

## Tracing proceeds of unauthorised dispositions of assets subject to a charge

### Key points.

- Principles governing proprietary tracing claims are complex and uncertain
- Proprietary tracing claims based on property law are not consistent with the law of charges as a matter of principle, and unjust enrichment offers a better fit
- Identifying traceable proceeds should be based on the effect of the defendant's exercise of the power to dispose of the initial asset, not value
- A well drafted charge agreement can help reduce the need for claiming traceable proceeds

*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*

### Introduction

It is well established that in English law a person who has a proprietary interest in one asset may in some circumstances assert 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: the sale proceeds, represented by a balance 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 like a simpler solution but it is not without its risks.

## Claims to proceeds arising as a matter of law

In *Foskett v McKeown*<sup>1</sup> Lord Millett held that claiming proceeds of non-consensual dispositions is a two-stage process. It is necessary to first demonstrate what happened to the asset initially charged by tracking the ‘value’ that resided in the initial asset through mixtures and substitutions into traceable proceeds. Second, once traceable proceeds are identified, the proprietary claim to proceeds is asserted by way of vindication of the proprietary interest.

*Foskett* was a case concerning unauthorised dispositions of trust property by a trustee but it could apply by analogy to a chargor (B, in the scenario above) disposing of the charged property without the chargee’s (A’s) consent. This would mean that A would be able to vindicate its fixed charge by claiming a proprietary interest, e.g. a lien, over the sale proceeds in B’s hands because the sale proceeds represent the exchange value of the van which B sold without A’s consent. If B were to transfer the sale proceeds to another party, D, A would be able to, on this analysis, assert a proprietary claim to the proceeds in D’s hands, so long as D is not a bona fide purchaser of legal title without notice.

The vindication analysis in the context of charges is problematic because A does not have an interest in property in the same way as claimants in *Foskett* had. Claimants in *Foskett* were trust beneficiaries. Trustees have the power to invest the trust property, which may involve, for example, sale of trust asset and purchase of another. The trustee is expected to hold the new asset on trust for the beneficiary. This is so in relation to proceeds of dispositions authorised by the trust instrument, so it may not be surprising that proceeds of unauthorised dispositions would also be held on the same trust.

But, the fixed charge, in its very nature, does not empower the chargor to sell the charged asset free of the charge without the chargee’s consent. To say, then, that the chargee would assert a proprietary tracing claim to proceeds as matter of property law overlooks a key characteristic of that form of security interest, namely that the chargor does not have the power to dispose of the assets without the chargee’s consent. Saying that proceeds of such a disposition become subject to a proprietary interest as a means of vindicating a fixed charge undermines the nature of the bargain that A and B are understood to have struck in law, at least in light of *Re Spectrum Plus Ltd.*<sup>2</sup>

To take this reasoning to its logical conclusion, allowing proceeds of unauthorised dispositions to be claimed on the basis of vindication of a fixed charge would introduce through a back door a fixed charge that would function as a floating charge. This means that vindication of property rights as the basis for claims to traceable proceeds identified in *Foskett v McKeown*, is as a matter of principle, not a good fit with the current law on the characterisation of charges.

*Buhr v Barclays Bank*<sup>3</sup> is a less-known but relevant decision handed down by the Court of Appeal a few months after *Foskett* although without much reference to it in the judgment. *Buhr* involved a legal charge over unregistered land. The legal charge was not duly registered

---

<sup>1</sup> [2001] 1 AC 102 (HL).

<sup>2</sup> [2005] UKHL 41.

<sup>3</sup> [2001] EWCA Civ 1223.

under the Land Charges Act and so, was void against the purchaser of the land.<sup>4</sup> It was found that the sale was unauthorised as the chargee did not consent to it. Lady Arden, who led the Court, held that the chargee was entitled to a proprietary interest in the proceeds of the unauthorised sale. The 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 chargee's right to proceeds arises automatically, as soon as the chargor becomes entitled to them, as a matter of a "[general] principle of substitutions".<sup>5</sup> The second, was that the chargee was able to "adopt [the unauthorised] transaction and thus retrospectively make the [chargor] its agent."<sup>6</sup>

There are some difficulties with the reasons in *Buhr*. If any chargee 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 chargee could *ratify*. Principals can only ratify unauthorised acts of those who intended to act on principal's behalf, and only where the principal was disclosed.<sup>7</sup> Generally, it is unlikely that the chargor would sell the asset ostensibly on behalf of the chargee, and that the chargor would wish to act on behalf of the chargee. Typically, C knows nothing of the existence of the chargee and thinks that B deals with the asset unencumbered, on its own behalf.

A possible alternative analysis is that the basis for the chargee'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 chargor'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 chargor might paint the charged asset a different colour.

In a given scenario it is important to ask whether the chargor'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 unauthorised disposition of the charged assets are the new

---

<sup>4</sup> Land Charges Act 1972, s 4(5).

<sup>5</sup> *Ibid*, at [39]-[44] and [53].

<sup>6</sup> *Ibid*, at [49].

<sup>7</sup> *Keighley & Maxted v Durant* [1901] AC 240 (HL).

derived asset which can now be claimed. On this analysis it is not necessary to, for example, look at the intention of the defendant.<sup>8</sup>

Unjust enrichment explanation of claims to traceable proceeds has been rejected in *Foskett*.<sup>9</sup> One of the key reasons was the difficulty of explaining why the enrichment of the defendant was unjust: “want of title” to the asset was not a satisfactory reason.<sup>10</sup> 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 characterisation of fixed and floating charges.

As a matter of policy, the unjust enrichment explanation allows to better balance the interests of innocent parties than the vindication because third parties who are not bona fide purchasers can raise a defence of change of position (as was recognised in *Lipkin Gorman v Karpnale*<sup>11</sup>), e.g. that they spent the proceeds in a way they would not have done had not been for receiving them in the first place. That said, situations where a chargee might need to assert a proprietary tracing claim against an innocent third party who is not a bona fide purchaser are likely to be rare in practice.

### **Claim to proceeds based on agreement**

There are various ways in which the chargor and the chargee could agree that the charge would extend to the proceeds of disposition of the charged asset even if the disposition is unauthorised. The parties could provide, for example, in the debenture that the charge extends to sale proceeds of the vans, or that the charge is over the chargor’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 (in the scenario above) 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 chargor would have the power to sell the charged asset without the chargee’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.<sup>12</sup> A similar risk exists were the chargor to obtain the chargee’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 chargee’s consent to the sale would not usually matter.

---

<sup>8</sup> 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.

<sup>9</sup> [2001] 1 AC 102 (HL) 115 (Lord Hoffmann) and 127 (Lord Millett).

<sup>10</sup> [2001] 1 AC 102 (HL) 127 (Lord Millett).

<sup>11</sup> [1991] AC 548 (HL)

<sup>12</sup> *Re Spectrum Ltd (in liquidation)* [2005] UKHL 41.

## Conclusion

Proprietary tracing claims are powerful tools in the chargee'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.