CURRENT DEVELOPMENTS
Automatic Crystallisation Clauses

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I. MEANING AND EFFECT

Background: restrictive clauses. The development of the automatic crystallisation clause arose out of the very limited effectiveness of the traditional restrictive clause contained in a floating charge, to the effect that the chargor covenanted not to create any specific charge ranging in priority or pari passu to the floating charge. The restrictive clause was introduced in the 1890s in an attempt to prevent the result that otherwise applied that a subsequent specific charge took priority over a prior floating charge even where the specific chargee had actual notice. The courts, however, held that a restrictive clause was effective only if the subsequent specific chargee had actual notice of the terms of the restriction. Actual notice of the existence of a floating charge was held not to constitute constructive notice of the restrictive clause contained within its contents. The result applied even where the floating charge was registered under the charges registration provisions of the companies legislation. Registration constituted constructive notice only of the existence of the floating charge, and not the contents including the restrictive clause.

Automatic crystallisation clauses. The introduction from the 1960s onwards of the automatic crystallisation clause has been a more recent drafting innovation in floating charges[1]. Under the traditional clause, where the charge became merely "enforceable" following default, the active intervention of the chargee by appointment of receiver was required in order to crystallise the charge. An automatic clause, however, provides that upon the happening of a certain stipulated event the charge shall, without more, automatically crystallise and become specific. The concept of automatic crystallisation was first held effective by the High Court of Australia in Stein v. Saywell[2], where the relevant clause stated that the charge would automatically crystallise on the appointment of a receiver under a previous debenture. A more sophisticated clause was also upheld in Re Manurewa Transport Ltd[3]. In that case the particular clause provided that the floating charge would

automatically crystallise on the subsequent attempt to create a specific charge ranking in priority or pari passu. Clear words in the contract, however, are necessary to achieve automatic crystallisation. A provision to the effect that the company's licence to deal will terminate upon default, whereupon the security will become "enforceable", will be insufficient[4].

Advantage of "attempted charge" clause. A clause of the kind upheld in Re Manurewa Transport Ltd confers a distinct advantage over the previous restrictive clause. The latter is merely a negative personal covenant, which is not effective unless the subsequent specific chargee has actual notice. In itself, the restrictive clause has no proprietary effect: it confers no equitable interest in the charged property on the chargee. By contrast, the "attempted charge" clause causes an equitable interest immediately and automatically to vest in the chargee, as soon as the event which triggers its operation occurs. If as in Re Manurewa Transport Ltd the clause can be triggered on the very attempt to create a subsequent charge (even as the chargor attempts to "put pen to paper" to execute the charge[5]), then an equitable interest necessarily arises before the actual creation of the subsequent charge. The floating chargee can therefore claim under the equitable rules of priority an equitable interest prior in time as against the subsequent interest.

Automatic crystallisation subject to estoppel. Although the priority of an attempted charge clause on grounds of time confers a valuable advantage on the chargee, it will not necessarily be effective in all cases to preserve priority against subsequent interests. Companies Code priority rules in relation to subsequent charges will be considered later, but even under the general law final priority still needs to be determined under the normal operation of equitable priority rules in relation to equitable as against subsequent legal and equitable interests. If the subsequent interest is a legal mortgage or purchase, the holder of which has no notice of the contents of the prior floating charge, then the specific interest will prevail on the grounds of bona fide purchase for valuable consideration of a legal interest, without notice, actual or constructive. If the subsequent specific charge is equitable only, then the floating charge will have first priority on grounds of time, since crystallisation causes the floating chargee to obtain an equitable proprietary interest by virtue of the "attempted charge" clause. Automatic crystallisation will also be effective to exclude subsequent rights of set-off (if notice is also given to the chargor's debtor) and execution creditors. As against a subsequent equitable interest, however, priority in time will be liable to reversal by estoppel in line with the general rules of equitable priority according to the nature of the property subject to the charge. For example, in the case of debts, priority of time in the case of an equitable assignment, notice of which has not been given to the debtor, is liable to reversal under the rule in Dearle v. Hall[6] as against a subsequent equitable assignment. Similarly, equitable priority on grounds

of time is liable to reversal by estoppel in the case of a charge over shares unprotected by possession of share scrip. In the case of chattels, cash, or negotiable instruments, however, since in relation to these forms of property neither the common law nor equity developed any general doctrine of estoppel whereby continued possession of charged property by the debtor would estop the secured creditor (whether under a legal or equitable mortgage) from asserting priority on grounds of time[7], the automatic crystallisation clause will be effective against all subsequent chattel interests, except a legal interest without notice[8].

II. CRITICISMS OF AUTOMATIC CRYSTALLISATION

Automatic crystallisation is "unjust". Under an automatic clause, the chargee attempts by express contract to protect himself by causing crystallisation to occur on stipulated events of default, without need for active intervention by appointing a receiver or waiting until trading stops. The case authorities on the subject are mainly all Australasian, with very little relevant English authority. The concept was first clearly approved in Stein v. Saywell[9]. Prior to that there had been some academic controversy as to whether or not crystallisation could be brought about by express stipulation in the charge contract. Some writers have pointed to 19th century decisions as being examples of automatic crystallisation but, it is submitted, this is unjustified, since none of the older cases dealt with clauses appropriately drafted to achieve this effect[10]. More recently in Australia, there has been occasion where the court has expressed itself to leave open the point as to whether or not automatic crystallisation is permissible[11], but without Stein v. Saywell being discussed. Generally, however, it is very difficult to see why there should be any agonising over the question in face of the clear High Court authority[12]. Recent English cases have approved the validity of automatic crystallisation[13].

Criticisms of automatic crystallisation. There have in recent years been certain criticisms, particularly in England, concerning the effects of automatic crystallisation[14]. These are usually expressed as follows:

(a) it is "extremely inconvenient"[15] that the charge could crystallise, perhaps upon some trivial or technical event, without the chargor and chargee themselves being necessarily aware of it and to the prejudice of third parties who may be surprised by its effect without having any means of discovering the fact of automatic crystallisation by public search; and

(b) it operates to the prejudice of unsecured creditors generally.

It has been argued that automatic crystallisation should be prohibited on grounds of "judicial policy"[16]. The United Kingdom Cork Report on Insolvency, while assuming its validity, recommended that it should be precluded by legislation[17].

The judicial policy argument. The basis on which the court could entertain jurisdiction in this context to set aside a contract is unclear[18]. All that automatic crystallisation does as a matter of contract between the parties is to determine that equitable title shall vest in the equitable chargee upon the happening of certain stipulated events, without need for further act or intervention by the chargee. It is submitted that it should be regarded as something of a commonplace to permit parties to make their own contract as to when title should pass. This is uncontroversial in the context of the sale of goods where, even in the case of specific goods, buyer and seller can agree to postpone passage of title until a later date. It is essentially the same question in regard to automatic crystallisation.

Prejudice to the parties argument. Parties are no doubt free to make good contracts or bad contracts. A sensible draftsman (even where acting for a chargee) would select only critical events for automatic crystallisation and not stipulate that automatic crystallisation should occur for any event of default at all, including any minor or trivial breach, unrelated to the chargor's financial position or third party threat to the charged property. The main events that, for example, a bank draftsman would seek to insert are those that protect the bank against subsequent adverse third party interests intervening or threatening, for example, subsequent attempts to create specific charges, factor book debts or enter into sale and lease-back arrangements, threats of execution by judgment creditors or circumstances of insolvency. Usually, where automatic crystallisation is adopted, the sensible draftsman also inserts a "de-crystallisation" clause, so that if something unintended happens, then the chargee can by notice de-crystallise the charge in respect of any asset over which it has previously attached. Just as parties can agree when an equitable interest will arise upon crystallisation, so they can also agree quite informally upon the circumstances in which an equitable interest can be released and crystallisation cease to apply.

Prejudice to third parties argument. The criticisms ignore the effect of estoppel and other priority rules under the general law. The result of automatic crystallisation (as indeed of crystallisation on any other grounds) is that the chargee then acquires an equitable proprietary interest. A subsequent legal purchaser for valuable consideration without notice actual or constructive (e.g. a trade customer purchasing items of stock-in-trade at retail premises) overreaches the prior equitable interest by virtue of legal title paramount. In regard to book debts, a subsequent absolute assignee or specific equitable chargee, who gives first notice to the debtor either under the statute[19] or under the rule in <u>Dearle</u> v. <u>Hall</u>, obtains first priority over the prior crystallised charge. Similarly, in

regard to shares, a crystallised chargee is estopped from asserting priority against a subsequent chargee who obtains possession of the scrip. The particular case where an automatic clause confers an advantage is as against a subsequent specific equitable charge over chattels[20]. This however would not affect a subsequent bona fide legal mortgagee without notice. Upon fuller analysis, therefore, of the traditional rules of the general law relating to priorities of equitable and legal interests, the consequences of automatic crystallisation become considerably more commonplace, and far less capricious, than is sometimes supposed. Automatic crystallisation is not some universal panacea enabling a chargee to obtain priority under all conceivable circumstances. At best, it can be said that automatic crystallisation does in certain circumstances confer additional advantages compared with the traditional form of floating charge, particularly in the context of chattel assets and as against execution creditors. In other circumstances, further action is still required by the chargee, e.g. giving first notice to debtors, in order to preserve the priority otherwise obtained on grounds of an equitable interest first in time.

Prejudice to unsecured creditors argument. It is hard to see the force of this argument, when even the floating charge in its traditional form without automatic crystallisation permits security to be taken over the whole of the company's present and future assets. The only particular difference as against unsecured creditors is that execution creditors are automatically postponed. This, it is submitted, is of little significance since it is unlikely that a traditional floating charge will stand by and permit executions without intervening by appointment of a receiver to postpone execution creditors and, in any event, unsecured creditors almost invariably prefer to enforce payment against insolvent companies through winding-up procedures rather than through judgment and execution. The argument, in essence, really seems to be that floating charges generally are prejudicial to unsecured creditors. If there is a mischief for this reason, then the proper remedy is through legislative reform, but it is a bad argument for saying that automatic crystallisation clauses in particular should be prohibited on grounds of "policy". Parliament has intervened in the past to protect creditors in certain cases, where the floating charge was considered too far-reaching. For example, the whole system of preferential payments to employees over a floating chargee, as now enshrined in s.441 of the Companies Code, was first introduced by amendment to the Companies Act in England in 1897[21]. Similarly, where the result of the decision in Stein v. Saywell was felt to cause prejudice to employees, because automatic crystallisation took the charge outside the scope of the preferential payments provision, being confined to floating charges, Parliament rectified the situation by subsequent amendment applying this section to any charge which not only was still floating at the time of receivership or liquidation but which also commenced life as a floating charge even though it had

subsequently become specific[22]. In short, it is submitted that this argument is greatly exaggerated. The current proposals of the Law Reform Commission, discussed below, should be considered in this light.

III. COMPANIES CODE PRIORITIES

Dual priority system following Code. The Companies Code in 1982 introduced significant changes to the Charges Division in relation to priorities affecting charges, especially under s.204 and Schedule 5. Registrable charges now take priority according to order of registration. In the particular case of a floating charge, notification of a restrictive clause in the particulars of charge now means that priority can be retained against a subsequent specific charge. Priority of charges, however, is not in all cases governed by the Code priorities. This is so because the transitional provisions of s.215A apply the Code priorities only in respect of charges registered subsequent to the introduction of the Code[23] and also because the Code priorities apply only between successive registrable charges. In other words, where a prior charge was created before the Code or, if created after the Code, where a subsequent charge is a non-registrable charge, the general law priorities still apply. A specific charge is non-registrable if it is given over non-registrable charge property (i.e. property of a kind not listed in any of the particular paragraphs (b) to (j) of s.200(1) or, although given over registrable charge property, if it is taken in a non-registrable manner (e.g. by a charge over shares protected by the simultaneous deposit of share certificates).

Pre-Code priority rule. In consequence, a floating charge registered prior to the Code (even where the floating charge contains a restrictive clause against subsequent charges or even absolute assignments) loses priority against a subsequent specific charge or absolute assignment taken without actual notice of the restrictive clause. As referred to above, there is no constructive notice arising by virtue of registration of the restrictive clause.

Code priority rule. The priority of a floating charge registered after the Code (incorporating both the Code priorities and, where applicable, the general law) with a notified restrictive clause as against subsequent non-registrable interests depends on assumptions concerning: (a) the relevance of the Code priorities; and (b) the extent of the doctrine of constructive notice subsequent to the Code.

Floating charge plus restrictive clause as against non-registrable charge. The answer whether the Code priorities apply to a registered floating charge with restrictive clause notified under the particulars of charge as against a subsequent specific charge over non-registrable charge property depends upon the correct interpretation to be given to s.204(4)[24]. In view of the recent advent of the Code, no authoritative case decision

exists in regard to the proper treatment to be given to this sub-section but it is submitted that the correct interpretation is that the sub-section should be read according to its plain language so as to refer to a floating charge, as well as a specific charge. A floating charge given over all the present and future assets of a company, extends to both registrable charge property and non-registrable charge property. The sub-section, therefore, governs priorities of a floating charge with notified restrictive clause in relation to registrable charge property according to the Code priorities but excludes the Code priorities in relation to non-registrable charge property[25]. Assuming that this is the correct interpretation, then the pre-Code general law priorities would apply, subject to the question of the extent of constructive notice in relation to restrictive clauses applying after the Code.

Constructive notice after Code of contents of charge. The question arises whether after the Code the doctrine of constructive notice survives according to the version prevailing prior to the Code, that constructive notice constitutes notice of the existence but not the contents of a registered charge. Or whether now, as a result of the Code provisions permitting registration of restrictive clauses, a restrictive clause notified in the registered particulars affects the world with notice of its contents. It is, of course, an unsatisfactory feature of the present Charges Division that this question should still arise. The Code itself failed to consider the doctrine of constructive notice at the time of its introduction in 1982. Subsequently, an amendment in 1983, inserting the new s.68C, did refer to the doctrine. That section abolished the doctrine of constructive notice in relation to registered documents generally, except that s.68C(2) expressly preserves the continuance of the doctrine in relation to documents registered under the Charges Division. The amendment, however, also failed to consider the form in which the doctrine previously existed and, consequently, the form in which it has been preserved.

Uncertainty as to wide or narrow view. There are in fact competing arguments concerning the extent of the doctrine subsequent to the Code. The arguments for the wide view that constructive notice now includes a restrictive clause is simply that, because a restrictive clause now appears on the register, a subsequent non-registrable chargee is able to discover it by search. The logic of Re Standard Rotary Machine Co Ltd[26], the leading authority establishing the previous "existence but not the contents" rule, being based on the fact that a subsequent chargee could not discover a restrictive clause by search, is now reversed as a result of the statutory amendment permitting the registration of a restrictive clause. The argument for a narrow view, principally, points to the fact that the statutory purpose of the Code in providing for registration of restrictive clauses was merely to relieve the floating chargee from the effect under the Code provisions otherwise applying of "deemed consent" by a floating chargee to postponement to a subsequent registered

charge[27]. The Code was not concerned to regulate priorities as against subsequent non-registrable chargees, who should not therefore be expected to search the register, so that constructive notice should not be raised against them.

Priority consequences. If the narrow view were correct, then in effect the pre-Code priority rules would still apply to a floating charge plus restrictive clause as against subsequent non-registrable charges and absolute assignments. The latter would be bound only if the chargee/assignee had actual notice of the restrictive clause. If the wide view were correct, then a registered restrictive clause would prevail against both a subsequent chargee over non-registrable charge property and a subsequent non-registrable charge over registrable charge property. There would, however, be no added protection given to a restrictive clause against a subsequent absolute assignment in the absence of actual notice, since the restrictive clause now placed on the register is confined to restrictions against charges, and not against absolute assignments.

Automatic crystallisation clauses after Code. The effect of an automatic crystallisation clause can be compared with a restrictive clause in light of the Code provisions. There is no provision under the Code to notify an automatic clause on the register, so there can be no argument that anything further is gained by reason of constructive notice of such a clause, whether on a wide or narrow view. As against a subsequent registrable charge, however, it appears that an automatic clause of the "attempted charge" variety can take advantage of the Code priority rule of first registration. The "deemed variation by consent" provision under the Code in the case of a floating charge applies in such a manner that the floating chargee is deemed to have consented to postponement to "a subsequent registered charge, being a fixed charge that is created before the floating charge becomes fixed"[28]. Under the "attempted charge" clause the floating chargee can properly claim to hold a crystallised charge before the creation of the subsequent charge. It follows, therefore, that in the case of an appropriately worded automatic crystallisation clause, the floating chargee can always claim priority by virtue of first registration and is not deemed by the Code to have consented to a variation of priority in favour of a subsequent specific charge. The automatic clause, however, would obtain no advantage under the Code as against subsequent non-registrable charges or absolute assignments. It would have to rely on general law advantages gained by priority of interest on grounds of time. For example, priority would be retained:

(a) in respect of non-registrable charge property, such as bank deposits and in general other contractual rights (other than book debts) as against subsequent chargees and absolute assignees (subject to first notice to the debtor);

(b) In respect of documents of title to goods or negotiable instruments as against a subsequent non-registrable charge created by letter of hypothecation[29] but not where created by means of pledge acquired without actual notice[30]; and

(c) in respect of book debts, as against a subsequent absolute assignment (subject to first notice to the debtor).

These advantages of an automatic compared with a restrictive clause arise only on the narrow view of constructive notice of a restrictive clause. On the wide view, the results obtained by each clause would be identical, except that the automatic clause would still obtain the added advantage against an absolute assignee of book (or other) debts. It appears therefore, that the automatic clause, even after the Code, still obtains a significant measure of advantage over the restrictive clause. In practice, however, the draftsman would insert both clauses in the charge, so as to obtain combined protection.

IV. SPECIFIC CHARGE COMPARISON

Code/general law priorities. Generally, a floating chargee would enjoy most of the advantages considering the protection of both restrictive and automatic clauses of a specific charge over registrable charge property. He would not, however, obtain as against a subsequent absolute purchaser the priority of a registered specific charge through constructive notice (where notice of existence of the charge is sufficient), because an automatic crystallisation clause as such cannot be notified on the charges register, and a subsequent assignee is not bound with constructive notice of the contents of a registered charge. A subsequent assignee will, of course, be bound by the clause, if he has actual notice of it.

Preferential creditors. The chargee is also subject to the Code provisions relating to invalidation of floating charges and preferential payments because the Code defines a "floating charge" to include a charge which floats at its inception but which subsequently becomes specific[31].

A specific charge takes priority in relation to debts due to a taxpayer company as against a notice from the Commissioner of Taxation given under s.218 of the Income Tax Assessment Act 1936, (or s.38 of the Sales Tax Assessment Act (No. 1) 1930, which is expressed in similar terms). Such a notice in effect attaches book debts to the chargor and takes priority over a floating charge, if given by the Commissioner to the relevant debtors prior to crystallisation[32]. In relation to s.218 notices from the Commissioner of Taxation, an appropriate event, e.g. failure by the chargor to pay tax when assessed, could need to be inserted in the charge as an appropriate automatic crystallisation event, in order to forestall the attachment effect of the Commissioner's notice. Generally, therefore, an automatic crystallisation clause is a useful improvement, if the

[28] Section 204(3), Companies Code.

[29] Charges in relation to negotiable instruments or documents of title to goods arising by way of pledge, deposit, letter of hypothecation and trust receipt are exempted from registration: s.200(2)(c), Companies Code.

[30] A pledge would not be fixed with constructive notice under the Code, as an automatic clause cannot be notified on the register.

[31] Section 5(1), Companies Code.

[32] See *Norgard* v. *Deputy Federal Commissioner of Taxation* (1987) 5 ACLC 527: *Tricontinental Corporation Ltd* v. *Federal Commissioner of Taxation* (1987) 5 ACLC 555.

[33] An appropriate precedent has appeared in "Palmer's Company Precedents" since 1912: see Farrar, "The Crystallisation of a Floating Charge", op cit, p. 415.

[34] *Re Obie Pty Ltd (No. 2)* (1983) 8 ACLR 574, at p. 581, per Thomas J.: see also *Re Woodroffes (Musical Instruments) Ltd* [1985] 3 WLR 543; *Re Brightlife Ltd* supra.

[35] Support has been expressed for the concept of selective crystallisation: see Prof. R.M. Goode, "Legal Problems of Credit and Security", Centre for Commercial Law Studies, Queen Mary College (University of London), (1982), pp. 41-42.

[36] See Law Reform Commission, Appendix to Discussion Paper No. 32, August 1987, General Insolvency Inquiry, p. 35, para. R1.

[37] See Law Reform Commission, Discussion Paper No. 32, August 1987, General Insolvency Inquiry, p. 55, para. 135.