

Fixed charges

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1. Introduction

Victorian England burgeoned with industry and creativity and the judges in England's Chancery courts struggled to keep pace. Joint stock companies needed to raise working capital and their financiers increasingly looked to their current assets as a form of security. These assets – raw materials, work in progress, stock-in-trade and, above all, book debts – were different in nature from land or other assets that had traditionally been offered by way of security, in that they were transitory in nature and circulated in the course of carrying on the business. The new security had to cover future assets as well as present assets and accordingly could only be identified generically by reference to a class, and because they were dealt with in the course of the company's business it was not practicable for the financier to be involved in these dealings; critically, it was not practicable for the financier to execute a release on each occasion that goods were sold or a book debt was collected. It is against this background that the judges invented the concept of a floating charge.¹

As a judicial invention, the concept of a floating charge took some time to develop and there is no recognised definition of the term even after 150 years. This is one of the difficulties. The nearest that the courts have come to defining a floating charge is the classic explanation given by Lord Justice Romer in *Yorkshire Woolcombers*:²

I certainly think that if a charge has the three characteristics that I am about to mention it is a floating charge.

(1) If it is a charge on a class of assets of a company present and future; (2) if that class is one which, in the ordinary course of the business of the company, would be changing from time to time; and (3) if you find by the charge it is contemplated that, until some further step is taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way as far as concerns the particular class of assets I am dealing with.

This is not a definition because the judge made it clear that a floating charge might be created which does not possess all three of these characteristics. Each of the three is no more than a characteristic or hallmark.

1 For a fuller description of the juridical history of floating charges, see the speech of Lord Scott in *Spectrum* beginning at paragraph 95 and *Gough on Company Charges*, 2nd edition, pages 102-108.
2 [1903] 2 Ch 284, 295.

However, the Privy Council in *Agnew v Commissioner of Inland Revenue*³ (*Brumark*) and the House of Lords in *National Westminster Bank plc v Spectrum Plus Limited*⁴ have made it clear that the third characteristic is the critical one, Lord Scott even going so far as to say that he was inclined to think that if the charge bore this characteristic it would qualify as a floating charge, whatever might be its other characteristics. Indeed, it is the emphasis given to the third characteristic in *Brumark* that has given rise to widespread concern among lawyers that charges which have hitherto always been regarded as effective fixed security may be susceptible to the risk of recharacterisation as floating security.

In this chapter, I will attempt to explain why I think that this concern is largely misconceived, but before doing so I would like to explain why secured creditors should be concerned about the risk of recharacterisation and to deal further with the existing case law.

2. **Why does it matter if a security which purports to be fixed is recharacterised as a floating security?**

Floating security (including security which purports to be fixed, but which is recharacterised as floating) is less advantageous to the secured creditor in three respects.

First, floating security by its nature tends to give the secured creditor less control of the asset. Thus, the company can subsequently sell the asset to a third party and the third party will acquire good title to the asset, provided that the floating charge has not crystallised at the time of the sale and the third party has no notice of any restriction in the floating charge prohibiting the sale. Similarly, the company can subsequently create a fixed mortgage or a fixed charge on the asset in favour of a third party and the third party will take priority over the floating charge, provided that the floating charge has not crystallised at the time that the subsequent security interest is created and the third party has no notice of any restriction in the floating charge prohibiting the creation of subsequent security interests.⁵ This is why well-advised purchasers or mortgagees or chargees will wish to examine the floating charge and may ask for a certificate of non-crystallisation. Third parties taking security from the company will almost invariably require the consent of the holder of the floating charge, as it has become standard practice for floating charges to contain negative pledges.

Also, an administrator may dispose of or take action relating to property which is subject to a floating charge as if it were not subject to the floating charge, something that may only be done in relation to property subject to a fixed charge with an order of court.⁶

The second respect in which floating security is less advantageous to the secured

3 [2001] 2 BCLC 188.

4 [2005] UKHL 41.

5 Registration of the floating charge at the Companies Registry is effective to give constructive notice of the charge, but not of the restriction: *Wilson v Kelland* [1910] 2 Ch 306. If the subsequent mortgagee or chargee makes a search, he may have actual notice.

6 Paragraphs 70 and 71 of Schedule B1 to the Insolvency Act 1986.

creditor than fixed security concerns priorities. I have already mentioned the risk that a floating security may lose priority to a subsequent fixed security. In addition, the claims of the holder of floating security in certain cases rank after the claims of certain unsecured creditors (including preferential claims and the claims of unsecured creditors up to the prescribed part) and the expenses of certain insolvency proceedings.

Claims which are preferential in a winding-up⁷ or receivership,⁸ or where the holder of the floating security takes possession,⁹ have been cut back by the abolition of Crown preference and are now limited to claims for occupational pension scheme contributions, the remuneration of employees within certain statutory limits and levies on coal and steel production.¹⁰

Further, where the company becomes subject to insolvency proceedings, a “prescribed part” of a company’s net property becomes available for the satisfaction of unsecured debts.¹¹ This prescribed part is fixed by secondary legislation¹² and is on a sliding scale depending upon the value of the net property, subject at present to a maximum of £600,000.

In many cases, the holder of floating security will not be overly concerned with preferential creditors (because the claims that rank preferentially are now much more limited) or unsecured creditors (because the amount of their priority is capped); of much greater concern (because their amount cannot be accurately assessed and therefore the effect on cash flow if the security is enforced is unpredictable) will be the expenses of administration¹³ and (once Section 1282 of the Companies Act 2006 has come into force)¹⁴ the expenses of a winding-up.

The third respect in which floating security is less advantageous to the secured creditor than fixed security concerns potential invalidation or avoidance. Section 245 of the Insolvency Act 1986 provides that a floating charge created at a relevant time is invalid except to the extent of (among other things) the value of the consideration for the creation of the charge as consists of money paid, or goods or services supplied, to the company at the same time as, or after, the creation of the charge. “Relevant time” in a case where the charge is created in favour of an unconnected person is a period of 12 months ending with the onset of insolvency. This will not apply where the asset in question is financial collateral subject to a security financial collateral arrangement,¹⁵ but this extends to a floating charge only where the financial collateral is “delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker”¹⁶ (which may well not be the case). A floating charge created by a company registered

7 Section 175 of the Insolvency Act 1986.

8 Section 40(2) of the Insolvency Act 1986.

9 Section 196 of the Companies Act 1985.

10 Section 386 of, and Schedule 6 to, the Insolvency Act 1986.

11 Section 176A of the Insolvency Act 1986.

12 The Insolvency Act 1986 (Prescribed Part) Order 2003.

13 Paragraph 99(3) of Schedule B1 to the Insolvency Act 1986.

14 Section 1282 of the Companies Act 2006 has the effect of reversing the decision in *Buchler v Talbot (Re Leyland Daf Limited)* [2004] BCC 214.

15 The Financial Collateral Arrangements (No 2) Regulations 2003, Regulation 10(5).

16 *Ibid*, definition of ‘security financial collateral arrangement’.

in Great Britain must be registered at the Companies Registry within 21 days of its creation, failing which it will be void against a liquidator or administrator or any creditor of the company.¹⁷ This is not the case in relation to a charge which is fixed, unless it is a charge required to be registered for any other reason.¹⁸ A security financial collateral arrangement is exempted from the registration requirement.¹⁹

3. The tension between the financier and the company

It can therefore be seen that the financier's clear preference will always be to attempt to take security which is fixed. However, in many cases the creation of a fixed charge on the borrower's circulating assets could have the effect of paralysing the company's business because it would mean that the consent of the financier would be required for every dealing with the charged assets. The theory is that if the effect of a fixed charge is to create an immediate proprietary interest in an asset in favour of the chargee, any dealing with the asset in a manner which is inconsistent with that interest would require the chargee's consent.

Very little can be done with regard to circulating assets other than book debts. It is simply not practicable, for example, to place restrictions on dealings with stock in trade in a manner that would give the chargee sufficient control to demonstrate that he had an immediate proprietary interest. Other devices could be used, such as the sales agency arrangement in *Exfinco*,²⁰ with a view to achieving the same commercial result.

For many years, clearing banks took debentures from companies incorporating what purported to be a fixed charge upon present and future book debts, placing their reliance upon the decision in *Siebe Gorman & Co Limited v Barclays Bank Limited*.²¹ In that case, Barclays Bank had taken such a debenture. The debenture contained a covenant to pay into the company's account with the bank all moneys which it might receive in respect of the book and other debts subject to the purported fixed charge and not without the consent of the bank to sell, factor, charge or assign them in favour of any other person. There was also an undertaking to execute a legal assignment of the book or other debts if the bank so required.

Justice Slade (as he then was) decided that the charge was fixed, commenting: "This conclusion that the charge is a specific charge involves the further conclusion that, during the continuance of the security, the bank would have the right, if it chose, to assert its lien under the charge on the proceeds of the book debts, even at a time when the particular account into which they were paid was temporarily in credit."²²

He also said that he was inclined to the opinion that if he had found that the chargor of book debts, having collected them, had the unrestricted right to deal with the proceeds of them so long as the account remained in credit, the charge could

17 Section 395 of the Companies Act 1985.

18 See Section 396 of the Companies Act 1985 and *Arthur D Little Limited (in administration) v Ableco Finance LLC*, referred to below.

19 The Financial Collateral Arrangements (No 2) Regulations, Regulation 4(4).

20 *Welsh Development Agency v Export Finance Co* [1992] BCC 270; [1992] BCLC 148.

21 [1979] 2 Lloyd's Rep 142.

22 *Ibid* at page 159.

have been no more than a floating charge. For the charge to work, the bank therefore had to have some sort of notional control of the proceeds paid into the account.²³

This was taken a step further in *Re New Bullas Trading Limited*²⁴ The draftsman of the debenture in this case wanted a fixed charge on present and future book debts. He knew that it would be impossible to argue that the chargee in that case (which was not a clearing bank and therefore did not operate the current account into which the proceeds of the book debts were to be paid) would have any control of the proceeds in the current account, however notional. He therefore conceived the clever idea of dividing the book debt from its proceeds. The chargee would obtain a fixed charge on the book debt, but would only attempt to obtain a floating charge on the proceeds of the debt when paid into the account.

The Court of Appeal held that the charge was fixed, Lord Justice Nourse commenting that there was no reason in law to prevent the parties from agreeing to divide its security in this way. He seems to have thought that it should be allowed as the parties were free to contract for whatever form of security they chose.²⁵

Both of these approaches have now been rejected.

4. **The rejection of *Siebe Gorman* and the disavowal of the *New Bullas* heresy**

Siebe Gorman was not followed by Justice Hoffmann in *Re Brightlife*,²⁶ who pointed out that in that case the judge had found as a matter of construction that the bank would not have been obliged to allow drawings from the account. He was able to distinguish *Siebe Gorman* from the case before him, where the chargee did not operate an account into which the proceeds of the debts could be paid.

The High Court of New Zealand declined to follow *Siebe Gorman* in *Supercool Refrigeration and Air Conditioning v Hoverd Industries Limited*²⁷ on almost identical facts. Justice Tompkins held that as the company was not placed under any restriction on how the company used the proceeds in the account, the bank did not have effective possession of those proceeds.

In the *Brumark* decision, Lord Millett, sitting as a member of the Privy Council, said that whether a charge falls into the category of a fixed or a floating charge cannot depend solely upon the manner in which the parties choose to describe it in the instrument creating it. He said:²⁸

The question is not merely one of construction. In deciding whether a charge is a fixed charge or a floating charge, the court is engaged in a two-stage process. At the first stage it must construe the instrument of charge and seek to gather the intentions of the parties from the language they have used. But the object at this stage of the process is not to discover whether the parties intended to create a fixed or floating charge. It is to ascertain the nature of the rights and obligations which the parties intended to grant

23 *Ibid* at page 158.

24 [1994] 1 BCLC 485.

25 *Ibid* at page 492.

26 [1987] Ch 200.

27 [1994] 3 NZLR 300.

28 [2001] 2 BCLC 188, 200.

each other in respect of the charged assets. Once these have been ascertained, the court can then embark on the second stage of the process, which is one of categorisation. This is a matter of law. It does not depend on the intention of the parties. If their intention, properly gathered from the language of the instrument, is to grant the company rights in respect of the charged assets which are inconsistent with the nature of a fixed charge, then the charge cannot be a fixed charge however they may have chosen to describe it.

The two-stage process has been followed in subsequent cases, in particular in *Smith (Administrator of Cosslett (Contractors) Ltd) v Bridgend County Borough Council*.²⁹ It was also cited with approval in *Spectrum*.

Nevertheless, the court in *Spectrum* seemed to impose an additional requirement. The traditional view is that the exercise of construing the charge document and categorising the nature of the rights and obligations of the parties does not take into account subsequent conduct, unless that conduct gives rise to waiver, variation or estoppel. However, *Brumark*³⁰ and *Spectrum*³¹ would seem to indicate that the restrictions on the chargor dealing with the charged asset must not only be set out in the charge document, but also be operated in practice.³²

In *Spectrum*, the House of Lords had to consider a charge which was expressed to be a fixed charge over present and future book debts, where the chargor was prohibited from disposing of, or creating security over, the uncollected book debts and where the chargor was obliged to place the payments made to it by its debtors in a designated account with the chargee bank. The charge did not prevent the chargor from drawing on the account for its business purposes, provided that its overdraft limit was not exceeded. In reaching its decision that the charge should be characterised as a floating charge, the House of Lords expressed the view that the essential characteristic of a floating charge that distinguished it from a fixed charge was that the asset subject to the charge was not permanently appropriated to the payment of the debt; instead, it floated over the assets subject to the security until the occurrence of some future event which had the effect of crystallising it. Until crystallisation, the chargor was left free to use the charged asset and to remove it from the security.

The House of Lords was faced with conflicting authorities on whether, in categorising a charge on book debts as a fixed or floating security, a court could ignore the rights of the chargor to the proceeds of the book debts. The House of Lords held that since the essential value of a book debt as security lay in the money that could be obtained from the debtor in payment³³ (I will refer to this as the ‘essential

29 [2002] 1 AC 336.

30 [2001] 2 BCLC 188, 204, per Lord Millett.

31 [2005] UKHL 41, paragraph 160, per Lord Walker.

32 In *Fanshaw v Amav Industries Limited (‘Re Beam Tube’)* [2006] EWHC 486, Justice Blackburne held that the moneys standing to the credit of the so-called ‘BLL suspense account’ were only subject to a floating charge even though they were never at the free disposition of the chargor. This is because (see paragraph [48] of the judgment) the terms of the debenture allowed the proceeds of the collections account to be used by the company until default and only purported to create a floating charge on the balance on the account. The judge found as a fact that the moneys standing to the credit of the BLL suspense account remained the property of the chargor and were not the property of the chargee. He further found that the payments into the account were intended to give effect to the terms of the debenture.

33 *Ibid*, Lord Scott at paragraph 110.

value test'), it was not sufficient, in order for the security to be classified as fixed, that control was exercised by the chargee over the book debts for as long as they remained uncollected: such control also needed to be exercised after collection over the use of the proceeds of the book debts by the chargor.

The House of Lords considered a number of factors in reaching its decision in *Spectrum*:

- the intentions of the parties as expressed in the documentation, including the label given to the transaction and the restrictions contained in it;
- the rights retained by or granted to the chargor to deal with its debtors and collect in money;
- the chargor's rights to draw on the account into which the collected debts had been paid; and
- the reality of control which the chargee was entitled to, and actually did, exercise over the proceeds of book debts.

However, the House of Lords gave most weight to actual controls which were exercised over the operation of the bank account in question. Lord Walker said that it made no difference whether the account was at any time in credit or overdrawn.

The House of Lords did state that a charge over book debts could be a fixed charge if restrictions existed which prevented the book debts being disposed of before collection and if, on collection, the proceeds were required to be paid to the chargee itself (for the credit of an account of the chargor with the chargee which was then blocked for the benefit of the chargee's security, with the proceeds unavailable to the chargor without the chargee's prior consent) or paid into a separate account with a third-party bank over which the chargee took an effective fixed charge.

In fact, there are passages in *Spectrum* that would seem to suggest that if the fixed charge on book debts is to be upheld, payment into something akin to a blocked account is a prerequisite. For example, Lord Hope put it like this:³⁴ "Was the account one which allowed the company to continue to use the proceeds of the book debts as a source of its cash flow or was it one which, on the contrary, preserved the proceeds intact for the benefit of the bank's security? Was it, putting the point shortly, a blocked account?"

Again, he said:³⁵ "In my opinion the company's continuing contractual right to draw out sums equivalent to the amounts paid in is wholly destructive of the argument that there was a fixed charge over the uncollected proceeds because the account into which the proceeds were paid was blocked."

As far as concerns *Siebe Gorman*, Lord Hope said³⁶ that Justice Slade's finding that the bank could assert a lien under the charge on the proceeds of the book debts overlooked the fact that the account into which the proceeds were paid was the company's current account with the bank which the company was to be free to operate for its own business purposes within the agreed limit of its overdraft. He

34 *Ibid*, paragraph 55.

35 *Ibid*, paragraph 61.

36 *Ibid*, paragraph 58.