APPOINTMENTS UNDER FLAWED SECURITY

1. Receivers are to be appointed under a security instrument. The proposed receivers or their advisers will wish to make some obvious checks to satisfy themselves so far as possible as to the validity of the security and of the appointment. The checks will usually include the following.

Validity of the Security

- Is the charge (a) signed (b) executed as a deed?
- Is the charge susceptible to challenge under the transaction avoidance provisions of the Insolvency Act 1986 (undervalue, preference, etc)?
- Is the charge susceptible to challenge on contractual grounds (mistake, misrepresentation, undue influence, duress etc)?
- Is the underlying debt susceptible to any such challenge, or challenge on any other grounds (eg Consumer Credit Act, Financial Services & Markets Act, financial assistance etc)?
- Is the charge on land, and if so is the land registered? Is the charge registered? If not, is there any power to convey the legal estate?
- Is the charge on agricultural land or assets to which special considerations may apply?
- Is the charge given by a company, and if so (a) did the company have power to grant the charge (b) has the charge been registered at the Companies Registry (c) does the charge include a floating charge which is invalid because it was created within the relevant time prior to the onset of insolvency?
- How up-to-date is the charge? Does it include all usual and necessary powers? If an old mortgage/debenture, was it stamped (a requirement abolished by the Finance Act 1971)?
- Are there any jurisdictional issues; is the charge on land situated in or otherwise subject to the law of a jurisdiction other than England & Wales?

Validity of the Appointment

- Have the conditions under the security for the appointment of a receiver been satisfied (has any necessary demand been made, or event of default occurred etc)?
- What formalities need to be satisfied for the appointment to be valid?
- To whom must notice of the appointment be given?
- What property falls within the scope of the charge?
- Are the charges fixed or floating?
- Are there any prior charges?
- What powers will the receiver have when appointed?

Invisible Defects

2. When an appointment is made there is usually an element of urgency and rarely time to consider all issues in detail. Some defects may not be apparent however much care is taken before the appointment is made - particularly defects arising out of the circumstances in which the charge was originally taken. The fact that a signature has been forged may not be obvious. The fact that the charge was procured by misrepresentation or undue influence may not come to light until the charge is to be enforced.

The De Mattos Principle

3. One such invisible defect which can exist but which practitioners may overlook dates back to 1858. In that year the Court of Appeal decided *De Mattos v Gibson* (1858) 4 De G & J 276. In 1857 the plaintiff had chartered a ship (The Allerton) to carry coal from the Tyne to Suez. In the Channel it suffered damage and put in for repairs. Gibson, who held a mortgage over the ship granted in January 1858, paid for repairs and effectively took possession of the ship in October 1858 with a view to securing its return to Newcastle so that he could exercise his power of sale. The plaintiff applied for an injunction to restrain Gibson's threatened action on the ground that it would be inconsistent with the performance of the charter-party of which Gibson had known when he had taken his mortgage.

4. In granting an interim injunction, Knight-Bruce LJ stated:

> *"Reason and justice seem to prescribe that, at least as a general rule, where a man, by gift or purchase, acquires property from another, with knowledge of a previous contract, lawfully and for valuable consideration made by him with a third person, to use and employ the property for a particular purpose in a specified manner, the acquirer shall not, to the material damage of the third person, in opposition to the contract and inconsistently with it, use and employ the property in a manner not allowable to the giver or seller. This rule, applicable alike in general as I conceive to movable and immovable property, and recognised and adopted, as I apprehend, by the English law, may, like other general rules, be liable to exceptions arising from special circumstances; but I see at present no room for any exception in the instance before us. The Defendant Mr Gibson as between him and the Plaintiff, has not, I think, any higher or better title … The title of Mr Gibson must, I conceive, be treated as originating after the charter-party … It preceded the mortgage … a mortgage taken with express notice of the charter-party; and by that charter-party I conceive that he is accordingly for every purpose of liability (I do not say damages, but to an injunction against diverting the vessel from the agreed voyage or interrupting it) … bound …"*

5. The true scope of the principle remains the subject of debate and the case has consistently given rise to controversy. When it eventually came on for trial the injunction was discharged. The legal principle was not doubted but on the facts the court held that the performance of the charter-party had been "virtually at an end" by the time Gibson took possession of the ship in any event. Thereafter, the principle had an equally chequered history perhaps best summed-up by Diplock J in *Port Line Ltd v Ben Line Steamers Ltd* [1958] 2 QB 146 who plainly did not think much of the *De Mattos* principle. He said (at 164-5):

> *"The broad principle as laid down by Knight Bruce L.J. applies to all species of property - real property, chattels and choses in action alike. It was applied (or at any rate treated as correct) in a number of cases relating to each of those species up to the turn of the century, but as a doctrine dependent upon notice alone was finally discredited in London County Council v Allen. Scrutton L.J. there shed a tear over its demise as respects real property, but five years later in Barker v. Stickney he regarded the period of mourning as over, and his judgment conveniently lists (and so saves me from citing) the cases which he considered had buried it as respects each class of property. In 1926, however, it rose from the grave in the Strathcona case which, being a decision of the Privy Council, is not binding upon me, but being, one*

of a Board which included Lords Haldane, Wrenbury and Blanesburgh, in addition to Lord Shaw, is (so far as it deals with questions of equity) entitled to respect which in a common law lawyer borders upon awe."

6. Despite that "awe", Diplock J went to on conclude that the *Strathcona* case ([1926] AC 108) had been wrongly decided, but he added for good measure (at 168):

> *"If I am wrong in my view that the case was wrongly decided, I am certainly averse from extending it one iota beyond that which, as I understand it, it purported to decide. In particular, I do not think that it purported to decide (1) that anything short of actual knowledge by the subsequent purchaser at the time of the purchase of the charterer's rights, the violation of which it is sought to restrain, is sufficient to give rise to the equity; (2) that the charterer has any remedy against the subsequent purchaser with notice except a right to restrain the use of the vessel by such purchaser in a manner inconsistent with the terms of the charter; (3) that the charterer has any positive right against the subsequent purchaser to have the vessel used in accordance with the terms of his charter."*

7. But this did not signal the end of the line for the *De Mattos* principle. It was again resurrected in 1979 in *Swiss Bank Corporation v Lloyds Bank Ltd* [1979] Ch 548. There the plaintiff loaned £2.1m Swiss Francs to the third defendant (IFT) on terms that certain securities (FIBI securities) would be purchased, deposited with an authorised depository, and held as cover for the loan. The securities were purchased and deposited, but then charged to Lloyds Bank at a time when Lloyds had no notice of the terms of the plaintiff's loan. Later, after being given actual notice of those terms, Lloyds sold the securities without the plaintiff's knowledge. The plaintiff claimed a right to be paid out of the proceeds of sale. It relied on *De Mattos* as supporting an argument that an injunction could be made to restrain Lloyds from dealing with the proceeds. Lloyds argued that *De Mattos* was no longer good law.

8. Browne-Wilkinson J examined the authorities and concluded (at 573) that:

> *"In my judgment that case is an authority binding on me that a person taking a charge on property which he knows to be subject to a contractual obligation can be restrained from exercising his rights under the charge in such a way as to interfere with the performance of that contractual obligation: in my judgment the De Mattos v Gibson principle is merely the equitable counterpart of the tort. But two points have to be emphasised about the decision in De Mattos v Gibson: first, the ship was acquired with actual knowledge of the plaintiff's contractual rights, secondly, that no such injunction will be granted against the third party if it is clear that the original contracting party cannot in any event perform his contract."*

9. And again (at 574):

> *"Therefore, in my judgment the authorities establish the following propositions. (1) The principle stated by Knight Bruce L.J. in De Mattos v. Gibson, 4 De G. & J. 276, is good law and represents the counterpart in equity of the tort of knowing interference with contractual rights. (2) A person proposing to deal with property in such a way as to cause a breach of a contract affecting that property will be restrained by injunction from so doing if when he acquired that property he had actual knowledge of that contract. (3) A plaintiff is entitled to such an injunction even if he has no proprietary interest in the property: his right to have his contract performed is a sufficient interest. (4) There is no case in which such an injunction has been granted against a defendant who acquired the property with only constructive, as opposed to actual, notice of the contract. In my judgment constructive notice is not sufficient, since actual knowledge of the contract is a requisite element in the tort."*

10. On the facts of the case the principle could not be relied upon to defeat Lloyds' rights because Lloyds had not taken its charge with notice of the plaintiff's charge. The case went to the Court

of Appeal and House of Lords on other issues, but nothing was said to detract from Browne-Wilkinson J's analysis of the *De Mattos* principle.

11. The principle was again unsuccessfully invoked in *Mac-Jordan Construction Ltd v Brookmount Erostin Ltd (in receivership)* [1992] BCLC 350 (CA). There Brookmount, a property developer, engaged the plaintiff under a building contract which provided for interim payments to be made by Brookmount subject to retentions of 3%. Brookmount's interest in the retention money was stated to be as a fiduciary trustee for the plaintiff, but no fund was set aside. Generale Bank SA held a floating charge on Brookmount's assets and appointed administrative receivers. The issue was whether the plaintiff or the bank took priority in relation to the retention money.

12. The Court of Appeal held that because no money had been set aside, the plaintiff did not in fact get any equitable interest in the retention money. Furthermore, even if the bank had notice of the plaintiff's right to have the retention fund set aside, it was unaffected because the plaintiff's right did not relate to a specific asset, and in any event the existence of the bank's charge was not inconsistent with the plaintiff's contractual rights. Scott LJ stated (at 357):

> *"First, in De Mattos v Gibson the contractual rights in question related to a specific item of property, a ship … In the present case, the contractual right does not relate to any specific asset or assets ... Second, the bank's charge in the present case was not, when granted, inconsistent at all with the plaintiff's contractual right, under cl 30-4.2.1 of the building contract. The terms of the charge did not, until the crystallisation of the floating charge, prevent effect being given to the plaintiff's contractual right. The plaintiff could not have obtained an injunction restraining the grant of the charge on the ground that it represented an interference with the plaintiff's contractual right. In the Swiss Bank case, on the other hand, the grant of the charge to Lloyds Bank could, on the view the judge took of the plaintiff's contractual rights, have been restrained …*
>
> *In my judgment these two distinguishing features disqualify the plaintiff from relying on the De Mattos v Gibson equity. When the bank took its floating charge under cl 3.2 of the charge dated 23 June 1989 it was not interfering with any contractual right of the plaintiff. Why then should it not be entitled to the benefit of its security? If a contractual right is not exercisable in respect of specific identifiable property, why should a purchaser who takes specific identifiable property, or some interest therein, from the debtor be affected by notice of that right? In general I cannot see any sufficient reason why in either of these cases equity should interfere and treat the contractual right as binding on the conscience of the third party. If, in the grant to the purchaser, the purchaser's interest were expressed to be subject to the prior contractual right, or if that were a matter of necessary implication, a different conclusion might be justified. But, in the present case, the bank's floating charge was not expressed to be subject to the building contract and it has not been suggested that that should be implied."*

13. In 1993 Hoffmann J referred to the *De Mattos* principle as one which "has had its ups and downs over the past 130 years" (see *Law Debenture Trust Corporation v Ural Caspian Oil Corporation Ltd* [1993] 1 WLR 128 at 143-4). More recently still, in *LauritzenCool AB v Lady Navigation Inc* [2005] EWCA Civ 579, Mance LJ referred (at para 16) to the principle as one which was and has subsequently remained "somewhat controversial". Nevertheless, there remains ample authority supporting its continued existence, as is acknowledged in many of the leading textbooks including, for example, *Lightman & Moss, The Law of Receivers and Administrators of Companies* 3rd ed (2000) who state (at para 7-056) under the heading "Wrongful Interference with Contract":

> *"If a person is granted a charge on property which he knows to be subject to a contractual obligation, he can be restrained from exercising his rights under the charge in such a way as to interfere with the performance of that contractual obligation. The essential feature is the attachment of the contractual obligation to a specific asset or specific assets as opposed to the mere imposition of a requirement*

to fulfil an obligation (eg to make a payment or to set up a fund out of the general funds of the company)."

A recent example

14. How might the principle apply in a modern day context? An example arose recently in the context of PFI contracts in *Governor & Company of the Bank of Scotland v Neath Port Talbot County Borough Council*. This case generated some interest last year among projects lawyers following the judgment of David Richards J on the issue whether there should be an interim order made for the sale of the project assets in advance of the trial of the issue whether those assets were or were not in fact charged to the bank by a debenture and chattel mortgage (see [2006] EWHC 2276 (Ch)).

15. That issue turned (in part at least) on an application of the *De Mattos* principle. In 1999 the Bank provided £27m project finance to its borrower, HLC (Neath Port Talbot) Limited (the "Provider" - being the SPV or project company) to finance the construction and provision of an innovative waste recycling facility for use by the Council over a 25 year period under a PFI project agreement. The land on which the facility was constructed was owned by the Council and let to the Provider. The Bank took a debenture from the Provider on all its assets. The project agreement made between the Provider and the Council expressly provided that on termination for Provider Default the assets (defined to include the land and equipment) would automatically vest in the Council. Because this was an early PFI scheme, there was no express provision for the Bank to release its security over any of the project assets.

16. The facility as designed and constructed was incapable of achieving performance criteria required to pass tests on completion. Negotiations between the parties eventually broke down and on 19 August 2005 the Council served notice terminating the project agreement with effect from 21 September. The Bank's response to the breakdown of negotiations was to take a chattel mortgage over the machinery in June 2005 and to put the Provider into administration on 19 September 2005. For all practical purposes, however, the administrators found that they were unable to take any useful steps whilst there remained uncertainty as to whether the right to possession and control of the project assets rested with the Council or the Bank in the events which had happened.

17. The Bank issued proceedings against the Council claiming the right to take possession of and to sell the equipment by virtue of its debenture and chattel mortgage, to reduce the Provider's liability to the Bank, by now in excess of £40m. The Council defended the proceedings on the following principal grounds:

    - title to the equipment had vested in the Council by reason of the degree and purpose of its annexation to the Council's land;
    - the equipment had automatically vested in the Council in accordance with the vesting clause in the project agreement - leaving the Bank's rights to whatever sum might be payable to the Provider (if any) in accordance with provisions contained in the project agreement for payment of compensation on Provider Default;
    - the vesting clause conferred on the Council a proprietary interest in the equipment taking priority to the Bank's security;
    - having taken its security knowing that the equipment was to be subject to the contractual provisions set out in the project agreement (including the vesting and compensation provisions), the Bank could not seek to enforce its security in a way which was inconsistent with those rights and could be restrained from doing so (the *De Mattos* principle).

18. The Bank disputed the Council's claims. It argued:

- the equipment had not been so annexed as to be part of the land or else it comprised tenants' fixtures which the Provider had the right to sever on the lease coming to and end;

- having regard to pre-contractual negotiations, the Council's notice of termination had been defective because prior notice should have been served on the Bank;

- if the vesting clause had given the Council a proprietary interest in the assets prior to their vesting, that interest was in the nature of a charge on the assets and was void against the Bank as a creditor of the Provider for want of registration under s 495 *Companies Act 1985*;

- having consented to the creation of the Bank's security, if the assets had vested in the Council, they had necessarily done so subject to the Bank's security.

19. The case settled in November 2006, shortly before trial. It does, however, provide a working example of the way in which a security interest may be the subject of defects which are not apparent to receivers (or, as in the Neath case, administrators) on appointment.

Claims Exposure

20. Where the mortgagor is a company, it seems that the directors retain sufficient power to bring a challenge in the name of the company to the appointment and the actions of the receiver: see *Newhart v Co-op Commercial Bank* [1978] QB 814 at 819 but compare *Tudor Grange Holdings Ltd v Citibank NA* [1992] Ch 53 (for a recent case in which members of a limited liability partnership were held entitled to challenge the validity of the appointment of administrative receivers, see also *Feetum v Levy* [2005] EWCA Civ 1601). A receiver who purports to take office when he is not entitled to do so (by reason of some defect in his appointment, whether visible or not) may incur a number of potential liabilities. We mention three main sources of liability below.

21. First among these is a potential liability to the mortgagor in trespass or conversion. Trespass (which may be to goods or land) involves no more than intentional and direct acts of interference with the claimant's property. Conversion involves dealings with a chattel in some way that amounts to a denial of the claimant's right to possess it. If goods are dealt with a such a way that they cannot be recovered, damages may be claimed for their full price or value as well as for loss of profits. If the property remains in the hands of the appointee, he may be ordered to deliver it up to the claimant and to compensate the claimant for any damage. For a case in which a receiver was found liable in damages for trespass and conversion, but only from a point in time after which the validity of his appointment was challenged by the company's liquidator, see *Ford & Carter Ltd v Midland Bank Ltd* (1979) 129 NLJ 543 (HL) in which Lord Wilberforce stated "it appears to me impossible to award damages against the receiver in respect of the period during which he was in charge of the appellant company's affairs with its active consent." In the event damages were ordered to run from the date when the writ was issued by the liquidator since that was the first unequivocal claim challenging the validity of the appointment.

22. Secondly, the receiver may incur liability as a constructive trustee. So, for example, where the mortgagee had notice (actual or constructive) that the directors had acted in breach of duty in granting the security, the mortgagee or receiver may be liable to account to the company or its liquidator as a constructive trustee of any assets received (see for example, *Rolled Steel Products (Holdings) Ltd v British Steel Corporation plc* [1986] Ch 246). In addition, where there is prior ranking security, the receiver (or the debenture holder receiving funds from the receiver) may be liable as a constructive trustee of monies realised.

23. Thirdly, there is the possibility that the receiver may incur liability in tort for damages for wrongfully interfering with the mortgagor's contracts with third parties. But this is also an area of considerable controversy.

24. In *OBG Ltd v Allan* [2005] QB 762 (CA) the first and second defendants were appointed as joint administrative receivers of the claimant by the third defendant. They attended at the company's premises and took control of its business. The claimant was a civil engineering company, and the receivers terminated the majority of the claimant's sub-contractors and settled claims which the company had made under those contracts. The company went into liquidation and proceedings were issued in the name of the company claiming damages for wrongful interference with the company's contracts and conversion.

25. The trial judge held that the administrative receivers had not been validly appointed because the charges pursuant to which they had been appointed did not in fact secure the liabilities of the company to the appointor. The trial judge also held that but for the appointment of the receivers the company would, through the liquidators, have obtained substantially better settlements of the outstanding contracts than the receivers achieved. He awarded damages for wrongful interference with contractual relations but dismissed a claim for damages for conversion on the ground that the contracts were choses in action which are not capable of being converted.

26. The Court of Appeal upheld the judge's judgment on the issue of conversion, but a majority of the Court of Appeal allowed the receivers' appeal against the finding of wrongful interference. Peter Gibson LJ stated (at para 47):

> *"I am not aware of any case where the tort has been held to apply to an act of a third party who, although aware of a contract between the contracting parties, was not intending to procure a breach of contract or other actionable wrong or to prevent or hinder the performance of the contract nor would the act have been a breach of contract if performed by a party … Such intention is lacking in a case such as the present, where the interference is not directed at preventing or hindering the performance of any obligation imposed by a contract. The objection to the interference goes only to who should be managing the contractual rights of one party. No doubt the receivers did intend to manage the contractual rights of the claimants, but, whilst that was an intention to interfere with the claimants' business (though without intending to cause loss or damage), it does not seem to me to amount to an interference with contractual relations in any relevant sense."*

27. Mance LJ gave a powerful dissenting judgment in which he concluded (at para 92) that the tort was made out because the claimant's legal position was altered and the claimant was thereby adversely affected because the receivers took over the handling of the run-off of the claimant's contracts without authority. That was a sufficient interference and it made no difference that the receivers did not realise that they were acting without authority and did not intend to cause harm.

28. Carnwath LJ felt torn between the two judgments, but came down in favour of the judgment of Peter Gibson LJ, largely because he felt that the view Mance LJ had taken represented an extension of the existing law, which he felt uneasy about taking on the unusual facts of this case.

OBG v Allan in the House of Lords

29. The claimant sought and was granted leave to appeal to the House of Lords (see [2005] 1 WLR 2847). The appeal was heard in November alongside *Douglas v Hello Ltd* and *Mainstream Properties v Young.* It is likely that their Lordships will review the whole field of economic tort and give new guidelines. No date has yet been given for judgment, which now seems likely to be in May or June.

Remedial Action

30. Remedial action is sometimes possible. For example it may be possible for the lender to correct the defect (eg the absence of a valid demand for the underlying debt) and re-appoint the receiver. But note the view expressed by Goff J in *Cripps (Pharmaceuticals) Ltd v*

Wickenden [1973] 1 WLR 944 at 957 that if the appointment of a receiver by the bank had been invalid:

> *"… the bank could not appoint a receiver until it had restored the company to possession of its assets and renewed its demand. If it could not do that because it had sold the assets, then there might be a serious question whether it had forfeited its right altogether, or would be entitled to appoint a receiver after restoring the proceeds, the company having an action for damages for conversion for any loss not recouped by return of the proceeds …"*

31. If the mortgagor is co-operative, it may be possible to get the defective appointment ratified or the defect waived.

32. Alternatively, if with full knowledge of the appointment the mortgagor has dealt with the receiver, the mortgagor might be estopped from disputing the validity of the receiver's appointment. For an example, see *Bank of Baroda v Panessar* [1987] 1 Ch 335 at 351-2. But this was not part of the primary reasoning of Walton J in that case and it may be doubted whether an estoppel can arise if the mortgagor does not know the grounds on which the appointment is invalid at the time when he deals with the receiver.

33. An administrative receiver may be able to rely on section 232 *Insolvency Act 1986* which provides that:

> *The acts of an individual as. . . administrative receiver, liquidator or provisional liquidator of a company are valid notwithstanding any defect in his appointment, nomination or qualifications.*

34. For the equivalent protection for administrators appointed under the new style administration procedure introduced by the *Enterprise Act 2002*, see *Insolvency Act 1986* schedule B1 para 104 which provides that:

> *An act of the administrator of a company is valid in spite of a defect in his appointment or qualification.*

35. In *OBG v Allan* the trial judge rejected a defence based on section 232 on the grounds that the section does not in terms apply to the situation where the defect lies not in the appointment but in the instrument or power under which it purports to have been made; section 232 does not apply where there was no power to appoint at all. The receivers were refused permission to appeal this part of the trial judge's judgment (see [2005] QB para 38).

36. If no other remedial action is available, it may be necessary for the appointee to consider whether he has any rights of indemnity from his appointor, whether under a specific contract of indemnity (if he has the benefit of one) or under section 34 *Insolvency Act 1986* which provides that:

> Where the appointment of a person as the receiver or manager of a company's property under powers contained in an instrument is discovered to be invalid (whether by virtue of the invalidity of the instrument or otherwise), the court may order the person by whom or on whose behalf the appointment was made to indemnify the person appointed against any liability which arises solely by reason of the invalidity of the appointment.

Neil Levy, Guildhall Chambers
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10 April 2007