Commercial trusts law

Section B: Equitable devices used to take security in commercial contracts

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Chapter 1: Taking security in loan contracts

Learning outcomes

By the end of this chapter and the relevant readings you should be able to:

- differentiate between the various ways in which trusts are used to take security in loan contracts
- conceptualise the various forms of trusts and powers which are used in such circumstances.
- you should be able to distinguish between the uses of
  - ordinary trusts
  - *Quistclose* trusts (as explained by Lord Millett in *Twinsectra* v *Yardley*)
  - retention of title clauses
  - equitable charges
  - mortgages
  - liens
  - pledges.

1.1 Introduction

Essential reading

- Hudson, A. *Equity and Trusts* (2005), Chapter 22.
- Thomas, G.W. and A.S. Hudson *The Law of Trusts.* (Oxford University Press, 2004), Chapter 47 (extract in the accompanying reading).

This section considers the way in which commercial people take security in their transactions. By 'take security' we mean the ways in which a commercial person will seek to protect himself from any action or omission of any other party to that transaction. The events against which the commercial person may want protection range from some other party's failure to make a payment or to perform some act required by a contract right, through to the other party going bankrupt or being legally prevented from performing the contract in some other way. Commercial people therefore rely on their legal advisors to devise the means by which they can acquire some protection. That protection can take many forms. This particular chapter is concerned with taking security specifically in relation to loan contracts.

1.1.1 Some of the various possible methods of taking security

A commercial person may take security in many different ways. The objective is always to ensure that the commercial person receives some rights or property which will provide adequate recompense to him if another party to a contract fails to perform its obligations for whatever reason. Suppose, for example, that a clothing manufacturer has entered into a contract to acquire cotton because he has a contract to supply a given number of shirts by a given date. In such a situation the clothing manufacturer's greatest fear will be that the cotton supplier fails to make delivery of the appropriate amount of cotton on the specified date. An appropriate means of taking security would be to withhold payment for the cotton until the goods have been delivered.

To look at the same facts from another perspective, the person supplying the cotton bears the risk that the clothing manufacturer may fail to pay for the cotton once it has been delivered. Therefore, the cotton supplier may take one of a number of routes. He may stipulate in the contract that he remains the absolute owner of the cotton until payment is made. Alternatively, he may have greater need of the money than simply to have a consignment of cotton on his hands which he might not be able to sell quickly to another buyer. Consequently the cotton supplier may require that the purchase price be paid to an independent trustee before the cotton is even shipped so that if the buyer fails to make payment then the money will be deemed to be held on trust for the cotton supplier.

In this chapter we will consider taking security in relation to ordinary loan contracts. The money lender, usually a bank, will be concerned that the borrower will fail to make repayment of the loan capital and that the borrower will also fail to make payments of interest when due. The lender will therefore wish to find some way in which the borrower's use of the loan moneys is restricted or in which the repayments of the loan is assured.

1.2 The use of trusts to take security

Essential reading

- Hudson, A. *Equity and Trusts* (2005), sections 2.5 and 21.1.

1.2.1 Two general circumstances in which trusts are used to take security

Trusts provide an excellent means of taking security in commercial transactions, if structured correctly. The situations in which trusts are used to take security are twofold:

(1) First, in transactions in which some identified property is being used as part of the transaction: for example, a transaction in which a specific machine is being used to manufacture goods. In such a situation, the owner of the machine will be concerned to ensure that his ownership of the machine is protected even if the transaction fails or one or other of the participants goes into bankruptcy. If the machine were purchased by the contracting

parties in equal shares solely for the purposes of their transaction, then the question of the ownership of that machine would be more problematic. A trust would identify the rights of the various parties. Importantly there will also be the goods manufactured as part of the transaction: before those goods are sold there will be a question as to who owns them. Suppose, for example, that one of the contracting parties went bankrupt before all of the goods had been sold, then the bankrupt party's creditors would wish to know which goods were part of the bankrupt person's estate and thus capable of being used to pay off his creditors.

(2) The second situation would be that in which there may not be any property used as part of the transaction. Nevertheless, each contracting party may be nervous as to whether or not the other party will perform its part of the contract. Therefore, the first contracting party may ask the second party to provide some property – whether money or some other thing – in which the first party can take absolute title if the second party fails to perform. Suppose a situation in which the parties have entered into a contract whereby the first party agrees to build a house for the second party. The construction process is expected to take one year. The builder will clearly be concerned that the second party will not pay after he has bought materials and paid people to put them together. Therefore, one of the ways in which the builder may seek protection is to require the second party to pay a quarter of the total construction price into a bank account every three months so that it can be held on trust by the bank as trustee for the benefit of the builder, provided that the builder builds the house properly.

The chief advantage of the trust is its flexibility. To continue with the example of the house construction contract: the second party may want protection against the possibility that the builder might fail to build the house properly. Therefore, the terms of the trust might be drafted so that the money held on trust is held for the benefit of the second party if the builder does not have his work certified by a surveyor as being of the appropriate standard. However, if the builder does perform the work properly then the money is to be held by the trustee to the builder's order.

Thus both parties to the transaction acquire protection under the same trust structure. This is the secret of the trust: it permits more than one person to have rights in the same item of property at the same time. Among the people with rights in the property is the trustee. The trustee has legal title in the property which enables the trustee to pay the money in and out of the bank account and to advance it to whichever party is entitled to it ultimately. As is considered in Hudson's *Equity and Trusts* (2005), the trust also grants the beneficiaries rights to sue the trustee for breach of trust if the trustee fails in its duties (Hudson's *Equity and Trusts* (2005), Chapter 18), to sue any third party who interferes with the trust (Hudson's *Equity and Trusts* (2005), Chapter 20), and to trace after the trust property if it is taken away from the trustee in breach of trust (Hudson's *Equity and Trusts* (2005), Chapter 19).

Other means of taking security

Essential reading

- Hudson, A. *Equity and Trusts* (2005), section 23.1.
- Hudson, A.S. *The Law on Financial Derivatives*. (Sweet & Maxwell, 2002) Chapter 11, extract in the accompanying readings, relating specifically to taking security discusses the differences between the various techniques considered here.

There are a range of other mechanisms for taking security other than the trust. This section lists them but most of them are considered in more detail in later chapters in this study guide as indicated below:

- mortgage (see Chapter 2)
- fixed charge (Chapter 2)
- floating charge (Chapter 2)
- pledge (see Chapter 4)
- retention of title (Chapter 3)
- contract of guarantee.

The contract of guarantee is not considered elsewhere in this course because it is not a proprietary form of security. A 'proprietary form of security' means a form of security in which some identified or identifiable property can be seized by the secured party if the other party fails to perform some relevant contractual obligation. This course focuses on proprietary structures in the form of trusts and in this section it also considers mortgages, charges, pledges and retention of title as forms of proprietary security: we are thus able to compare these other forms of proprietary security with the trust and so capable of a better understanding the nature of the trust.

All of those forms of security listed above are comprised of common law and equitable mechanisms. There are others not on the list which are typically included in commercial contracts themselves and form common law mechanisms but we will not consider them here. For present purposes we should distinguish between the contract of guarantee – which is not a proprietary form of security – and the other techniques on the list. A contract of guarantee provides that X will make a payment to Z if Y does not perform his contractual obligations to Z in full. Importantly, the main contract is between Y and Z and X is not a party to it: rather, X is guaranteeing that Z will suffer no loss from any failure by Y to perform the terms of that main contract. Z is the party acquiring security in these circumstances but, importantly, Z acquires no right to any identified property under the guarantee. Rather, Z has a merely personal right against X to recover the amount calculated by reference to the guarantee. Significantly, then X has a right to a calculable amount of money but not to any specific fund of money: therefore if X went into insolvency, Z would be an unsecured creditor because no specific fund of money is set aside for his benefit. It would only be if a specific fund of money were segregated from all other funds of money that there could be a trust over any such money and only then could Z be a secured creditor.

Activities 1.1–1.2

1.1 In what circumstances would a contracting party be content with a contract of guarantee as opposed to a trust?

1.2 Jed and Josh entered into a contract under which Jed agreed to provide computer chips to Josh so that Josh could use them in the manufacture of computers. Josh was not obliged to pay for the computer chips until the computers had been sold. The contract provided that 'the computer chips shall be held by Josh for Jed's benefit until such time as the computer in which any individual chip is incorporated has been sold'. What manner of right does Jed have to the computer chips before they are sold? How could this provision be better drafted to achieve that same goal?

Feedback: see page 15.

1.3 The particular context of taking security in loan contracts

In a loan contract, the lender ordinarily enters into a contract with the borrower such that the borrower receives absolute title in the loan moneys. The borrower is therefore entitled to use the money as his own money, provided that there are no contractual terms to the contrary. The borrower's obligations are to repay the capital amount of the loan and to pay interest on the loan as provided in the contract. Loan contracts, particularly corporate loans, contain a range of 'covenants'. Loan covenants provide that the borrower will be obliged to repay the entire amount of the loan, including interest, at an earlier date than the ordinary effluxion of the loan period if the borrower contravenes the terms of the covenant. An example of such a covenant might be that the borrower would be in default under the loan if the borrower breached the terms of any other loan contract with any other lender. Such covenants give the lender protection against the risk that the borrower might be unable to repay the loan at some point in the future. A well-drafted loan contract will protect the lender against such risks in advance of the risk coming to pass.

The material in this chapter considers another way in which lenders take protection against such risks. It is common for guarantees to be taken from third parties whom the lender considers to be reliable, but *Quistclose* trusts (see Chapter 1.4) offer a different form of protection as part of a loan contract.

1.4 *Quistclose* trusts

Essential reading

- Hudson, A. *Equity and Trusts* (2005), section 22.3.

1.4.1 The nature of a *Quistclose* trust

A *Quistclose* trust is a term in a loan contract which provides that the borrower can only use the loan moneys for a specific purpose with the result that, if the loan moneys are used for another purpose, then rights to the loan moneys revert to the lender. The reason for this provision being known as a 'trust' is that the borrower retains the legal title in the loan moneys but the equitable interest is said to be held by the lender.

In the case of *Barclays Bank* v *Quistclose* [1970] AC 567, Quistclose lent money to a company, Rolls Razor Ltd, so that this company could pay a dividend to a group of its shareholders. Rolls Razor Ltd subsequently went into insolvency having misapplied the money in discharging its overdraft with Barclays Bank. Barclays Bank argued that the money which Rolls Razor Ltd had borrowed from Quistclose should be set off against the company's overdraft with Barclays Bank. It was held by the House of Lords that the loan money, held separately in a share dividend bank account, should be treated as having been held on resulting trust for the lender. The House of Lords held unanimously that the money in the share dividend account was held on trust for the lender on the basis that the specified purpose of the loan – to pay the dividend – had not been performed.

1.4.2 Problems with the nature of the *Quistclose* trust

The structure of a *Quistclose* loan contract

What is complex about this form of trust is that it is unclear precisely how the lender's rights arise. This problem causes a lot of difficulty in theory but, it is suggested, in practice the source of the lender's rights will be best explained by the precise terms of the loan contract. In theory it is not clear whether the lender has rights in the loan moneys throughout the life of the contract, or whether the lender has rights in the loan moneys which are held in suspense in some way during the life of the contract, or whether the lender's rights arise for the first time when the borrower uses the money for an unspecified purpose.

The time sequence operates as follows:

Day 1: Loan contract entered into between lender and borrower, including a provision that the borrower use the money only for a specific purpose.	Day 2: Loan moneys transferred at common law to borrower.	Day 3: Borrower breaches the term in the loan contract by using the money for an unspecified purpose.	Day 4: Lender seeks to recover the loan moneys as a result of the breach of the term in the loan contract.

Table 1

The question is therefore as follows: Does the lender retain some equitable interest in the loan moneys from Day 1, or are all rights given up on Day 2 with the transfer of the loan moneys, or does the lender acquire rights in the money on Day 3? For there to have been a trust it cannot be that the lender acquires rights in the loan moneys only on Day 4 because that would be to make the trust remedial, something which is not possible at English law (as decided in *Westdeutsche Landesbank* v *Islington* [1996] AC 669, [1996] 2 All ER 961).

The explanation given in the *Quistclose* case itself

Lord Wilberforce held that the *Quistclose* trust operated as a resulting trust. That is, His Lordship held that whereas the money had passed from the lender to the borrower under the loan contract, the breach of the loan contract meant that the equitable interest in the moneys passed back to the lender on resulting trust. Lord Wilberforce considered that there was a primary trust under which the borrower was empowered to use the money for the specified contractual purposes. His Lordship further considered that there was a secondary trust which came into existence once the contractual provision governing the use of the loan moneys had been breached. This secondary trust gave effect to the resulting trust.

However, as is considered in relation to *Twinsectra* trusts in the next section, this secondary trust could also be explained as being a provision in an express trust which is only called into operation if the terms of the loan contract are broken.

1.5 *Twinsectra* trusts – another view of *Quistclose* trusts

The case of *Twinsectra* v *Yardley* [2002] 2 All ER 377 contained a dissenting speech by Lord Millett which suggested another approach to *Quistclose* trusts. In the *Twinsectra* case itself moneys had been lent to a borrower with conditions as to how the property could be used. Lord Millett was the only member of the House of Lords to consider the importance of *Quistclose* trusts in this context because the remainder of their lordships were appraised of the question whether or not a solicitor who had become involved in the transaction had assisted in a breach of trust: therefore, it is possible that Lord Millett's views were *obiter dictum* in any event.

Lord Millett suggested that the lender could be considered to have retained some form of right in the loan moneys throughout the life of the transaction. The breach of contract caused those rights to crystallise. Therefore, the *Quistclose* trust did not arise by means of a resulting trust but rather resulted from some form of express trust under which the lender's rights had existed throughout the life of the transaction.

Lord Millett considered the nature of the *Quistclose* trust as being akin to a retention of title clause, as considered in Chapter 3 of this study guide. His Lordship explained his view that a *Quistclose* trust operated in the following manner [2002] 2 All 377, 398-399:

> '…the *Quistclose* trust is a simple, commercial arrangement akin…to a retention of title clause (though with a different object) which enables the borrower to have recourse to the lender's money for a particular purpose without entrenching on the lender's property rights more than necessary to enable the purpose to be achieved. The money remains the property of the lender unless and until it is applied in accordance with his directions, and in so far as it is not so applied it must be returned to him. I am disposed, perhaps predisposed, to

> think that this is the only analysis which is consistent both with orthodox trust law and with commercial reality.'

The lender could therefore be taken to retain the equitable interest in loan moneys throughout the life of the contract. One problem with this approach is that the expression 'the money remains the property of the lender' might suggest that the loan moneys remain absolutely the property of the lender. If that were true, then the borrower would not be able to spend the loan moneys as is the purpose of the loan contract. The least satisfactory analysis of a *Quistclose* trust would be that the lender retains absolute title in the money because that would deny the existence of a trust. A better reading of this expression is that it is the equitable interest in the money which remains vested in the lender, except that the borrower must nevertheless still have the power to spend the money for the purpose identified in the loan contract. Consequently, the lender's equitable interest must be capable of being defeated by the borrower's proper use of the money.

Objections to this approach are considered in the next section.

1.6 Covenants in loan contracts and the crystallisation of rights

Essential reading

- Hudson, A. *Equity and Trusts* (2005), Chapter 22 generally.
- Thomas, G.W. and A.S. Hudson *The Law of Trusts*. (Oxford University Press, 2004), Chapter 47, extract in the accompanying readings.

1.6.1 The terms of the loan contract govern the *Quistclose* arrangement

The principal weakness in Lord Millett's approach is that it purports to give a universal answer to the nature of all *Quistclose* trusts whereas, in truth, the nature of such trusts will depend upon the terms of the loan contracts which give rise to them. The precise nature of any given *Quistclose* arrangement will depend upon the structure of the loan agreement which the parties have effected. The loan contract itself may provide that the loan moneys are to be held on express trust by a third party so that the trustee is only empowered to use the moneys for the contractually-specified purpose: this structure would be used if the lender did not trust the borrower at all and would be unusual. It might be that the lender would act as trustee and make payment directly to the intended recipient on behalf of the borrower. This would clearly be an express trust and would go beyond the *Twinsectra* explanation. It would also be possible to construct this mechanism without using a trust at all and simply provide that the lender has a contractual obligation to make a transfer.

What is not considered in the decided cases is the following problem: if the loan moneys have been misapplied and paid to some person who was not meant to receive them, how is it possible to impose a trust over them? If the money has been passed into a general bank account then the money will be unidentifiable. It would not be possible to impose a resulting trust over those moneys nor to impose an express trust over those moneys in its ordinary terms. The key feature of the *Quistclose* trust is that it gives the lender the potential to trace after the lost moneys and to recover them or their equivalent in one of the ways considered in Chapter 19 of Hudson's *Equity and Trusts* (2005).

A more traditional explanation

There have been explanations of the *Quistclose* trust as being based on general equitable principles of conscience and not therefore based on any particular category of trust. This approach has been stated in *Carreras Rothmans Ltd* v *Freeman Mathews Treasure Ltd* [1985] Ch 207, 222 in the following terms:

> '…equity fastens of the conscience of the person who receives from another property transferred for a specific purpose only and not therefore for the recipient's own purposes, so that such person will not be permitted to treat the property as his own or to use it for other than the stated purpose.'

Activity 1.3

How should a *Quistclose* trust be best understood?

Feedback: see page 15.

Summary

This chapter has introduced some of the principal means of taking security in commercial transactions. The reading provided with this section considers other methods of taking security but this chapter has focused on the *Quistclose* trust. The *Quistclose* trust protects a lender of money by requiring that the borrower use the money only for specified purposes with the result that if the money were not used for the specified purposes then the money is held on trust for the lender. The original form of the *Quistclose* trust recognised it as being a resulting trust which returned the equitable interest in the money as being passed back to the lender. Latterly, Lord Millett has explained the *Quistclose* trust as operating as a form of retention of title provision such that the lender retains rights in the loan moneys throughout the loan contract, rather than having an equitable interest result to him only when the terms of the loan contract have been breached. There are also discussions of the *Quistclose* trust as arising *sui generis* on the basis of the good conscience of the borrower of the money.

Reminder of learning outcomes

By the end of this chapter and the relevant readings you should be able to:

- differentiate between the various ways in which trusts are used to take security in loan contracts
- conceptualise the various forms of trusts and powers which are used in such circumstances.

- you should be able to distinguish between the uses of
  - ordinary trusts
  - *Quistclose* trusts (as explained by Lord Millett in *Twinsectra* v *Yardley*)
  - retention of title clauses
  - equitable charges
  - mortgages
  - liens
  - pledges.

Sample examination questions

Question 1 What is the best explanation of the nature of the *Quistclose* trust?

Question 2 Ted borrowed money from Profit Bank to fund the construction of a new factory for his shoe manufacturing business. The loan contract provided that the money could be used only for the construction of the factory. Nevertheless Ted used the money to pay off his overdraft so that the bank with whom he held his business's current account would not increase the rate of interest payable on his borrowing. Consider the effect of the following, hypothetical provisions in the contract:

(a) 'Profit Bank shall remain the absolute owner of the loan moneys until the construction of the factory is complete'.

(b) 'The loan moneys shall be absolutely the property of the borrower (Ted) provided that Ted shall use them to build the factory as aforesaid, and if Ted shall use any of these moneys for any other purpose then the whole of the equitable interest in the loan moneys shall revert to the lender'.

(c) 'The loan moneys shall be held by the borrower (Ted) so that Ted shall use them to build the factory as aforesaid, and if Ted shall use any of these moneys for any other purpose then the whole of the equitable interest in the loan moneys shall be considered to be the property of the lender'.

Advice on answering the questions

Question 1 *This question was considered above in relation to the learning activities in this chapter.*

Question 2 *(a) This provision suggests that no* Quistclose *trust will come into effect because the property rights remain the property of the lender throughout the transaction.*

(b) This provision has the effect that Ted holds the property as its absolute owner but subject to an obligation to transfer those moneys back to the lender if they are misused: this seems very similar to the original form of Quistclose *trust. An alternative analysis might be that there is an express trust over the money with a power for Ted to spend the money appropriately and with a beneficial interest in remainder for the lender: this second alternative, however, is perhaps a less natural reading of this provision.*

(c) This provision suggests more clearly that there is an express trust with a power permitting the use of the money to build the factory with a beneficial interest in remainder for the lender should that term be breached.

Feedback to activities: Chapter 1

Activity 1.1 *A person would be content with a contract of guarantee if that person had a long history of transacting with the other party or if the party providing the guarantee was known to have a good credit rating: in such circumstances it would be satisfactory to know that the person providing the guarantee was likely to make payment in the event that the contract was not properly performed.*

Activity 1.2 *It appears that the parties' intentions would be best described as an intention to create a trust over the computer chips such that if Josh failed to perform, then Jed would have an equitable interest in the computer chips. What this provision does not consider, however, is who owns the computers into which the chips have been incorporated. The provision could be better drafted to make it clear that all computers into which the chips have been incorporated are to be held on trust for Jed and also that any chips which have not yet been incorporated into the computers are also held on trust for Jed. As the provision is currently drafted it would be possible to interpret it as meaning that Jed has a floating charge over the stock of computers of a value equal to the amount owed to Jed by Josh from time-to-time. Floating charges are considered in detail in Chapter 2.*

Activity 1.3 *This chapter has considered this question in detail. You should attempt to consider the arguments in favour of the* Quistclose *trust as being: (1) a resulting trust composed of primary and secondary trusts; (2) a form of express trust with a power to use the loan moneys; (3) a hybrid trust and retention of title clause as in* Twinsectra*; (4) any one of the preceding analyses dependent on the terms of the loan contract.*