



April 2005

## IN A FIX (Over Charges on Book Debts)

The recent decision in Spectrum Plus has created some uncertainty as to the validity of fixed charges created by financiers over the book debts of their customers.

### The Background

For some time now it has been well understood by lenders and borrowers alike that there is a distinction between a fixed charge and a floating charge. A floating charge has been defined as one which hovers over the assets that are the subject of the charge in such a way that the chargor can continue to deal with the assets in the ordinary course of its business without the chargee's consent unless or until some event occurs and the charge becomes fixed upon the assets in the chargors hands.<sup>1</sup> The development of charges and the position of the secured creditor has developed over a number of centuries dating back to the early 1700's in the United Kingdom. The need for a floating charge developed as it became evident that the chargor was required to deal with the relevant assets on a day to day basis in the ordinary course of trade, whilst at the same time the chargee required security over those assets in the event of the chargor's insolvency. Assets that traditionally fall under a floating charge are those of stock in trade, debtors and other assets which are required to be dealt with on a daily trading basis by the company. A floating charge changes and becomes fixed or "crystallises" upon the occurrence of a particular event such as the chargor's insolvency rather than attaching or fixing to the assets on the date on which the charge was created as is the case with a fixed charge over real property assets. Without the use of floating charges it would be necessary for the chargor to seek approval from the chargee every time they wish to sell an item of stock or for that matter collect or deal with a debtor. Clearly a burdensome imposition, which would be unacceptable.

### The Predicament for financiers

A predicament arises as a result of Sections 433 and 561 of the Corporations Act 2001 (Cth) ('the Act') where by the law requires that certain debts be

<sup>1</sup> Illingword v Houldsworth on appeal in the House of Lords [1904] AC355.

granted priority out of the proceeds of floating charge assets, in the case of a receivership or Liquidation.

Therefore the need to distinguish between realisations from assets subject to fixed charges and floating charges becomes a critical element of any insolvency for a number of stakeholders including the secured creditor, the liquidator or receiver (as his or her fees have a priority under the Act), and the priority creditors, such as employees.

### The Law

Over the years it has commonly been considered that a charge is a floating charge where the company can carry on its business in the ordinary way as regards to the charged assets until some future step or event occurs and the chargee restricts the chargors ability to deal with the assets.<sup>2</sup>

Therefore the general view was that unless the chargee imposed restrictions on the chargor's abilities to deal with the assets or the assets were under the direct control of the chargee then the charge could not be a fixed charge.

Invoice Discounters and Factorors wishing to achieve a greater level of security over the book debts of the borrower have attempted to overcome this by requiring that the book debts can not be dealt with by the company prior to collection (i.e. assigned or sold) without the approval of the chargee and that there was a specific requirement to pay all collected debts into a bank account held with the chargee bank.<sup>3</sup> In essence creating a fixed charge over the company's book debts.

However, this structure has not completely resolved the problem as lenders continue to want the best of both worlds, they want to have a fixed charge on the book debts while also allowing the company the freedom to use the proceeds of the collections without restriction as if the charge were a floating charge. As a result an attempt was made by secured creditors to create a distinction between book debts and the proceeds of book debts whereby the former

<sup>2</sup> Lord Millett opinion in Commission of Inland Revenue v Agnew [2002] 1 NZLR 31.

<sup>3</sup> Siebe Gorman v Backlays Bank Limited [1979] 2 L1 Rep 142 Slade J granted in favour of Backlays Bank where it was held that it created a fixed charge with regards to book debts.



might be subject to a fixed charge while the proceeds i.e. the cash banked into the bank account were subject to a floating charge. The purpose of this structure was to provide the borrowing company with freedom to continue to trade as a going concern while also ensuring that once a formal insolvency occurred the uncollected book debts were subject to a fixed charge and therefore could not be eroded by the priorities granted to certain creditors.

### The Spectrum Plus decision

The recent English decision known as Spectrum Plus has however blurred the logic in this area of the law<sup>4</sup>. It was held that in effect all charges over book debts structured in this way are fixed charges so long as the proceeds are paid into any bank account, whether in credit or overdrawn, and whether with the chargee or not. In this way the proceeds of the book debts would go into the bank account, and as such the book debts would cease to exist and be replaced with a new asset being cash or through the discharge of a liability via the reduction of an overdraft account. Therefore although the new asset i.e. the cash might be subject to a floating charge this would not affect the characterisation of the charge over the remaining book debts which would remain fixed.

### The Uncertainty

Although the Spectrum Plus decision has not been tested here it would appear likely that if it was tested in the courts it would be considered as an all too easy way for secured creditors to avoid the intention of Sections 433 and 561 of the Act. As a result there can be no certainty at this stage as to how the courts in Australia would treat a Spectrum Plus type arrangement. Of particular note is what has happened in New Zealand. In order to avoid the confusion surrounding this issue and to ensure that the intention of the law is followed the New Zealand legislators have amended the law to ensure the problem no longer exists. An amendment to the New Zealand Companies Act 1993 (amended 1999) ensures that priority creditors have priority with regards to proceeds from certain classes of assets, regardless of whether the charge over those assets is a fixed or floating charge. In this regard priority is

afforded to priority creditors over assets such as receivables, book debts and inventory.

At this stage it is uncertain as whether or not the courts in Australia will be required to make a decision to clarify the law in this area or if the Australian legislators will follow the moves of their New Zealand counterparts and make legislative amendments to ensure that the intent of the law in this area is fulfilled.

### The Fix

The only thing that is now clear is that the law in this area is unclear. Therefore secured creditors such as Invoice Discounters and Factorers who rely on security from book debts should continue to take a cautious approach to the value of the security assigned to these assets. Whilst secured creditors will continue to instruct their lawyers to try to develop more robust charges to protect their interests it is clear that until a court decision is handed down or the law in this area is clarified secured creditors will need to remain cautious and assume that fixing clauses will continue to be challenged.

### Taylor Woodings

One way to ensure a cautious approach is to continue to gain a full and complete understanding of the financial position of the borrower at the time of advancing the funds and taking security and to continue to monitor this position during the life of the facility. Full and complete knowledge of all priority creditors and other issues which may erode the value of security must be obtained. This is best achieved by engaging an independent insolvency practitioner to undertake a **Limited Scope Pre-Lending Review** or to act as a **monitoring agent** during the life of the relationship.

**Should you wish to discuss this matter or require more detailed advice on a particular situation please contact **Quentin Olde**, Partner, [Quentin.Olde@twcs.com.au](mailto:Quentin.Olde@twcs.com.au).**

Disclaimer: This publication is for information purposes only and should not be relied on in place of advice.

<sup>4</sup> In this decision by Lord Phillips known as the Spectrum Plus Decision in National West Minister Bank PLC V Spectrum Plus Limited [2004] EWCA Civ 670 (12 July 2004).