

Bank finance and regulation

Multi-jurisdictional survey

Scotland

Enforcement of security interests in banking transactions

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1 Part I – types of security

1.1 *What are the most common types of security in banking transactions in your jurisdiction (eg, standard security package)? Please provide a brief characteristic of each type of security.*

1.1.1 Standard security

A standard security is the only form of fixed security over real estate in Scotland. A standard security must be in writing and in one of the two forms prescribed by the Conveyancing and Feudal Reform (Scotland) Act 1970.

The Conveyancing and Feudal Reform (Scotland) Act 1970 provides a template of standard conditions that form part of standard securities unless these conditions are expressly varied by the parties, as they often are. The statute prevents any variation of the standard conditions relating to the powers of sale, foreclosure and the security holder's exercise of those powers.

A standard security is not created until it is registered at the Land Register of Scotland or recorded in the General Register of Sasines (GRS), depending on at which location the secured property is registered or recorded. Once a standard security is registered in the Land Register of Scotland or recorded in the General Register of Sasines, as appropriate, it will vest a real right in security for the satisfaction of the obligation to which it relates in the party in whose favour it is granted.

If the granter of a standard security is a company the standard security must also be registered with the Registrar of Companies within 21 days of its date of creation – the date of creation being the date on which the standard security was registered at the Land Register of Scotland or recorded in the GRS, as appropriate.

1.1.2 **Pledge**

Pledge is a possessory security by which a creditor takes actual or civil possession of the security subjects. Creation of a security by way of pledge requires an intention on the part of the owner of the security subjects to grant a pledge and delivery (whether actual or constructive) of the security subjects to the security holder. Possession is essential in the perfection of this type of security – without possession there can be no real right in security over the subjects.

Given its possessory nature, the granting of a pledge prevents the pledgor from dealing with the security subjects; for this reason, the most common usage of pledge in the commercial context is in respect of goods in transit, when intromission with the security subjects would be impractical in any event.

Pledge can be created by actual delivery of the security subjects, specifically identified by the pledgor as such, to the security holder. As noted, pledge is more commonly used when the subjects are in the actual possession of a third party carrier; in such cases the pledgor will effect constructive delivery of the security subjects by delivering a document transferring civil possession of them to the security holder and subsequently intimating this transfer to the third party carrier in actual possession of the security subjects; pledge is created at the moment of intimation.

A pledge does not require to be in writing, nor does it generally require to be registered (but see 1.2.4, below, regarding registration practice in relation to share pledges). Although a pledge does not require to be in writing, a document regulating the terms of a pledge will often exist. There is no prescribed form for this pledge document.

1.1.3 **Floating charge**

As its name suggests, a floating charge is not a fixed security – the charge floats over a pool of security subjects which is continuously changing as the chargor acquires and disposes of various specific assets until such time as it 'crystallises' and attaches to the security subjects then forming the chargor's property. The pool of subjects over which the charge floats can be restricted to certain assets falling within the chargor's property, but it is more common for the charge to be granted over the whole of the chargor's assets (real and personal, heritable and movable, corporeal and incorporeal, present and future). Crystallisation occurs on any of the winding up of the chargor, the appointment of a receiver in respect of the charged assets or at the discretion of an administrator. On crystallisation the charge attaches to those assets falling within the chargor's property at that moment.

Floating charges may only be granted by companies, limited liability partnerships, and industrial and provident societies. Although there is no prescribed form for a floating charge, it must be created expressly as a floating charge – there is no possibility of an implied floating charge. The floating charge is created at the date upon which the instrument creating it is signed. There is a statutory requirement to register a floating charge with the Registrar of Companies within 21 days of its date of creation; failure to do so will result in the charge becoming void against any liquidator, administrator or creditor of the chargor.

The instrument creating a floating charge and any documents relating thereto can be altered by the execution of an instrument of alteration (eg, a ranking agreement) by the granter of the floating charge, the security holder and by the holder of any other charge who would be adversely affected by the alteration. There is a statutory requirement to register any such alterations with the Registrar of Companies within 21 days of the instrument of alteration's execution.

1.1.4 **Assignment in security**

Security over incorporeal property may be granted by way of written assignment by the granter of the security in favour of the security holder, followed by intimation of that assignment to the debtor in the contract being assigned (eg, an assignment of an insured's rights under an insurance

policy must be intimated to the insurer). An assignment does not take effect unless and until it is intimated.

Registration requirements of assignments in security vary depending on the particular type of incorporeal property to which they relate; these are dealt with individually, below.

1.2 In relation to the following types of assets, please provide the types of security that can be created or granted in your jurisdiction and give details of any registrations required:

1.2.1 Real estate

Real estate includes land and fixtures – those things attached to land. Real estate includes within its definition buildings, as they are attached to the land, but also includes things that are attached to buildings which are intended to be permanently attached and which are not capable of being removed without damaging the land or building to which they are attached (for example, pipe-work and cabling).

As noted at 1.1.1, above, the only form of fixed security which can be granted over real estate is a standard security, and the registration requirements are detailed therein.

Floating charges can include real estate within their security subjects, depending on how they are constructed. A floating charge over a company's whole assets and undertakings, for example, will include such real estate falling within that company's property at the time of crystallisation within that class of assets.

1.2.2 Charging assets (inventory, stocks, etc.)

In Scotland security may be taken over corporeal movable property by way of pledge, but given the restrictions relating to the chargor's use of the pledged assets (see 1.1.2, above), it is more common to take security over corporeal moveable property by way of a floating charge.

Detailed consideration of the creation and registration requirements of floating charges is given at 1.1.3, above.

1.2.3 **Movables**

See 1.2.2, above.

1.2.4 **Shares**

In Scotland security over shares in a company may be taken by means of a share pledge. As with pledge generally, no security is created until the transfer of shares is recorded in the relevant company's register of members. There is no requirement to register a share pledge with the Registrar of Companies, although it is common practice to present the charge for such registration in any event.

Shares may also fall under the security created by a floating charge, for which see 1.1.3, above.

1.2.5 **Rights under contracts**

Assuming that a particular contract does not prevent assignment, a fixed security over the rights under such a contract may be created by an assignment in security. An assignment in security creates a real right in security once the assignment has been intimated to the debtor under the contract in question.

Assignations in security are generally required to be registered with the Registrar of Companies within 21 days of the date of the assignment's intimation to the debtor.

Security over rights under contracts may also be created by way of a floating charge, as the rights will form part of the grantor's property and undertaking. For more on floating charges see 1.1.3, above.

1.2.6 **Bank accounts**

Whether one may take security over a bank account depends on the position of the proposed security holder. If the proposed security holder is a party other than the bank which is lending to the creditor, then that party may take security over a bank account in the form of an assignment of the sums held on deposit which must be intimated to the account holding bank. If granted by a company this assignment would require to be

registered with the Registrar of Companies within 21 days of the date of the assignation's intimation to the account holding bank.

If, however, the proposed security holder is the lending bank the usual course is for the lending bank to document its common law right of set-off in relation to the sums held at credit on the account. This declaration will normally be constituted in writing, but does not require to be registered, although it is common practice to present such a charge, if granted by a company, for registration with the Registrar of Companies.

1.2.7 **Financial instruments**

Security over shares has been discussed at 1.2.4 above.

The right to payment due in respect of a negotiable instrument is inherent in the possession of it. As corporeal movable property, security over a negotiable instrument may be created by way of pledge, for which see 1.1.2 above. In effecting a pledge of negotiable interest the grantor may transfer actual possession of the instrument to a third-party custodian who will hold the instrument to the order of the security holder. Civil possession of the instrument will be transferred to the security holder by way of a security document, which will regulate the pledge and set out the circumstances under which delivery of the instrument to the security holder may be required.

Alternatively, the grantor of the security may deposit a negotiable instrument with a third-party custodian who will hold the instrument to the order of the grantor. Security over the grantor's right to be paid under the negotiable instrument may be taken by assignation of that right in security, for which, see 1.1.4 above.

Both of the above options are potentially unsatisfactory in that, by the nature of negotiable instruments, the third party custodian becomes a 'holder in due course' of the instrument in question and, notwithstanding that third party's purported holding of the instrument in question to the order of one party or another, is entitled to payment under the instrument by virtue of its actual possession.

As with other forms of property and assets considered, security may also be taken over negotiable instruments by way of floating charge, for which see 1.1.3, above.

1.2.8 **Intellectual property**

For registered intellectual property such as patents or trade marks, a fixed security may be created by way of assignment. As there is no party on whom to effect intimation of such an assignment, the registration of the transfer of the registered intellectual property in the relevant public register (eg, the Register of Patents, the Register of Designs, etc.) effectively serves as intimation of the assignment to the public generally.

There is no means for taking a fixed security over unregistered intellectual property generally, although fixed security over copyright specifically may be taken by way of assignment. There is no requirement to intimate an assignment of copyright.

Floating charge is the most common means of taking security over intellectual property. For more on floating charges see 1.1.3, above.

1.2.9 **Plant and machinery**

See 1.2.3, above. Note that, as discussed at 1.2.1, above, depending on the intention, manner, permanency and purpose of the fixing (if any) of plant and machinery to the building in which it is housed or to the land on which it is placed, consideration must be given to whether the plant and machinery in question falls to be classified as a 'fixture.'

1.3 *Can a trustee or security agent be used in your jurisdiction, or must security be granted in favour of all lenders? Is the parallel debt clause concept recognised in your jurisdiction?*

It is common practice for a trustee or security agent to be used in Scotland.

The parallel debt clause concept is recognised in Scotland.

1.4 *Please explain the latest amendments to the law governing secured transactions in your jurisdiction. Are there any amendments which will be introduced in the near future (within one to two years) which might have an impact on the legal framework*

of secured transactions? Please also explain recent practical developments regarding secured transactions in your jurisdiction.

Part 2 of the Bankruptcy and Diligence etc (Scotland) Act 2007 proposes, among other things, to create a new register of floating charges under the auspices of the Keeper of the Registers of Scotland. Registration of floating charges in this proposed register will replace the current requirement to register floating charges with the Registrar of Companies. Under the proposed scheme the date of creation of the floating charge will no longer be the date that the security document is signed, but rather the date on which the charge is registered in the proposed register. Although the majority of the Bankruptcy and Diligence etc (Scotland) Act 2007 is currently in force, there is no indication when the provisions noted above will be implemented.

2 Part II – enforcement of security

2.1 Please explain briefly general rules of enforcement of security indicated in answer to the question 1.1 in part 1, above, (excluding rules in a bankruptcy or insolvency proceeding – see question 2.3, below). In your answer please explain whether specific security may be enforced only through judicial proceedings or whether extra-judicial methods are also available. Furthermore, please provide estimate of costs (if they create significant obstacles in enforcement, including applicable taxes and any other duties/costs) and timing for enforcing such security. Please also explain the degree of difficulty (eg, burdensome formalities, whether enforcement requires actions of a state body) in enforcing security. Also please explain whether taking security by an entity from another jurisdiction influences the possibility of establishing security and its enforcement.

2.1.1 Standard security

On the default of the grantor of a standard security the security holder may acquire a power to sell the security subjects, the right to enter into possession of the security subjects to uplift rents or to let the subjects, the right to enter the security subjects to repair or maintain them and the power to apply to the court for decree of foreclosure.

In order to exercise these rights the security holder must serve a calling-up notice, a notice of default, or make an application to the court for warrant to exercise his rights.

If a calling up notice is issued and the grantor fails to make payment or perform his obligations then the security holder becomes entitled to exercise his rights. The notice period is usually two months, although the grantor may agree to a shorter notice period. Strict adherence by the security holder to the form of notice and service procedures set out in the Conveyancing and Feudal Reform (Scotland) Act 1970 is essential.

Where the grantor has failed to comply with any requirement in terms of the standard security the security holder may issue a notice of default requiring the grantor to remedy the default. The grantor normally has one month in which to remedy the default and, if he fails to do so within that time, the security holder may proceed to sell the security subjects, enter the subjects to repair or maintain them, or apply to the court for a decree of foreclosure. Upon registration of a decree of foreclosure the security holder acquires title to the property and the debt owed to him by the grantor is reduced by the amount at which the secured property was last exposed for sale. This does not prevent the security holder from enforcing his personal right against the grantor for any amounts which remain outstanding.

Where the grantor has failed to comply with any requirement in terms of the standard security or has become insolvent the security holder may apply to the court for a warrant to exercise any of the remedies in terms of the standard conditions of the standard security.

2.1.2 **Pledge**

Enforcement of pledge is by way of sale of the secured assets. The security document will normally specify events of default upon which the security may be enforced. The security document governing a pledge of movable property must include a specific power of sale; failure to include this power in the pledge document would require court authorisation in advance of executing a sale of the secured assets.

2.1.3 **Floating charge**

A floating charge 'attaches' to the security subjects falling within the scope of that floating charge on the appointment of an administrator to or the liquidation of the grantor, subject to the rights of a) anyone who has

effectually executed diligence on the property or part of it; b) anyone who hold a fixed security on the property or part of it ranking in priority to the floating charge; or c) anyone who holds a prior ranking floating charge over the property or part of it.

Enforcement of the security is by way of sale of the secured assets. Note that the distribution of funds ingathered from the sale of the security subjects may be subject to the restrictions noted at 2.2.2 below.

2.1.4 **Assignment in security**

Enforcement of an assignation in security will normally be governed by the security document, which will specify events of default upon which the security may be enforced.

2.2 *How does a commencement of bankruptcy or insolvency proceedings influence the rights of the security holder to enforce its rights? In bankruptcy or insolvency proceedings, what are the suspect periods, is claw-back possible, and what other types of rights (tax debts, employees, etc) have preference over security granted? Please explain briefly specific features (if any) of enforcement of security established over the following types of assets in a bankruptcy or insolvency proceeding:*

Alienation of assets for inadequate consideration by a debtor within two years (five years in the case of persons 'connected' to the debtor company) of the date of commencement of winding-up proceedings or the appointment of an administrator may be challenged by a security holder as a gratuitous alienation. Application may be made by the security holder, among others, to the court to reduce the transaction.

If, within the six months preceding the commencement of winding-up proceedings or the appointment of administrators the debtor effects a transaction which creates an unfair preference in favour of a single creditor at the expense of the general body of creditors, application may, as above, be made to the court to reduce the transaction.

A secured creditor may also challenge an 'extortionate credit transaction' – eg, a transaction requiring exorbitant payments to be made or in some other way grossly contravenes the ordinary principles of fair dealing. The court may examine credit transactions entered into up to three years before the day on which the company entered into administration or went into liquidation, and may a) set aside the transaction; b) vary the terms of the transaction; c) order repayment of certain sums;

d) order the surrender of property held as security; and e) order an accounting between parties.

2.2.1 **Real estate**

As noted at 2.1.1 above, if the grantor of a standard security becomes insolvent the security holder may apply to the court for warrant to exercise the remedies provided to him in terms of the standard conditions of the standard security. The court has no discretion to refuse such an application if it is convinced that the security holder is entitled to the remedies sought.

2.2.2 **Movables**

Floating charges created within the 12 months (or 24 months, in the case of a security holder who is connected to the debtor) prior to the onset of the debtor's insolvency will be invalid except to the extent of the aggregate of a) the value of money paid or goods/services supplied at or after the creation of the floating charge; and b) the amount required to reduce or discharge the debts of the grantor to the security holder at or after the creation of the floating charge.

On the assumption that a floating charge has not been avoided, as above, the proceeds of the sale of the secured assets on the insolvency of the grantor will first be distributed to preferential creditors (if any) and roughly 20 per cent of the proceeds will be ring-fenced in favour of the grantor's body of unsecured creditors. Preferential creditors are narrowly defined by statute as certain remuneration claims by employees of the grantor, and certain claims by pension schemes for sums owing by the grantor.

In the case of pledge, the security holder is not, on the grantor's insolvency, subject to the above-noted provisions relating to the distribution of the proceeds of sale; the pledge holder will be paid first.

2.3 *Are there any specific features or problems of enforcement proceedings if the security is granted to a trustee or security agent or the parallel debt structure is used?*

There are no unusual problems of enforcement proceedings if the security is granted to a trustee or a security agent, or if the parallel debt structure is used.

In such circumstances the security agent or trustee will be the beneficiary of the security and will enforce the particular securities in the usual way, subject to any restrictions or controls set out in the particular facility agreement or any related intercreditor agreements.

2.4 Please explain the latest amendments to the law governing secured transactions in your jurisdiction in relation to a bankruptcy or insolvency proceeding. Are there any amendments which will be introduced in the near future (within one to two years) which might have impact on the legal framework of the enforcement or secured transactions in light of insolvency law? Please also explain recent practical developments regarding secured transactions in your jurisdiction in relation to insolvency law.

The Home Owner and Debtor Protection (Scotland) Bill is currently being debated in the Scottish Parliament. If this Bill is enacted in its current form by the Scottish Parliament it will, among other things, provide robust protection to natural persons against creditors attempting to enforce securities held over an insolvent debtor's residential home. The impact of this proposed legislation is limited in so far as the protections it may introduce are limited to natural persons.

There is no guarantee that this proposed legislation will be enacted by the Scottish Parliament, nor is it clear when it will come into force if it is so enacted.