ARTICLE

An 'Unsatisfactory Area of the Law' – Fixed and Floating Charges Yet Again

Sarah Worthington, Professor of Law, London School of Economics, London, UK

News of the Court of Appeal's unanimous decision on fixed and floating charges in the test case, *National Westminster Bank plc v Spectrum Plus Ltd & Ors*,[1] is now a little stale, but incredulity over the result persists. Few lawyers had correctly predicted the outcome. If Lord Phillips MR is right,[2] a bank's charge will be fixed so long as the proceeds obtained by the debtor from any sale of the charged assets are paid into the debtor's account with the lending bank. How the account is then operated is immaterial. In particular, the debtor is free to use the account in the ordinary course of its business, subject only to any contractual restrictions the bank cares to impose. Put like this, the decision is astonishing. All the post-insolvency advantages of fixed security can be obtained without any of the pre-insolvency disadvantages: the debtor can sell the charged assets in the ordinary course of its business, pay the proceeds to the bank, and then use the account at will; if the debtor defaults, the bank can realize its fixed security over the charged assets without a thought for statutory floating charge invalidity provisions,[3] or for the claims of preferred or general unsecured creditors.[4] For banks, the Court of Appeal decision suggests the floating charge has all but disappeared. If a bank wants a floating charge,[5] perhaps for control rather than for financial security, it will need to take some rather odd steps to ensure that its security falls outside this new expanded class of fixed charges. This note respectfully suggests that the Court of Appeal decision is unsupportable, and that the case well merits the forthcoming appeal to the House of Lords.[6]

Facts

The debenture in *Spectrum* secured a relatively insignificant overdraft of GBP 250,000. Crucially, it specified that the security was by way of specific charge over all present and future book debts and other debts, and that the chargor was prohibited from charging or assigning the debts, and was required to pay the proceeds of collection into an account with the lending bank. The debenture did not specify any restrictions on the chargor's operation of that account.[7] The issue was whether this charge was fixed or floating.

Decision at first instance

At first instance, Sir Andrew Morritt V-C decided the charge was floating.[8] He held, first, as a matter of law, that if a chargor is entitled to use proceeds in the normal course of business unless and until the chargee intervenes, then the charge will necessarily be floating notwithstanding other restrictions on the dealing with the book debts. This followed the Privy Council's approach in *Agnew v Commissioner of Inland Revenue*[9] (better-known simply as *Brumark*). Secondly, he held that the effect in law of the actual terms of the debenture was this. This second step effectively over-

Notes

1 [2004] EWCA Civ 670 (CA), 26 May 2004 (Lord Phillips MR, Jonathan Parker LJ, Jacob LJ) ('*Spectrum*').

2 Lord Phillips MR gave the only reasoned decision. Jonathan Parker and Jacob LLJ simply concurred.

3 Insolvency Act 1986 s 245 and Schedule B1 para 70.

4 Insolvency Act 1986 ss 40 and 175(2)(b), and, more recently, s 176A.

5 All charges *created* as such, regardless of subsequent crystallization: Insolvency Act 1986 s 251.

6 Some sense of the scale of the problem emerges from the realization that there are apparently over 500 post-*Brumark* insolvency distributions frozen, awaiting determination of this test case. The outcome may indicate that distributions effected earlier in the debate were incorrectly made.

7 [12] (all unattributed paragraph numbers in this comment are references to the judgment in *Spectrum* [2004] EWCA Civ 670 (CA)).

8 15 Jan 2004, [2004] 2 WLR 783.

9 [2001] UKPC 28, [2001] 2 AC 710 (PC) ('*Agnew*').

ruled the 25-year-old decision of Slade J in *Siebe Gorman & Co Ltd v Barclays Bank Ltd*,[10] where a clause in essentially the same terms had been upheld as a fixed charge.

The Court of Appeal's three-step analysis

The Court of Appeal disagreed. Lord Phillips MR gave the only reasoned judgment; Lord Justices Jonathan Parker and Jacob simply agreed. The argument was delivered in three steps. First, the Court of Appeal held that it was not entitled to follow the Privy Council decision in *Brumark*. That decision was in direct conflict with an earlier Court of Appeal decision, *Re New Bullas Trading Ltd*,[11] and the rules of judicial precedent required the Court of Appeal to follow *New Bullas*.[12] This latter case held that it was possible to have a fixed charge over book debts regardless of what might then happen to the proceeds. In particular, a charge over book debts could be fixed even though the chargor was at liberty to collect and use the proceeds in the ordinary course of its business. However, all parties conceded that this rule of precedent could deliver only an 'ephemeral' victory,[13] in that an appeal to the House of Lords would inevitably overrule *New Bullas* and would insist that freedom to collect the book debts and use the proceeds in the normal course of business, unless and until the chargee intervenes, is the hallmark of a floating charge over book debts. This must be right, and that legal principle seems unlikely to be re-visited with real vigour in any future appeal.[14]

The next crucial step, then, was to determine whether the chargor here did have this type of freedom to deal with the proceeds of the book debts. The Court of Appeal held it did not. The implication is that, even following *Brumark*, the charge would safely be classified as fixed, just as in *Siebe Gorman*. With respect, this conclusion seems impossible to defend. This is the critical part of the Court of Appeal's judgment, and must be the focus of the House of Lords appeal. Before considering the relevant issues, the third and final step in the court's reasoning should be noted.

In concluding his judgment, Lord Phillips MR made a startling observation. He indicated, obiter, that since banks had relied on the decision in *Siebe Gorman* for over 25 years, he would be inclined to hold that this form of words had, by customary usage, acquired the meaning and effect that Slade J had attributed to it even if Slade J's construction of the debenture had been erroneous.[15] This conclusion might be justified when the issue of construction relates solely to the rights and obligations of the contracting parties. The essence of the fixed/floating charge distinction, however, is that it affects third parties (preferred and general unsecured creditors). Statutory prescription gives these parties particular rights to the secured assets if the agreement between the contracting parties is, at law, a floating charge. No amount of self-interested desire or customary usage by debtors and secured creditors can expropriate these statutory rights from the unsecured creditors if, at law, the charge is floating.

Defining the characteristics of fixed and floating charges

Characterization of charges is a matter of law, and this brings us back to the second step in Lord Phillips MR's judgment. As Lord Phillips MR rightly surmised, 'the critical issue of principle [is] whether the restrictions imposed ... on the use that the chargor can make of the proceeds of the book debts charged are sufficient in law to create a fixed charge on those debts.'[16]

The easy cases are at the extreme ends of the spectrum. If the debenture denies the chargor *any* freedom to dispose of the charged assets, and instead requires them to stand permanently as security for the discharge of the obligations owed to the chargee, then the charge is fixed. On the other hand, if the debenture gives the chargor *complete* freedom to dispose of the charged assets unless and until the chargee intervenes, and only then requires them to be made

Notes

10 [1979] 2 Lloyd's Reps 142 ('*Siebe Gorman*').

11 [1994] 1 BCLC 485 (CA) ('*New Bullas*').

12 [58]-[59].

13 [7].

14 See the comments at [7], [59] and [86].

15 [97].

16 [86].

© 2004 Chase Cambria Publishing

available to the chargee in priority to the other creditors, then the charge is floating.[17] It is the intermediate cases that cause difficulty, and, unfortunately, most debentures fall into the intermediate range. These are the debentures that impose *some* restrictions on the manner in which a chargor may dispose of the charged assets, but not a total embargo. *Spectrum* is just such a case. Is this type of charge fixed or floating?

Every charge must inevitably be one type or the other. Lord Phillips MR's attraction for an intermediate third category is conceptually impossible.[18] The fixed/floating charge distinction is not one that specifies the relative rights of chargor and chargee (here a third category might be apt); it is one that defines the rights of non-contracting third parties to have access to the asset pool. Either these third parties have access or they do not: only those two possibilities exist.

It follows that these difficult intermediate cases require a correspondingly more sophisticated assessment of what distinguishes fixed and floating charges. The issue is critical. Very few charges are drafted to leave the chargor with no power at all to deal with the charged assets, nor, equally, with complete freedom to deal. Most fall at some intermediate point on the continuum, and difficult characterization decisions have to be made. This must be done on a principled, defensible, and commercially certain basis. It is difficult to tease out of the Court of Appeal's decision the precise basis for its particular conclusions. Lord Phillips MR's judgment can be interpreted in at least two ways, although both appear flawed.

A false step in characterization?

First, Lord Phillips MR may have based characterization on his preferred view of the doctrinal dividing line between fixed and floating charges. He seems much attracted by the idea that a floating charge is one that permits the chargor *unrestricted* freedom to deal with the charged assets.[19] He quotes Lord Halsbury in *Illingworth v Houldsworth*:[20] '... the whole purport of this instrument is to enable the [debtor] ... to carry on [its] business *exactly* as if this deed had not been executed at all. That is what we mean by a floating security [my emphasis].' *Brumark*, too, seems to be subjected to this interpretation: '[ignoring the *New Bullas* precedent, the decision in *Brumark*] would surely lead this court to the conclusion that an *unrestricted* freedom on the part of a chargor to use the proceeds of book debts charged necessarily means that the charge cannot properly be described as a fixed charge [my emphasis].'[21] Starting from this perspective, a charge is either 'floating' or 'not-floating', and it is floating only if the chargor has unrestricted freedom to deal.[22]

From this perspective, Lord Phillips MR can readily conclude that the debenture in *Spectrum*, which restricts charging or assigning the book debts, and insists that all proceeds be paid into an account with the lending bank, gives the chargor insufficient freedom for the charge to be floating. It is, therefore, fixed. The degree of control that the bank might choose to exert over the bank account is irrelevant, except to reinforce the finding that the chargor is not left free to carry on its business *exactly* as if the debenture had never been agreed.

Evidence that this is Lord Phillips MR's definitional starting point comes from his repeated suggestions that these difficult cases do not really fit the category of floating charges 'proper', and that there should be a special third category to accommodate this class of security.[23] Failing that, his touchstone remains that floating charges must leave chargors free to conduct

Notes

17 Indeed, this overstates the degree of freedom assumed this end of the spectrum. Precedent indicates that the assumed freedom associated with a floating charge is confined to the right to deal with the charged assets *in the ordinary course of business*. To reinforce this, a floating charge will crytallize automatically once the chargor is unable to carry on its business in this way, even though no term in the debenture so provides: *Re Woodroffes (Musical Instruments) Ltd* [1986] Ch 366 (CA), 377-8 (Nourse LJ); *Re Brightlife* [1987] Ch 200, 212-215 (Hoffmann J). As charged assets are dissipated, it is assumed that any newly acquired assets matching the same description will be subjected automatically to the same charge.

18 See especially [24]

19 See especially [20], [24], [34], [52], [54] choice of the words 'unrestricted right of the chargor'.

20 [1904] AC 355, 357, cited by Lord Phillips MR at [20].

21 [86]. Also see [54], and contrast it with the more appropriate description in [55] which recognizes that Lord Millett's approach in *Brumark* is that a charge is floating if the chargor remains free to use the charged assets to run its business. It follows without question that if the chargor has an *unrestricted* right to collect the book debts and use the proceeds, then the charge is floating.

22 See especially [20], [24],

23 See the text to n. 18, above.

© 2004 Chase Cambria Publishing

their business without restriction. He finds further support for this in several cases where minor restrictions imposed on the chargor were deemed sufficient to render the charge fixed, even though the chargor remained free to collect and use any proceeds derived from the charged assets.[24]

The better alternative – an orthodox definition of the fixed charge

If this is the rationale, then Lord Phillips MR's conclusions follow, but, with respect, the initial premise is unsound and cannot be supported. Fixed charges have long been recognized as security devices, but their existence was always conditional on an obligation on the chargor to preserve the secured asset for the benefit of the chargee. Until floating charges were finally recognized, the absence of this requirement meant that there was no true security. In the United States, this remained the case: floating charges were not recognized by the courts because the absence of a requirement to preserve the charged asset for the benefit of the security holder was seen as inconsistent with the security holder having a proprietary interest in the assets rather than a simple contractual claim to priority (and one that would not work in the face of an insolvency regime that demanded pari passu distribution). English courts' recognition of the floating charge, and then the legislature's later intervention to give unsecured creditors rights over the floating charge assets, needs to be read in the light of this history. This suggests that any definition should start at the fixed charge end of the continuum. In other words, a charge is either 'fixed' or 'not-fixed'; if it is not fixed, then it is floating. A charge is fixed if, and only if, it imposes restrictions on the activities of the chargor that are sufficient to ensure that the charged assets are preserved for the benefit of the security holder. If the charge does not do this, then it is floating, with all the statutory consequences that entails. The issue in *Spectrum* is whether the debenture restrictions achieve this end.

Parts of Lord Phillips MR's judgment can be seen as addressing this very issue.[25] This is the second possible interpretation of his judgment. It sees him starting from a defensible definitional standpoint, and then concluding that the terms of the debenture are sufficient to ensure that the charged assets (the book debts) are preserved for the benefit of the chargee. If this is his task, then his conclusion seems impossible to defend. There are only two ways to ensure that the book debts are preserved for the benefit of the chargee. The chargee may either prohibit all dealings by the chargor (clearly not done here), or may allow dealings, but only on account of the chargee, so that any substitute assets are, in turn, either handed over absolutely to the chargee, or are preserved for the benefit of the chargee's security.[26] What must not happen is that the chargor be allowed to remove the charged assets from the ambit of the security without giving the chargee either the absolute or the security benefit of the substitute.

Control and benefit tests – asking the right question

At various points in his judgment, Lord Phillips MR appears to advance different reasons for finding that the chargee has the necessary control of the book debts and their proceeds to ensure that the charge is fixed according to the second, and arguably proper, approach outlined above. None is convincing. First, there is a persistent, if subliminal, suggestion that prohibitions on charging or assigning the book debts will suffice to meet this test, even though the chargor is allowed to collect the debts and use the proceeds at will.[27] This is clearly flawed. The assertion either assumes the false first test of the fixed/floating charge distinction noted earlier (ie *any* restriction on the chargor's activity will render the charge fixed), or it insists, contrary to the reality, that the second test is met even though the chargor retains the right, albeit restricted, to use the charged assets at will. Lord Millett, in *Brumark*, described this second supposition as 'contrary to both principle and authority'.[28] It is

Notes

24 See the long discussion at [35]-[43], analysing *In re Atlantic Computer Systems Plc* [1992] Ch 505, *Re Atlantic Medical Ltd* [1992] BCC 653, *Re New Bullas Trading Ltd* [1994] 1 BCLC 485, *Royal Trust Bank v National Westminster Bank* [1996] 2 BCLC 682. All these cases have been the subject of significant criticism. See especially R Goode, 'Charges Over Book Debts: A Missed Opportunity' (1994) 110 LQR 592; A Berg, 'Charges Over Book Debts: A Reply' [1995] JBL 433; S Worthington, 'Fixed Charges Over Book Debts and Other Receivables' (1997) 113 LQR 562. These cases are in direct conflict with *Brumark*, discussed by Lord Phillips MR at [46]-[50], and also with *Re Brightlife Ltd* [187] 1 Ch 200, discussed by Lord Phillips MR at [22]-[24], [41], and more recent cases discussed at [44].

25 See especially [95]: 'The [chargor] Company never had any control of these proceeds.'

26 In *Brumark* at [20], [38] and [48], Lord Millett suggests that Slade J in *Siebe Gorman* had interpreted the debenture in that case in this restricted way to support his finding that the charge was fixed, although Lord Millett also appears to suggest that, on the facts, this interpretation is open to doubt.

27 See the tenor of [51]-[56], even before determining as a matter of law that the Court of Appeal must follow *New Bullas* rather than *Brumark*.

28 *Brumark* at [36].

© 2004 Chase Cambria Publishing

impossible to disagree. Lord Phillips MR cites Lord Millett's analysis in full.[29] Put briefly, this partial restriction undoubtedly allows withdrawal of the debt and its proceeds from the ambit of the security at the will of the chargor. On this basis, the charge should be floating.

Secondly, Lord Phillips MR seems at times to suggest that the bank has control over (ie has the benefit of) any proceeds because the chargor must pay them into an account with the bank, and the bank is then entitled to impose restrictions at will on the chargor's use of the account.[30] Slade J in *Siebe Gorman* may have adopted the same reasoning.[31] This, too, is plainly insufficient to render the charge fixed within this second, and arguably proper, definition of a fixed charge. This provision does not give the bank the benefit of the proceeds (either absolutely or as an enhancement to its security); it merely gives the bank the right to demand, at will, that it be given this benefit at some time in the future. Until such intervention, the chargor remains free to dissipate the proceeds at will. Translating this into the language of security, the bank has a present floating charge over the book debts, with the right, in the future and at will, to convert or crystallize this into a fixed security. On the facts of *Spectrum*, this right had not been exercised. Even if it had, however, this would not have assisted the bank. The statutory carve-outs for preferred and general unsecured creditors apply to any charge which, *as created*, is a floating charge.[32]

Thirdly, Lord Phillips MR goes even further than this, and asserts that the bank has the necessary benefit of the proceeds simply because the chargor must pay them into an account *at the chargee bank*.[33] In a remarkable paragraph, he says:[34]

> I do not consider it satisfactory that the limited restraint that Slade J held arose under the debenture should be the critical factor in determining whether the charge should be categorized as a fixed or floating charge. It seems to me that it is at least arguable that a debenture which prohibits a chargor from disposing of book debts before they are collected and requires him to pay them, beneficially, to the chargee as and when they are collected properly falls within the definition of a fixed charge, regardless of the extent of his contractual right to draw out sums equivalent to the amounts paid in. Strictly speaking, the chargor is neither entitled to dispose of the book debts before they fall due for payment, nor to dispose of the proceeds. What he does enjoy are contractual rights to payments ... from the bank. .... It is not satisfactory that the categorization of a charge created by a debenture should turn upon the precise details of a bank's relationship with its customer.

With respect, this loses sight of the question that needs to be answered. It also seems inconsistent with principle and common sense. Indeed, the final sentence goes so far as to suggest that it is inappropriate 'that the categorization of a charge created by a debenture should turn upon the precise details of a [chargee's] relationship with its [chargor].' It is very difficult to see what else categorization can be based upon. This *is* the relationship that must be assessed to determine whether the security is of one type or another.[35]

At issue is whether the *charge over the book debts* is fixed or floating. According to the orthodox definition, the charge is fixed if the chargor is required to preserve the charged assets (the book debts), or their permitted substitutes, for the benefit of the chargee (either absolutely, or as part of the pool of charged assets standing as security for the chargor's obligation).

Notes

29 [48].

30 See his discussion of *Siebe Gorman* at [76]-[77] and [82]-[83].

31 See *Siebe Gorman* pp 158-9 (cited by Lord Phillips MR at [72]), where Slade J concedes that the charge in that case would certainly be floating if, prior to crystallization or enforcement of the security, the bank had no rights to prevent the chargor from dealing with the proceeds of the book debts at a time when the account was in credit. He decided that this was not the position in the case before him, however. His reasoning is difficult to distil, but it seems that this is because either (i) 'the bank had the right, *if it chose*, to assert its lien' on the proceeds (p 159, my emphasis); or (ii) the parties *intended* the charge to be fixed, and nothing in the debenture, including the absence of prohibitions on certain forms of dealings, was sufficient to negative the existence of a specific charge. The first alternative is that discussed in the accompanying text to this footnote, although it is in fact exceedingly difficult to decide which term in the debenture might give the bank this right to intervene. It appears that Slade J decided that the charge was fixed because the parties said it was, and that *therefore* the bank would have the right to intervene and block the account even though it was in credit (*Siebe Gorman* p 159). Also see Lord Phillips MR at [83], [85], [87], [93]. The second alternative seems patently flawed, in that it places too much reliance on the parties' intention and their own labelling, and not enough on the actual rights given to chargor and chargee, and, in any event, it seems to adopt the inappropriate distinction between fixed and floating charges discussed earlier, where most charges are fixed rather than floating, because the chargor is usually subject to *some* restriction on use of the charged assets.

32 Insolvency Act 1986 s 251.

33 [87]. Also see especially [88]-[91] and [94]-[95].

34 [94].

35 *Brumark* at [48]. This is true whether the secured assets are tangible or intangible: see, eg, *Re Cosslett (Contractors) Ltd* [1998] Ch 495 (CA).

© 2004 Chase Cambria Publishing

Otherwise the charge is floating. In particular, it is floating if the chargor is free to remove the charged assets, and their substitutes, from the scope of the security, and use them for its own benefit in the course of its business (at least until the charge crystallizes or the chargee intervenes to enforce the floating security). The security in *Spectrum* seems to fall very clearly on the floating side of this line. Why was Lord Phillips MR so sure that it did not, so long as the proceeds had to be paid to the chargee bank?

The relevance of payment to the chargee bank

It is uncontroversial that a charge over book debts is floating if the chargor can collect the book debts, pay the cash proceeds into a bank account *with some bank other than the chargee*, and then draw on the bank account at will.[36] Why should the result be any different simply because the charge requires the chargor to pay the proceeds into an account with the chargee bank? The test remains the same: the charge is fixed only if the asset or its permitted substitute is necessarily preserved for the benefit of the chargee's security. A transaction where the chargee itself makes the substitution, accepting one form of property and delivering another, which the chargor is then free to dispose of at will, does little more to preserve the chargee's security than if the substitution is made by a stranger.

Consider inventory, and some trivial sums of money for ease of explanation. Assume A has a charge over B's goods to secure a debt of GBP 100. This charge is unquestionably floating if B can sell the goods to C and use the proceeds at will. B might, for example, sell some of the goods to C for GBP 25 and then use the proceeds at will. It makes no sense to suggest that the charge will be *fixed*, not floating, simply because B may only sell the goods to A, but when A then pays GBP 25 for the parcel, B is free to use the cash at will. This undoubtedly restricts B's freedom to deal with the charged assets,[37] but this is not enough to make the charge fixed. To ensure that the charge is fixed, the restriction must preserve A's protection against the risk of B's default in repaying the loan. This restriction does not do that. It allows B to remove the charged assets from the ambit of the security, and to use the substitute at will. The result is that value of A's security interest in the goods is reduced with no countervailing benefit by way of security over the substitute asset (the GBP 25), or outright assignment of the substitute asset in part payment of the outstanding debt (so that although the value of the security is reduced, so too is the value of the outstanding obligation). In short, a requirement that the chargor may dispose of charged assets only by way of sale to the chargee, will not make the charge fixed if the chargor is then allowed to dispose of the proceeds at will.

Precisely the same reasoning applies with intangibles, and with substitutions further down the chain of dealings. In particular, if a chargor is permitted to dispose of the charged assets (whether book debts or inventory) to anyone, but must then pay the cash proceeds (the first substitute asset) into an account with the chargee bank, yet is then left free to deal with this *second* substitute asset at will (ie the chose in action constituted by the contract between chargor and chargee governing the bank account), then the same process of reasoning suggests that this charge too is floating. The chargee has simply insisted that it be party to the transaction which effects the second substitution. Notwithstanding this, the end result is that the chargee's security is reduced (book debts have been removed); no substitute asset stands as replacement security; and the chargee's exposure to the chargor's potential default has not been reduced by mandatory repayment of part of the outstanding debt. Accordingly, this charge, too, must be floating.[38]

As Lord Millett puts it:[39] 'Taking the relevant assets to be the uncollected book debts, the [chargor] company was left in control of the process by which the charged assets were extinguished and replaced by different assets which were not the subject of a fixed charge and were at the free disposal of the company. That is inconsistent with the nature of a fixed charge.'

Notwithstanding this, Lord Phillips MR pursued various leads that enabled him to reach the contrary conclusion. His analysis is not, for the most part, explicit. This makes it very difficult to respond to what might have been the persuasive arguments. Even so, and with respect, any possible reasoning to a 'fixed charge' conclusion seems to be flawed. What were the pitfalls?

Notes

36 *Siebe Gorman*, *Brumark* and *Spectrum* are at one on this.

37 This is commercially unrealistic, admittedly, but serves a pedagogic purpose: see below.

38 The only way to reach the contrary conclusion is to revert to the flawed definition of fixed and floating charges discussed earlier, which suggests that any restriction on the chargor's dealings with the charged assets is sufficient to render the charge fixed rather than floating. This seems unsupportable as a matter of history and commercial sense.

39 *Brumark* at [49], cited by Lord Phillips MR at [50]. Also see *Spectrum* [48]-[49].

© 2004 Chase Cambria Publishing

A proprietary diversion – the bank's interest in the cash proceeds

The first pitfall seems to arise from the uncontroversial proposition that '[m]oney, when paid into a bank, ceases altogether to be the money of the principal ... it is then the banker's money ... to do with is as he pleases',[40] although there is inevitably a corresponding contractual obligation to repay the principal at least an equivalent sum.

The significance of this familiar proposition to Lord Phillips MR's reasoning is unclear. It certainly allowed him to find that, although collection of the book debts was allowed, the chargee bank then acquired absolute ownership and control of the cash proceeds. Surely, however, this did not then lead him to suppose that, with such complete control over the proceeds, the charge could safely be characterized as fixed. Such a conclusion would take the literal words of *Brumark* and apply them without understanding their context. The Privy Council opinion in *Brumark* shows that if the chargor, not the chargee, has control of the substitute for the book debts (ie their proceeds), then it has control of the book debts, and so the charge over the book debts is floating. It misconceives the logic, however, to suggest that if the *chargee* has control of the proceeds, even though the chargor has control of *their substitute* (ie the chose in action – the bank account), then the charge is fixed. This was explained in detail in the previous section.

Alternatively, Lord Phillips MR may have thought there was some significance in the fact that the chargor's substitute for the proceeds was a chose in action, the benefit of which was to some extent governed by the contractual arrangements with the chargee bank. He says, 'Insofar as the customer is entitled to call upon the bank to pay over the amount of the proceeds received, the right will be contractual, *not proprietary* [my emphasis].'[41] The significance of these final words is unclear.[42] But somehow, without explanation, perhaps because these substitute rights were 'not proprietary', they became irrelevant in characterizing the charge. The error in this is clear. The issue being pursued is whether the charged asset, *or any permitted substitutes*, whatever their value, are required to be preserved for the benefit of the chargee's security. If they are, then the charge is fixed; if they are not, then the charge is floating. In *Spectrum* there is no requirement that adequately protects the chargee in this way.

The relevance of overdrafts

The second pitfall is more subtle. Lord Phillips MR made much of the fact that the account with the chargee bank was always overdrawn, with no suggestion that this would ever be otherwise. For this reason he insisted that:

> it is wholly artificial to ask the question, would the [chargor] Company be entitled to draw freely on its account if in credit? .... In the result payment of book debts into the account were received beneficially by the Bank by way of partial repayment of the indebtedness of the Company to the Bank. The Company never had any control of these proceeds. It was bound to permit them to be used to reduce its indebtedness. Admittedly it then had, until withdrawn, the contractual right to borrow from the Bank up to the overdraft limit, but as a matter of strict analysis that did not mean that the charge on the book debts remained floating.[43]

This analysis does not adequately address the core issue. It is essential to determine whether the cash proceeds derived from the book debts, or their substitutes, must stand for the benefit of the chargee (either by reducing the chargor's outstanding debt, as is suggested by Lord Phillips MR here, or by augmenting the security that protects that obligation), or whether they, or their substitutes, are left at the free disposal of the chargor. In an account with an overdraft limit, the position is unquestionably the latter, not the former. This is true even when the account is overdrawn, despite the implications in Lord Phillips MR's judgment.

Take a practical example, closely mirroring *Spectrum*. Assume A has a charge over B's book debts to secure an overdraft of GBP 1,000. Assume also that B is allowed to collect the proceeds but required to pay them into the overdraft account at A's bank. Consider the position where the account is GBP 400 overdrawn when B receives GBP 100 in proceeds and deposits this sum in the account. Before the collection of proceeds, A has advanced GBP 400 and is contractually obliged to advance a further GBP 600, with this total GBP 1,000 loan secured by a charge over the book debts. When B collects GBP 100 in proceeds, and

Notes

40 *Foley v Hill* (1848) 2 HLC 28, 36, cited by Lord Phillips MR at [88].

41 [89].

42 Lord Phillips MR may simply have been pursing the problem of how Slade J had managed to find that the chargee bank in *Siebe Gorman* could assert a lien on the proceeds if it so decided. It seems more likely, however, that they were material to Lord Phillips MR's later finding, cited in full earlier: see the text at n. 34 above.

43 [95]. Also see his comments at [68], in relation to *Siebe Gorman*.

© 2004 Chase Cambria Publishing

pays it into the account, the pool of charged assets securing B's obligation is reduced. B's current debt to A is also *temporarily* reduced from GBP 400 to GBP 300.[44] But, importantly, B is now entitled to withdraw GBP 700 from the overdraft account, not the GBP 600 it was entitled to withdraw before the proceeds were deposited.[45] Clearly, the GBP 100 proceeds paid into the overdraft account with A are being applied for B's benefit, not A's. *This* is the crucial feature, not whether the advances to B (the initial GBP 400 or any subsequent withdrawals) are 'B's funds' (ie somehow *B's* proceeds)[46] or are, instead, fresh advances by the bank of the bank's own money. The latter is in fact the case,[47] but this is immaterial to the issue in dispute. What is important is that the substitute assets – the cash proceeds and, later, the corresponding chose in action – serve to augment B's position, not A's.

This characteristic means that the charge over the book debts is floating: the book debts can be removed from the ambit of the security and used for the benefit of B; there is no requirement that they, or their substitutes, be segregated and preserved for the benefit of A. The reasoning is no different if the account is in credit. Indeed, this is as it should be. The charge should be either fixed or floating *as created*, at its inception. The nature of the charge should not change as the loan account moves into and out of credit.

Potential tracing confusions?

How did this muddled thinking begin? Some of the blame might be laid at the door of tracing rules and consequential proprietary remedies. There is admittedly no explicit reference to these issues in Lord Phillips MR's judgment, but some of his preoccupation with distinctions between proprietary and contractual claims seems to come from here.

The tracing rules can be relevant in security agreements, but only if the chargor *breaches* the terms of the charge agreement. If the charge *is* fixed, according to the orthodox definition discussed earlier, but the chargor nevertheless disposes of the charged assets notwithstanding the prohibition on such dealing, the chargee will expect some remedy. The rule is that the chargee can *follow* its proprietary interest in the charged assets into the hands of anyone who is not a bona fide purchaser for value (although it is perhaps unlikely to find that the transferee is such a party), *or* can *trace* the charged assets into their substitutes in the hands of the defaulting chargor. This possibility inevitably raises the question of whether the unauthorized disposal has generated a traceable substitute in the chargor's hands. Traditionally, payment of the charged assets, or its traceable cash substitute, into an overdrawn bank account marks the end of the tracing trail.[48] The chargor is then considered to have no traceable asset representing the substitute for the initial charged asset, and the chargee is therefore left without any substitute proprietary security for the outstanding obligation owed by the defaulting chargor. This analysis is fundamentally different from that applied when determining the initial characterization issue – i.e. is the charge fixed or floating. In the former case the issue is whether there is *property* that will stand as the traceable substitute for the charged asset. In the latter case the issue is whether the chargor can make use of the original asset, and its substitutes, *for its own benefit, regardless* of whether this use produces a proprietary end-product.

Taking security – ensuring the charge is fixed

From all of this, it follows that there are a limited number of ways to ensure that a charge over book debts is fixed. The first is to prevent all dealings with the book debts so that they are preserved for the benefit of the chargee's security. This is commercially unattractive if the restriction has to include a ban on collection. Restrictions on other dealings are less problematical, and can be seen as the fair price for the commercial advantages of credit. The second method is to prevent all dealings other than collection, and to require the collected proceeds to be paid to the chargee in reduction of the chargor's outstanding debt. In this way, both the value of the security and the value of the outstanding obligation are reduced in tandem, and the security is effectively redeemed as the obligation is reduced. The third method is again to prevent all dealings other than collection, and to require the collected proceeds to be paid into a bank account with the chargee bank. This account must then be *blocked*. The purpose of this is not to expropriate the chargor's contractual chose in action, as in the previous case.[49] This chose in action is a valuable

Notes

44 As Lord Phillips MR found.

45 *Williams & Glyn's Bank Ltd v Barnes* [1981] Com LR 205.

46 See the next section on tracing confusions.

47 See the Insolvency Act 1986 s 127 cases, eg, *Re Gray's Inn Construction Ltd* [1980] 1 WLR 711 (CA); *Hollicourt(Contracts) Ltd v Bank of Ireland* [2001] Ch 555 (CA).

48 *Bishopsgate Investment Management Ltd v Homan* [1995] Ch 211 (CA), although 'backwards tracing' certainly has its adherents.

49 The analysis applies equally whether the chargor has a credit balance or an overdraft: see the previous section.

© 2004 Chase Cambria Publishing

asset and continues to belong to the chargor. Blocking the account merely ensures that this substitute asset is not at the free disposal of the chargor, to be dissipated at will, but is instead preserved for the benefit of the chargee's security. The preceding analysis, based on the orthodox definition of a fixed charge, suggests that this blocking requirement will be interpreted strictly.[50] The final method is, yet again, to prevent all dealings other than collection, and to permit the collected proceeds to be paid into a bank account with a third party bank. The chargee must then take a fixed charge over this account, or enter into a control agreement with the third party bank to ensure that the account is blocked. These controls are necessary for the same reasons that control is required over the account with the chargee bank.

Incidental issues

Clearly the choice is limited, and each option is undoubtedly commercially unattractive. This only serves to highlight why fixed charges over book debts, inventory and other circulating assets will rarely arise in practice. The analysis raises three important incidental issues. First, it cannot be emphasized too strongly that the characterization of charges is a matter of law. The agreement between the parties must be construed to determine the rights and obligations that have been agreed between the chargor and the chargee. If, and only if, these rights and obligations are sufficient to ensure that the charged assets are preserved for the benefit of the chargee, then the charge is fixed. Otherwise it is floating. In particular, a charge is floating if the chargor can remove the charged assets from the ambit of the security and use them, or their permitted substitutes, for its own benefit, rather than preserving them for the benefit of the chargee.[51] In making this assessment, it is irrelevant that the parties intended their agreement to be characterized differently;[52] or that the permissions given to the chargor to take particular benefits are only those agreed in the contract;[53] or, conversely, that the written agreement prohibits disposal by the chargor if in reality the parties operate differently;[54] or that the chargee allows the chargor to deal, but subject to termination of this permission at will by the chargee;[55] or, finally, that the chargee's economic position is not in fact made materially worse,[56] or even that it is not made worse at all, because the facts are such that as charged assets are removed by the chargor, new assets of the same description are acquired and subjected to the same security, so preserving the chargee's position.[57]

Conclusions

Spectrum is a difficult case.[58] It is also an important case, and one likely to generate much debate and disagreement. The personal property security legislation currently mooted by the Law Commission[59] will

Notes

50 In particular, as argued here, it is not met by an ability to control the account in the future (as in *Siebe Gorman*), nor, probably, by blocked accounts subject to an advance agreed facility or sweeper agreement.

51 *Brumark*, passim.

52 *Spectrum* [33]; *Brumark* [32]. Contrast *Siebe Gorman* and *New Bullas*.

53 *Brumark* [34], roundly criticizing the contrary finding in *New Bullas*, pp 491-3, cited by Lord Phillips MR at [39].

54 *Brumark* [48], cited by Lord Phillips MR at [79].

55 As in *Siebe Gorman*, but criticized above at text to n. 30.

56 See Lord Phillips MR at [51], suggesting that it is possible to distinguish long-term and short-term debts on the basis that collection of the former, normally paid by instalments, does not remove the [bulk of] the charged asset from the ambit of the security, and so might be considered as readily meeting the requirement of a fixed charge, even though similar provisions permitting collection of short-term debts would be characterized as floating charges. This assertion is reminiscent of the decisions in *Atlantic Computers* and *Atlantic Medical*, and reflects similar errors in legal analysis (see n. 24 above). It is irrelevant that the value of the pool of charged assets *in fact* remains relatively constant despite the chargor's dealing for its own benefit. If the chargor can engage in such dealing, then the charge is floating. Characterization depends upon the rights to deal with *each item* of the charged assets, as granted by the parties' agreement, so that the charge can be characterized 'as created', not by virtue of some process of taking accounts during the course of the operation of the security. Take a practical example: a fixed charge over machinery (such as computers) will permit the chargor to use the machines for its own benefit, collecting rents and using these rents at will, so long as the machines themselves are preserved for the benefit of the chargee. If the charge is over the rental stream, however, then the charge is necessarily floating if the chargor is permitted to collect the rents and use the proceeds for its own benefit rather than preserving these substitute assets for the benefit of the chargee.

57 Both fixed and floating charges can be drafted to attach to future assets: see *Holroyd v Marshall* (1862) 10 HL Cas 191 (fixed charges), and almost every authority on floating charges. The security in both cases may be enhanced, but this says nothing at all of the proper characterization of the charge. That depends solely upon whether charged assets can be removed from the ambit of the security at the will of the chargor: see *Brumark* and its precedents.

58 Lord Phillips MR's judgment runs to 30 pages, and contains strings of long quotations from the relevant authorities, often with little to explain the particular emphasis to be given to them.

59 Law Commission Consultation Paper No. 164 (2002) on the registration of security interests.

© 2004 Chase Cambria Publishing

remove the particular problem, but only to replace it by another. The real issue is not what parties can agree about security, but how parliament then intervenes to make special rules for the insolvency distribution of the proceeds of sale of secured assets. At the moment the test relies on a distinction between fixed and floating charges. Any new regime will undoubtedly want to maintain some form of mandatory sharing with preferred and unsecured creditors, and will have to develop a new test.

For now, however, the fixed and floating charge characterization is essential to the process. This has been the case for decades, so it is astonishing that the procedure remains so controversial. On the view presented here, the *Spectrum* appeal has failed to deliver defensible answers. It remains the case, as Lord Phillips MR so accurately notes, that this 'is an unsatisfactory area of the law.'[60]

Notes

60 [99].

© 2004 Chase Cambria Publishing