

1 (a) Describe the features of and differences between:

- Hire Purchase
- Conditional Sale
- A Finance Lease
- An Operating Lease

(b) Describe the legal effect of the differences between:

- Receivables financing by charge and by outright sale
- Block discounting and whole turnover financing
- A legal and equitable assignment of a debt

- In a hire purchase agreement goods selected by the borrower are purchased by the hirer and bailed to the borrower, who agrees to make a series of periodic payments. At the end of the period of hire the borrower has an option but not a duty to purchase the goods outright, typically by making a specified payment.
- In a conditional sale, the seller agrees to sell goods to the buyer with the purchase price to be paid in instalments but on the basis that title to the goods will not pass to the buyer until the final instalment is paid and any other conditions specified in the contract have been fulfilled. In the meantime the goods are bailed to the buyer.
- In a finance lease goods are leased to a business in return for a series of payments calculated to represent the full value of the goods and the lessor's required return on capital over a period which is the anticipated economic lifetime of the equipment. At the end of the lease the business may have an option to extend the lease for a reduced 'rent' or, alternatively, the lessor may sell the equipment typically rebating the proceeds to the lessor. The cost of maintaining the goods during the period of the lease falls on the lessee.
- In an operating lease, goods are leased to a business in return for a series of payments calculated to represent the use value of the goods over the period of the lease which is less than the anticipated economic lifetime of the equipment. At the end of the lease the business will return the goods to the lessor. During the period of the lease the cost of maintaining the goods falls on the lessor.
- In receivables financing, the benefit of an income stream due to a business is used as a means of financing the business. The business can either assign or agree to assign the income stream outright in return for a capital payment. Alternatively it can borrow money and assign or agree to assign the income stream as security for the loan. Although the terms of an outright sale can, in effect, place the financial risks and rewards of the income stream back on the business, the courts will generally not re-characterise a receivables financing described as one by way of sale as one by way of security.

- In block discounting, the business and the financier will have a master agreement under which the business will offer blocks of its receivables to the financier, who may or may not accept the offer on the standard terms set out in the agreement. Under a whole turnover, agreement the parties agree that all of the business' receivables which meet the specification set out in the agreement (called 'eligible debts' very commonly) will automatically become subject to the master agreement as they arise.
- Prior to 1925, with some limited exceptions relating to land, it was not possible to assign the benefit of a contract at law, whilst in equity even an agreement to assign was treated as the equivalent of an assignment. Under s136 LPA 1925, it is now possible to assign the benefit of a contract at law if done in writing and if notice is given to the obligor. Failure to meet these criteria will typically result in an equitable assignment. There appears to be no obvious advantage to legal as opposed to equitable assignments, since the priority is dependent on the rule in *Dearle v Hall*, namely the first bona fide purchaser to notify the obligor has first claim on the property, rather than the normal rule in property law that gives priority to bona fide purchasers of legal interests.

2 ‘The lack of recourse by a lessee under a finance lease to anyone other than his lessor can be readily cured through careful documentation.’

Discuss.

## Introduction

- As with all essays, you should begin with an introduction that sets out what the question is about, why the topic is an important one, and how your essay will go about answering the question set. By providing an outline structure of the discussion to follow, your essay will be clearer and more structured.
- This essay makes two assertions and you will need to explain both and challenge at least one of them. The first assertion is that a lessee under a finance lease has no recourse other than to his lessor – this needs explaining. The second is that any problems can be dealt with by appropriate documentation - this needs explaining and evaluating because this is what the question specifically asks you to do. But first you will need to explain what a finance lease is in broad terms and what sort of commercial function it performs, both for the lessor and the lessee.

### The rights of the lessee of goods against the supplier

- Clearly there are two key contracts to consider in a finance lease, the contract between the lessor and the lessee and the contract of sale between the supplier and the lessor. You will need to explain the problem that this structure creates for the lessee if the goods are in some way unsatisfactory – principally that caused by the lack of privity between the lessee who suffers the problems with the equipment and the supplier.
- On pages 724 – 728, *Commercial Law* suggests four mechanisms which might give the lessee direct or indirect recourse to the supplier in relation to a breach of the supply contract to the lessor – the lessor sues for the benefit of the lessee – the lessor assigns his rights to the lessee, - a claim under the Contracts (Rights of Third Parties) Act 1999 and a claim based on a collateral contract against the supplier. You will need to outline these mechanisms but it is probably sensible to postpone any evaluation of these ‘solutions’ until later, save perhaps to note that none of them is without its difficulties.

### The rights of the lessee of goods against the lessor

- The issue that the lessor can probably exclude liability for the supply of unsatisfactory goods will need a brief explanation here.

### How can documentation help?

- Perhaps the most obvious documentary solution is that the lease agreement should not exclude the lessor's liability giving the lessee a claim under that contract and leaving the lessor to sue his contractual counterparty, the supplier. You will need to consider whether this is a commercially satisfactory solution – for example, why might the lessor feel that if there is a choice of who to blame for any defect in the goods between himself and the lessee, then it is the lessee who should shoulder it? There is also a legal point – it may be that the lessee may obtain higher damages against the lessor than the lessor obtains from the lessee based on the foreseeability of loss, though this could be dealt with by contractually limiting the lessee's recovery to whatever the lessor recovers.
- You should now move on to consider how documentation might improve the plight of the lessee in relation to the four mechanisms mentioned above. One is easy – as *Commercial Law* makes clear, a collateral contract is going to arise fairly rarely.
- Moving on, whilst the lessee probably would not be able to take advantage of s1(1)(b) of the Contract (Rights of Third Parties) Act (you would need to explain why briefly), there is no overwhelming reason why the contract of sale between the supplier and the lessor should not grant him the right to enforce it. The problem is that the sale is going to be on the standard terms of the seller, who can only be disadvantaged by the inclusion of such a term while, unless it is a term of the finance lease that the lessor will secure such a right for the lessee, there is no incentive to the lessor/buyer to seek a non standard variation in this form. However the lessee is incentivised to seek a variation of the lessor's standard lease terms to this effect. That said the lessor is very unlikely to agree – if only because he may well be factoring the income stream arising from his leasing operations and will have agreed with the factor to allow no contractual variations in the leases.
- This latter point poses difficulties with the next two possibilities. It would clearly be advantageous if the lease agreement contained provisions which imposed a duty on the lessor to assign its rights to sue to the lessee or to sue in its own name on the lessee's behalf. The difficulties which arise were the lessor to agree to do this as set out in *Commercial Law* will need to be explained at this point and the legal difficulties evaluated.

### Conclusion

You will need to reach a sensible conclusion, perhaps along the lines that, in theory at least, appropriate documentation can go a long way to dealing with the problem, but that specific legislation to give the lessee rights is perhaps the only sure solution. However, consider the last paragraphs of the chapter. Might adopting a slightly different commercial structure to the deal (some possibilities are outlined in *Commercial Law* on pages 729-730) help? Would the lessee agree?



3. You are an in-house lawyer for FinHoCo Ltd, a finance house which does receivables financing. You receive an urgent phone call from the finance director at about 7:00pm, just as you were about to go home early. He says that one of the company's clients BussiCo Ltd has just notified them that it is insolvent. The finance director tells you FinHoCo has bought over £10m of debt owed to BusiCo from its clients and wants to know whether FinHoCo's agreement with BusiCo Ltd will 'stand up'. You can't access the BussiCo' file until tomorrow morning but have a copy of FinHoCo's standard receivables financing agreement.

The agreement is headed 'Master Factoring Agreement'. Under its terms FinHoCo agrees to 'consider purchasing debts offered to it by the Business' (meaning BussiCo in this instance) from time to time.' If FinHoCo agrees to purchase the offered debts then, by clause 10 of the agreement, the business warrants that the debts will be paid in full by its customers and that it would re-purchase any bad debts at face value. The 'Purchase Price' for the debts is 'the discounted value of the block of debts'. The agreement then stated that FinHoCo would pay 'the Purchase Price to the Business on the last working day of every month'. A little later on, the agreement stated that FinHoCo was:

'entitled to retain a percentage of the Purchase Price, calculated in its sole discretion as security for the Business' obligations arising under clause 10 hereof ('the Retention'). The Retention shall be used in the first instance to meet the Business' re-purchase obligations under clause 10 in respect of the block of debts to which it relates but to the extent that the amount recovered in respect of that block of debt is greater than that assumed by FinHoCo in determining the amount of the Retention, the Retention shall be returned to the Business.'

You analyse the agreement to determine:

1. Is this a whole turnover or block discounting agreement?
2. Is this intended by the parties to be an outright sale of the debts or to operate as a security?
3. Regardless of what the parties intended might the court characterise this as an assignment by way of security?
4. If it is a security what would the impact be on the validity of the agreement?

You check the Companies Register on-line and discover to your horror that BussiCo Ltd granted a floating charge over its whole undertaking over a year ago and the charge was duly registered. However the charge permits BussiCo to enter into receivables financing. You then consider the effect of this charge on priorities between the Master Agreement and the charge assuming the Master Agreement takes effect as an outright sale.

**What advice did you give to the finance director?**

**Is this a whole turnover or block discounting agreement?**

- We know that ‘FinHoCo agrees to ‘consider purchasing debts offered to it by the Business’ so this is block discounting because under a whole turnover agreement the finance house is obliged to acquire all debts in the defined block. Since this is not a ‘whole turnover’ agreement, it does not automatically cover debts as they come into existence. Nor will it ‘back-date’ the date of acquisition of the debts to the date of the Master Agreement. In an outright sale it is difficult to see how a ‘whole turnover’ Master Agreement could have this effect but it would mean that the moment the asset came into existence it is assigned in equity to the finance company.
- Although the question does not ask us about this, it is worth spotting that clause 10 of the agreement, under which the business warranted that the debts will be paid in full by its customers and that it would re-purchase any bad debts at face value, means that this is ‘recourse’ financing so that the business bears the risk of bad debt.

**Was this intended to be an outright sale or by way of security?**

- The extracts from the agreement that we have all use ‘buy/sell language indicating that the debts are to be assigned by way of outright sale rather than by way of security.

**Regardless of what the parties intended might the court characterise this as an assignment by way of security?**

- You should refer to the extract from the judgment of Romer LJ in *Re George Inglefield Ltd* and show how in theory a recourse financing has many characteristics of a charge rather than of sale. However in practice the courts will not characterise a sale as a charge except where the underlying nature of the parties’ relationship is one of security only – see *Re George Inglefield Ltd* itself.
- In this agreement, however, we can see that the financier is entitled to a retention which the agreement states is a security against the business’ obligation to re-purchase bad debts at face value. This resembles the term in *Re Charge Card Services* where the court concluded that the retention there was simply part of the mechanism for determining the purchase price of the debts, which was the discounted value the debts actually realised. In other words, the financier never had rights over any property belonging to the business – the business was not entitled to the retention in the first place. However, in our problem the ‘Purchase Price’ for the debts is ‘the discounted value of the block of debts’ – in other words, the finance house is obliged to pay the discounted value of the face value of the debts and the business has a duty to re-purchase bad debts. The financial outcome is identical to that in *Re Charge Card Services*, but it is structurally different, so that it is true to say that the retention is something which the business was entitled to receive but, for the withholding of it, said to be by way of security for a very real obligation to buy back bad debts.

- But can the financier have a charge over a debt owed by itself? *Re Charge Card Services* states, probably obiter that it cannot. Lord Hoffman in *Re Bank of Credit and Commerce International SA (No 8)* suggests very firmly to the contrary so the arrangement in our question may well be a charge.
- Alternatively, the court might conclude the whole arrangement is what it said it was and conclude that as in *Re Charge Card Services* there never was a debt equal to the Purchase Price owing to the business, only a debt equal to the Purchase Price less the Retention, so the financier has no claim against anything that belongs to the business and cannot have a charge over it.
- However, the charge (if any) is only over the ‘Retention’, not the debts themselves, so in all likelihood the sale of the debts themselves is unlikely to be characterised as an assignment by way of security though this part (the ‘retention’ might be regarded as a security).

**If it is a security, what would the impact be on the validity of the agreement?**

- On this basis, the charge is registrable under S860 CA 2006 (it wouldn’t matter were this characterised as a mortgage, as ‘charge’ includes ‘mortgage’ S861(5)). As such, it is void against a competing creditor.

**The effect of this charge on priorities between the Master Agreement and the charge**

- Priorities are determined under the rule in *Dearle v Hall*, as the floating charge and the assignment take effect in equity only. All charges are equitable anyway (except the charge by way of legal mortgage over land,) and even if the assignments of the debts have been formalised, *Pffeifer* determines that s136 LPA does not affect priorities. Under *Dearle*, as between bona fide purchasers without notice of prior interests, priorities are determined by the date of notification of assignment of the debt to the debtor, not as is the case of competing equitable interests in chattels, when it is determined by date of creation.

**What advice did you give to the finance director?**

- First advice is notifying the debtors quickly. If this is a ‘notified’ financing, notice will already have been given so there would be no problems if FinGoCo is safe. If FinHoCo has taken over the sales ledger, then it will know the names, addresses, and probably e-mails of all the debtors now - so get the night shift in and open up the files! If it is non-notifiable and Bussico still collects the debts on FinhoCo’s behalf, then there is a problem.

- Secondly, notification *prima facie* is no good in respect of any debts purchased if FinHoCo had notice of the charge which it will get on the date of registration of the charge at Companies House – it's an open register – and theoretically before accepting any new block of debt it ought to check the register. However, we can see the charge permits BussiCo to factor its debts so the notice is non-problematic; BussiCo is entitled to sell its debts in the ordinary course of its business. However, if factoring had not been permitted under the charge then FinHoCo could not have been entitled to claim to be without notice of the charge in respect of all blocks of debt purchased after registration. Consequently, it could not benefit from *Dearle* and would take subject to the charge.
- It should be noted that if BussiCo has been collecting the debts, for FinHoCo there are issues over the cash held by BussiCo. Without doubt the Master Agreement will state that such funds will be held in trust for FinHoCo, but unless the funds are segregated in a designated trust account they will lose their identity, though FinHoCo may be able to trace the proceeds or alternatively claim against the bank as a constructive trustee for 'knowing assistance' in a breach of trust. But this is all for an equity course, really.
- Finally, you should say that you need to check that the underlying debts did not prohibit assignment because, if they do, then any assignment may be void. If this is the case, there is still the possibility that the agreement may operate in such a way to create a proprietary claim against the debts as the business collects them – but might it be a chare and so void for non-registration as against the liquidator. (See page 721 of *Commercial Law*.)