

SECURED TRANSACTIONS REFORM:

DISCUSSION PAPER 2

FIXED AND FLOATING CHARGES ON INSOLVENCY

- 1 In November 2012, the Financial Law Committee of the City of London Law Society issued a Discussion Paper on Secured Transactions Reform which identified certain areas of the law concerning secured transactions which would merit further investigation.
- 2 Following discussions with interested parties, there was a widespread feeling that, as a first step, two issues should be considered further:
 - the requirement to draw a distinction between fixed and floating charges under insolvency legislation; and
 - restrictions on the assignment of receivables and contract rights.
- 3 This Discussion Paper considers the first of those two issues. This issue is seen as the area of law concerning secured transactions most in need of review.

Summary

- 4 In our view, there is no doubt that there is a problem. The necessity to distinguish between those assets which are the subject of a fixed charge and those which are the subject of a floating charge creates material practical problems not just in insolvencies but - perhaps more importantly - when structuring transactions. The problem does not prevent transactions being done, but it does increase their complexity, and therefore their cost. It also creates uncertainty in an area where certainty is of paramount

importance.

- 5 Although it is clear that there is a problem, the solution is much more difficult to identify. There are policy issues at work here which we cannot resolve. But what we can do is identify the possible solutions and discuss the pros and cons of each.

What is the problem?

- 6 The problem is that insolvency legislation requires a distinction to be drawn between fixed and floating charges; and that doing so creates a substantial degree of uncertainty as to the effect of secured transactions. This is inefficient and expensive for borrowers and for lenders. It may lead to an increase in the cost of credit, over-collateralisation or even the refusal of credit altogether.
- 7 There are two main reasons why we need to draw a distinction between fixed and floating charges. Both derive from insolvency legislation. In the first place, it is easier for a liquidator or administrator to set aside a floating charge than a fixed charge. And secondly, certain liabilities of the debtor rank ahead of a floating charge, but not of a fixed charge.
- 8 When a company goes into liquidation or administration, security granted in the period running up to the insolvency is vulnerable to being set aside. Security granted within six months before the insolvency proceedings start can be set aside as a preference if the company was insolvent at the time the security was given and, when giving the security, it was influenced by a desire to put the creditor in a better position. That provision applies to all types of security – whether fixed or floating.¹
- 9 The insolvency legislation also contains a provision which only applies to floating charges. Under section 245 of the Insolvency Act 1986, to the extent that a floating charge secures money lent before the charge was created, it will be set aside if it was created within twelve months before the commencement of insolvency proceedings and, at the time the charge was created, the company was insolvent. There is no requirement to prove any desire to prefer the creditor.
- 10 In the result, it is much easier for a liquidator or administrator to set aside a floating charge than a fixed charge.

¹ Insolvency Act 1986, s239.

- 11 More importantly, when the charged assets are sold, the way in which the net proceeds of sale are applied differs depending on whether the charge is a fixed charge or a floating charge. Where the charge is fixed, the chargee is entitled to the net proceeds of sale. But where the charge is floating, the chargee is only entitled to the net proceeds of sale once certain other liabilities have been paid.² An administrator of the chargor also has much wider powers to use floating charge assets than fixed charge assets,³ and in effect controls their realisation, leading to delays in repayment.
- 12 The liabilities which rank ahead of a floating charge but not a fixed charge are:
- preferential creditors;⁴
 - a percentage of unsecured claims;⁵
 - expenses of an administration and certain expenses of a liquidation.⁶

How does the problem manifest itself in practice?

- 13 The problem manifests itself in two ways – when structuring transactions, and when the company gets into financial difficulties.
- 14 Perhaps the most obvious effect of a rule which requires a distinction to be drawn between fixed and floating charges in an insolvency is the necessity for those dealing with the affairs of an insolvent company to decide which side of the line a particular charge falls. It is clear that the parties are not the sole determinant of the question. The parties decide what the rights are of the debtor and the creditor in relation to the charged assets; but whether the charge is fixed or floating is ultimately a question of characterisation for the court. It depends on the degree of control which the creditor has over the assets which are the subject of the charge.⁷
- 15 Although it is relatively easy to state the test of whether a charge is fixed or floating, it is much more difficult in practice to determine which side of the line any particular charge falls. We know that if a creditor takes a charge over the book debts of a company and does not control the debtor's use of their proceeds, the charge will be

² Unless the charge arises under a security financial collateral arrangement – the Financial Collateral Arrangements (No. 2) Regulations 2003, (SI 2003/3226), regs 6, 8(1)(aa), 8(1)(b) and (c), 8(3)(b) and (c), 10(2A) and (2B) and 10(3). There is also an exception under The Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (SI 1999/2979), reg 14(6).

³ Insolvency Act 1986, Sch B1 paras 70 and 71.

⁴ Insolvency Act 1986, ss40 and 175(2)(b) and Sch B1, para 65(2); and Companies Act 2006, s754.

⁵ Insolvency Act 1986, s176A; Insolvency Act 1986 (Prescribed Part) Order 2003, SI 2003/2097.

⁶ Insolvency Act 1986, Sch B1, paras 70 and 99; Insolvency Act 1986, s176 ZA; Insolvency Act 1986, Sch A1, para 20.

⁷ The principles are summarised in *Re Brumark Investments (Agnew v Commissioner of Inland Revenue)* [2001] 2 AC 710 and *National Westminster Bank v Spectrum Plus* [2005] 2 AC 680.

floating. We also know that a charge over the benefit of a particular contract will be fixed if the debtor has no right to use its proceeds. But what we do not know is how much control is required before a particular charge can be said to be fixed rather than floating. There is a spectrum of possibilities between total control and no control at all, but how much control is required in any particular case to establish that the charge is fixed is by no means clear.

- 16 The problem with applying the test in practice is that it is very fact-specific, and it is a matter of judgement which side of the line any particular transaction falls.
- 17 This creates particular problems when structuring secured transactions. When a lender takes security, it expects to be paid out of the net proceeds of sale of the charged assets. If there are to be any limitations on its ability to do so, it expects to be able to work out what those are with certainty, so that they can be factored into the lending decision.
- 18 The difficulty with the current law is that it is very difficult in practice to give lenders clear advice whether or not they will be entitled to the proceeds of sale of assets charged to them. Preferential liabilities will often be relatively small, and there is a maximum figure for the priority of unsecured creditors' claims, but the expenses of an administration can be huge, and in many cases will account for the entirety of the proceeds of sale of floating charge assets. This would prove less of a problem if it were possible to be clear which assets are the subject of floating charges and which are the subject of fixed charges. But there is no certainty into which category many assets fall.
- 19 These problems occur in most types of secured transaction. For instance:
 - In a property finance transaction, where the borrower is able to collect rents until default, is all or part of the security floating?
 - In an asset finance transaction (for instance in relation to a ship or an aircraft), does the use by the borrower of the charterhire or lease rental before a default mean that some or all of the security is fixed or floating?
 - In the case of a share charge, does the ability of the borrower to receive dividends or to vote the shares before enforcement mean that the security is floating?

- Where security is taken over assets in custody, does the ability of the borrower to direct the management of the fund – within limits – before enforcement, mean that the security is floating?

- 20 Because the decision of whether the charge is fixed or floating is a matter of judgement which depends on the precise facts of each individual case, and because there is little guidance in the cases, it is very difficult in practice to answer the question which lenders ask: Are they entitled to the net proceeds of sale of the charged assets?
- 21 A further problem with the current law is that, even if the restrictions contained in the documentation are themselves sufficient to create a fixed charge, the determination of the question whether a charge is fixed or floating does not depend entirely on the wording of the documentation. The way in which the parties actually conduct themselves in practice is also relevant to the determination of whether the charge is fixed or floating. What is the effect of the parties deciding, in practice, not to enforce all the restrictions strictly in accordance with the terms of the documentation? Does this mean that a charge which would otherwise be fixed has now become floating? This is a concern in many financings.⁸
- 22 This uncertainty does not stop deals being done. Lawyers find ways round the problem, and people have got used to the inevitable fudges which result. But, in practice, what this means is that the time, and therefore the cost, of secured transactions is increased. And that is in no-one's interests. One way round the problem is to turn a secured transaction into an outright one – for instance by means of title transfer. This avoids the fixed/floating charge problem, but at the cost of destroying the transferor's equity of redemption. In a secured transaction, both parties have a proprietary interest in the asset. In a title transfer arrangement, only one does. This shifts the balance of risk.

How can the problem be solved?

- 23 If it is clear that there is a problem, it is much less clear how to resolve it. There are competing policy issues which need to be considered before a choice can be made as to the most appropriate approach. It is not for us to make decisions of that kind. What we try to do, in the remaining part of this note, is to point out the issues and to suggest the pros and cons of some alternative approaches.

⁸ It is clear from the authorities that what the parties actually do is relevant, although it sits uneasily with the principle that subsequent conduct cannot be used to interpret a contract.

Policy issues

- 24 There are two key policy issues to be considered.
- 25 The first is the need for certainty in financial transactions. The importance of security in making finance available to businesses would seem to be generally accepted. If a lender is to lend money on security over particular assets, it must necessarily take a risk on the value of the assets if they come to be enforced, but it would expect to be able to know, at the inception of the transaction, that it will recover the net proceeds of the value of the charged assets or, if not, the extent of any prior claims on those assets. Uncertainty as to the effect of a secured transaction can only reduce the likelihood of the debtor being able to borrow the money.
- 26 The second policy issue concerns the funding of administrations. The purpose of an administration is to enable the business (or, at least, the profitable parts of the business) of the debtor to survive – normally by the sale of the business as a going concern. There is a public interest in preserving viable businesses, and therefore in ensuring that the administrator has sufficient funds to do his job. The issue is whether, if the debtor has created a debenture over its assets and therefore has no free funds, the administrator should be able to use at least some of the charged assets in order to enable the business to be sold as a going concern.
- 27 It is not a self-evident truth that the administrator should have the free use of charged assets. If the business really is worth saving, then it will be in the interests of the debentureholder to enable that process to be achieved and to fund the administrator accordingly. The extent to which the administrator should be able to use charged assets without the consent of the chargee is therefore open to debate.
- 28 Where these two policies diverge, a view has to be taken as to the extent of which one should prevail over the other. Lenders need certainty as to their right to the proceeds of the assets charged to them. Administrators need to be able to rescue the debtor's business. How can these two differing policy requirements be reconciled?
- 29 It is suggested that the first line of discussion is to look at the types of claim which are paid in priority to security and to see to what extent it is appropriate that they should be paid by a levy on the secured creditor's assets.
- 30 Having decided which (if any) claims ought to have priority over the rights of secured

creditors, it is then necessary to decide how best that should be achieved. We have considered three options:

- Option 1: to clarify the distinction between fixed and floating charges.
- Option 2: to identify particular assets out of which the levy should be paid.
- Option 3: to pay the levy as a small percentage of all charged assets, subject to a cap.

Option 1

- 31 The first option is to clarify the law on whether a charge will be floating, rather than fixed. The law would broadly remain the same, but guidance would be given on areas where there are particular difficulties in practice.
- 32 There are very few cases on the topic, and in very few of those was there any real attempt at control. So clarification would be welcome about the extent to which, in particular types of transaction, the arrangements between the parties will constitute sufficient control by the creditor that the charge is fixed. For instance, the guidance could cover the extent to which the charge can remain fixed if the chargor can withdraw excess charged assets or substitute charged assets.⁹
- 33 The advantage of this approach is that it does not involve a wholesale review of the underlying issues. It can therefore be achieved more quickly than the other options. It can also, at least to some extent, preserve the status quo.
- 34 The disadvantage is that it does not deal with the underlying problems, and therefore the law would still be uncertain – even if less uncertain than before. Whether or not a charge is fixed or floating is such a fact-specific issue that it is difficult to achieve a great deal of certainty – even with guidance. This is particularly the case because the answer does not only depend on the way in which the documentation is drafted, but also on what happens subsequently. The practical difficulties involved in framing such guidance should not be underestimated, and non-legally binding guidance is of doubtful value.

⁹ It would also help if the regulations concerning financial collateral could be clarified.

Option 2

- 35 The second option would be to do away with the necessity to distinguish between fixed and floating charges on insolvency, and to replace it with a requirement for those claims which it is decided ought to have priority to be paid out of certain assets.¹⁰
- 36 This could, for instance, provide for payment of these claims out of particular types of asset - for instance, stock-in-trade and receivables. An alternative approach would be to look, not at the nature of the asset, but at the nature of the chargor's use of the asset: whether it is a fixed or a current asset. Another possibility would be to combine the two.
- 37 One advantage of this approach is that it should produce more clarity than Option 1. And it has been used in other jurisdictions which have had to grapple with the same problem – New Zealand and Australia, although it is interesting that the ways they have tackled it are very different.¹¹
- 38 A further advantage of this approach is that it might be said to reflect an argument that, if revolving assets can be used by the directors of the company whilst it is a going concern, they should also be capable of being used by its administrator once it has entered into insolvency proceedings. Those creditors that take security over revolving assets can be taken to have authorised the management and disposal of those assets not just whilst the company is a going concern, but also once it has entered into administration.
- 39 The problem with this approach is trying to decide which types of asset it should apply to. If a decision is to be made on the basis of the nature of the asset concerned, why is it that security over certain types of asset is somehow inferior to security over others?
- 40 If, alternatively, it is decided to distinguish between fixed and revolving assets, how will the distinction be drawn in practice? It is a very fact-specific distinction – depending on the nature of the business of the company concerned; and it is very difficult in practice to draw a clear dividing line between the two types of asset. In the event, the change in the law may replace one uncertain test with another.

¹⁰ This would, of course, need to exclude financial collateral.

¹¹ For New Zealand, see Companies Act 1993, Schedule 7, para 2(b). It is more complicated in Australia. See Duggan and Brown, *Australian Personal Property Securities Law* (LexisNexis Butterworths, 2012), 13.21-13.26.

Option 3

- 41 The third approach would be to do away with the requirement to distinguish between fixed and floating charges in an insolvency, and simply to pay the levy as a small percentage of all charged assets up to a cap. The concept appears to have worked well under section 176A of the Insolvency Act 1986 in relation to the “prescribed part” of floating charge assets.
- 42 The advantage of this approach is that it is (relatively) clear and simple. It should produce a far more certain result than the other two options. There will be no need to strive to draw ever more artificial distinctions. And it should work more fairly, with less scope for arbitrage. It would also be efficient because the percentage would be constant for all security, and the amount of assets required to cover the borrowing would be easier to ascertain.
- 43 If this approach were adopted, it would be necessary to consider the extent to which it is really necessary for all the amounts which are currently payable in priority to continue to do so. For instance, should an administrator always be able to use charged assets to fund all his expenses? Should there be controls on the extent to which he can use other peoples’ money to do so?
- 44 The disadvantage of this approach is that it is very different from the current system. This means that it will need to be worked out in detail, which will be time-consuming. And because it is different, there will be winners and losers – paradoxically, it could be seen as limiting the rights both of secured lenders and of insolvency practitioners.

Conclusion

- 45 Resolving the problem is not straightforward. But the uncertainty caused by the current law creates real practical problems. And they will not go away until the issues discussed in this paper are tackled.
- 46 We hope that this paper will start a debate about the issues.