohibits the customer from assigning its receivables to another person, an assignment by way of security in respect of those receivables will not be effective. Provided the prohibition is not expressed to restrict the customer from granting a charge over the receivables (which is quite uncommon), a charge will be effective.

As such, where a financier is not undertaking due diligence on all the relevant contracts from which the relevant receivables arise, the financier will take a charge over the receivables (or an assignment by way of security with a back-up charge). With regard to an RP Facility, the financier will take a charge over Non-Vesting Receivables for obvious reasons.

FIXED SECURITY VS FLOATING SECURITY

Under English law, security can be characterised as either:

- fixed security; or
- floating security.

The characterisation of security taken over receivables / Non-Vesting Receivables owned by an English customer is important as it will determine when a financier is paid out and how much it receives in the event of that customer's insolvency.

To obtain a fixed charge over receivables / Non-Vesting Receivables, it was established in *National Westminster Bank plc v Spectrum Plus Limited and others* [2005] UKHL 41 that, amongst other things, the security holder must have control of the receivables / Non-Vesting Receivables **and** their proceeds at all times. Although the judgment in this case was limited to charges, we think it is reasonable to assume that the principle equally applies to assignments by way of security (which was indicated in obiter dictum in the case).

Control of the receivables / Non-Vesting Receivables is achieved by the inclusion of a negative pledge within the security agreement. But how do you control the proceeds?

For BB Facilities, control of the proceeds of receivables is typically demonstrated by the borrower being required to direct all account debtors to pay receivables into a collection account secured in favour of, and controlled by, the financier. The borrower is not permitted to access the proceeds without the consent of the financier. This arrangement is typically documented in a bank account control agreement between the financier, the borrower and the account bank.

For RP Facilities, control of the proceeds of Non-Vesting Receivables is typically demonstrated by the customer being required to direct all account debtors to pay receivables (which includes Non-Vesting Receivables) into a collection account owned and controlled by the financier. Due to the fact that the collection account is owned by the financier, there is no need for a bank account control agreement. In some cases, the collection account may be a collection account in the name of the customer which the customer has declared on trust for the financier. In that case, a bank account control agreement would be advisable.

REGISTRATION

Section 859A of the Companies Act 2006 ("**CA 2006**") requires security granted by an English and Welsh company to be registered at Companies House within 21 days of its creation. Failure to register the security within this time period will result in the security being void against any liquidator, administrator or creditor of the company.

Under the CA 2006, the customer is obliged to register the security. However, given that the financier's security could be void if not registered within the 21-day period, it is market practice for the financier's legal counsel to deal with the registration.

SECURITY NOTICES

In England and Wales it is generally accepted that notice of the creation of the security (whether by assignment or charge) does not need to be served on account debtors or account banks in order to create effective security over receivables / Non-Vesting Receivables / collection accounts.

Service of notice is, however, required to obtain certain protections/rights (see below) and a financier will need to decide whether or not it wants the benefit of those protections/rights from day 1 or whether, for commercial reasons, it is willing to serve notices at a later date.

If an bank account control agreement is being entered into for control purposes (see the "Fixed security vs floating security" section above), a notice to the account bank will be contained within that agreement.

Set out below are certain of the key protections/rights obtained by serving notice on an account debtor / account bank.

(i) Protection of the priority of the security

If a financier does not give notice of its security over the receivables / Non-Vesting Receivables / collection accounts to the account debtors / account banks (as applicable) and the customer subsequently grants security over or disposes of its receivables / Non-Vesting Receivables / collection accounts (as applicable) to a third party who was acting in good faith and unaware of the financier's security, that third party's security may take priority over the financier's security should the third party serve notice on the accounts debtors / account banks first.

However, if the financier's security has been registered at Companies House within the prescribed timeframe (see above) and the third party could reasonably be expected to search the register, arguably the third party may have constructive notice of the financier's security (irrespective of whether or not it did actually search the register) and therefore it may not be able to claim priority.

(ii) Protection against subsequent set-off rights and defences

Service of notice on an account debtor / account bank freezes certain set-off rights and defences that the account debtor / account bank may have with respect to the customer. To the extent that a financier requires all set-off rights to be excluded, it would need to obtain an agreement to that effect from the account debtor / account bank.

(iii) Protection against unauthorised discharge of receivable

Service of a notice to an account debtor prevents that account debtor from getting good discharge of receivables by paying amounts to the customer instead of the financier.