

RECENT DEVELOPMENTS

Floating Charge Contractual Models

BILL GOUGH

**Consultant
Minter Ellison, Solicitors, Sydney**

The purpose of the current session is to discuss recent case law developments in the selected context of the floating charge.

I shall deal with the effect of express contractual terms agreed by the chargor and chargee as parties to the floating charge contract, where the actual intention is to achieve a particular fixed or floating charge outcome.

My co-speaker will discuss the reverse context of disguised floating charges, where the parties as a matter of form have expressed themselves to intend a specific charge, which has been held by the court to be floating in substance.

Case law in recent years has improved our understanding of the conceptual nature of the floating charge and the practical purposes for which it can be used and adapted. I propose to develop the discussion in stages:

- The starting point is to describe the floating charge in its traditional form.
- Next I shall compare different forms of floating charge, including express crystallisation and convertible charges, that have been judicially approved in recent years.
- The contractual basis underlying the different forms of floating charge can then be analysed.
- It is also important to assess the degree of first-ranking priority protection available in relation to the different forms of charge.
- Finally, I shall discuss the opportunities created by the contractual flexibility of the floating charge to devise new security techniques for use in the context of corporate financing and project and structured financings.

CLASSIC MODEL

Standard Characteristics

The floating charge in its traditional form was judicially recognised by the courts of equity in the 1870s.

There are three characteristic elements to the floating charge in its traditional form:¹

- First, there is the **business continuity** element. During the initial phase of the charge, the company chargor continues to carry on business as a going concern. The charge floats over the present and future property of the company comprised within the charged property. The charge does not fasten on or attach to any particular or specific property.
- Second, there is the essential **business dealing licence**. The company chargor is free to assign property subject to the charge, so as to confer a good title upon the third party assignee as against the floating chargee. The subsequent assignment can be by way of sale or specific charge.
- Third, there is the feature of **crystallisation**. In certain events, the floating charge may crystallise. At that point it converts from its floating phase into a normal fixed or specific charge.

Specific Charge Comparison

A floating charge is the opposite of the normal fixed or specific charge. Under a specific charge there is no business dealing licence. The chargor cannot sell or charge the charged property by assignment free of the specific charge, so as to confer a clear title on a third party assignee.

The hallmark of a specific charge is that the chargor cannot deal with the charged property without need for the consent of the chargee to release the charged property from the specific charge.

The consent of the specific chargee is necessary because the chargee acquires a legal or equitable proprietary interest. It is a general principle of property law, both at law and in equity, that title can pass under an assignment when the property is specifically appropriated to the contract of assignment. Property is appropriated when it is identified or ascertained by agreement between the parties.

At law, title can be transferred in relation to present property, but not future property. A new act is required to transfer legal title to the property when subsequently acquired or created. For example, in the case of sale of goods, under the present statutory code adopting the previous common law rules in the case of an unconditional contract for the sale of specific goods in a deliverable state the property passes on the making of the contract. In the case of a contract for the sale of unascertained or future goods by description the property passes when goods of that description are unconditionally appropriated to the contract by mutual agreement, usually by means of delivery to the buyer by the seller. The same principles apply at common law in relation to legal mortgages.

In equity, title can pass only in relation to specifically appropriated property, because equitable remedies such as specific performance and injunction can be obtained from the court only if the property is specifically identified or ascertained.

¹ See W J Gough, *Company Charges* (2nd edition, 1996), Butterworths London, at 85-90.

By contrast with the common law, future property can be assigned or charged in equity without any new act. A present transfer of future property supported by valuable consideration operates as a present contract to assign the property, when subsequently acquired or created by the assignor. Title in equity passes immediately and automatically when the future property subsequently exists and is identified or ascertained so as to conform with its description in the contract.²

Where an assignment extends to all future property of the assignor, mere acquisition subsequently by the assignor constitutes sufficient identification and ascertainment of the property and causes final and irrevocable appropriation.

The same result applies in relation to a more limited contractual description of future property to be assigned, for example, where the assignment extends to:

- all additional future property to be brought on to specified premises;
- future property to be acquired in substitution or replacement for existing property;
- all future property of a specified class.

Under a specific equitable charge, the mere acquisition of the future property can constitute a final and irrevocable appropriation of that property to the charge. The chargor cannot within the terms of the contract, as under a floating charge, subsequently decide by his unilateral act that the future acquired property can be dealt with for purposes wholly inconsistent with the satisfaction of the charge.³

Business Continuity

The floating charge is a charge over the whole or part of the undertaking of the company chargor. The court held that the undertaking meant the assets of the business as they change from time to time. The business itself as going concern is charged. The chargor was intended to be left free to carry on its business by dealing with its assets. If the consent of the chargee was required for business dealings as under the specific charge, the business would be "tied up", "stopped" or "paralysed".⁴

Business Dealing Licence

Because of the business freedom, the chargor was held to have a licence to deal with its assets "in the course of its business" or "in the ordinary course of its business". Dealings with assets within the business dealing licence under a floating charge included:⁵

- sale;
- subsequent specific mortgages or charges;
- exchanges;
- hire purchase or leasing;

² See *Company Charges* at 39-41, 59-77.

³ See *Company Charges* at 77-82, 92-100.

⁴ See *Company Charges* at 88-92.

⁵ See *Company Charges* at 194-200.

- sale and lease-back;
- payment of debts;
- cash applications;
- mutual transactions conferring rights of set-off.

Crystallisation

The traditional grounds for crystallisation required either a business cessation event or a chargee intervention event, including:⁶

- winding up;
- stopping trading or ceasing to carry on business prior to winding up;
- disposal of substantially all the undertaking or assets with a view to ceasing trading or operation as a going concern;
- appointment of a receiver and manager;
- taking possession by the chargee;
- obtaining or exercising a remedy, for example, an injunction to enforce the charge or protect the charged assets generally.

Modern Implied Term Analysis

In the older cases the court reached decisions relating to the three characteristic elements of the floating charge based on the intention of the parties ascertained outside the express contractual terms of the floating charge contract:

- the intention of the parties that the business of the chargor company should continue during the floating phase of the charge;
- the intention that the company chargor should have a licence to deal with its assets in the ordinary course of its business;
- the intention that in certain events the charge should crystallise into a fixed charge, including winding up, receivership and business cessation.

None of the older cases explicitly stated that these three essential elements of the floating charge should be incorporated into the contract as an implied term.

In identifying the business continuance, business dealing licence and crystallisation features of the floating charge, the classic cases considered that their inference or implication was "necessary" to avoid business "impossibility" or "paralysis". The floating charge contract required that judicial "treatment" to render it "workable" or efficacious for "practical purposes".⁷

⁶ See *Company Charges* at 135-168.

⁷ See *Company Charges* at 172-176.

This language was identical to the business efficacy test of an implied term described by Bowen LJ in *The Moorcock*,⁸ a leading case on implied terms decided in the same classic period.

Some older cases had stated that the business dealing licence or crystallisation in particular events, such as winding up, was a matter of "accepted law" or "general law".⁹

The modern classification of implied terms was formulated in *Liverpool City Council v Irwin*.¹⁰ The first category comprises "established usages" or "legal incidents", where the court has held that as a general rule in all contracts of a certain kind a term is to be implied, unless expressly excluded or modified by the parties. The second category, encompassing *The Moorcock* doctrine, comprises terms implied into a contract under the "necessary principle" to make the contract work.¹¹

Recent cases have explicitly analysed the business continuance, business dealing licence and traditional crystallisation events as being implied terms of the floating charge contract.¹²

Crystallisation events are not fixed by law but by the agreement of the parties. The general law rule that crystallisation occurs in the event of winding up, receivership or business cessation is merely a contractual implied term, capable of exclusion or modification, for example by specifying additional crystallisation events as express terms. It is not a mandatory legal rule restricting crystallisation to those three traditional events.¹³

ADVANCED MODELS

Express Crystallisation

The older cases held that a floating charge crystallises, in effect by means of an implied term, upon the occurrence of:

- a business cessation event, including winding up and ceasing business operations as a going concern prior to winding up; and
- a chargee intervention event, including appointment of a receiver or manager, taking possession as mortgagee, and obtaining an injunction against company dealings with the charged assets generally.

More recent authorities, in interpreting appropriately drafted charge contracts, have held that a floating charge also crystallises upon the occurrence of an event where the floating charge expressly provides that the charge shall crystallise in that event.

Explicitly agreed crystallisation events are express contractual terms. It is preferable to describe as "express crystallisation" the occurrence of an event agreed as an express term of the charge contract. Previously, this process was also called "automatic crystallisation". The expression

⁸ (1889) 14 PD 64 at 68.

⁹ *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979 at 992-993 per Fletcher Moulton LJ; *Re Crompton & Co Ltd* [1914] 1 Ch 954.

¹⁰ [1977] AC 239 at 253 per Lord Wilberforce.

¹¹ See *Company Charges* at 175-177.

¹² *Re Brightlife Ltd* [1987] Ch 200 at 212-213 per Hoffmann J; *Re Obie Pty Ltd (No 2)* (1984) 8 ACCR 574 at 581 per Thomas J; *Fire Nymph Products Ltd v Heating Centre Pty Ltd (in liquidation)* (1992) 7 ACSR 365 at 376 per Sheller JA.

¹³ See *Company Charges* at 177-178.

"automatic crystallisation" is confusing as it has also been used by the court to refer to an implied term crystallisation event, for example, winding up, where there was not necessarily any act or event of chargee intervention and where in that sense crystallisation occurred "automatically". For the sake of clarity, the term "automatic crystallisation" is better avoided.¹⁴

In recent years, the court has upheld the effectiveness of express crystallisation clauses specifying in appropriate language the occurrence of a range of events:

- Appointment of a receiver and manager under a prior ranking fixed and floating charge.¹⁵
- Charging or attempting to charge its assets by a chargor, contrary to the provisions of a restrictive covenant against creating any prior or equal ranking charge.¹⁶
- The giving of a notice to the chargor converting the floating charge into a specific charge in relation to the charged assets specified in the notice.¹⁷
- Any specified event of default, for example, non-payment of a demand by the chargee for immediate payment of all moneys due.¹⁸
- Dealings with the charged property contrary to an express restrictive covenant against dealing with the charged property other than in the ordinary course of its business.¹⁹

It appears that an express provision conferring an option or election on the chargee to terminate the business dealing licence of the chargor, when exercised, operates with the same effect as an express crystallisation conversion notice.²⁰

¹⁴ See *Company Charges* at 232-233.

¹⁵ *Stein v Saywell* (1969) 121 CLR 529; *Company Charges* at 233-235, 262-263.

¹⁶ *Re Manurewa Transport Ltd* [1971] NZLR 909; *Deputy Commissioner of Taxation v Horsburgh* [1983] 2 VR 591 (Murphy J); affd on different grounds [1984] VR 773 (Victorian Full Court); see also *Company Charges* at 233-236, 263-265.

¹⁷ *Re Brightlife Ltd* [1987] Ch 200 (Hoffmann J); *North Western Shippings & Towage Co Pty Ltd v Commonwealth Bank of Australia* (1993) 118 ALR 453 (Federal Court); *Company Charges* at 236-237, 256-258.

¹⁸ *Deputy Commissioner of Taxation v Horsburgh* [1983] 2 VR 591 (Murphy J) (default in repayment); *Re Permanent Houses (Holdings) Ltd* [1988] BCLC 563 (Hoffmann J) (demand repayment); *DFC Financial Services Ltd v Coffey* [1991] 2 NZLR 513 (Privy Council) (any event of default); *Dovey Enterprises Ltd v Guardian Assurance Publications Ltd* [1993] 1 NZLR 540 (New Zealand Court of Appeal) (lease termination by lessor re-entry on grounds of non-payment of rent); *Re Rex Developments Pty Ltd (in liquidation)* (1994) 13 ACSR 485 (ACT Supreme Court) (filing of court winding up application); *Company Charges* at 236-238.

¹⁹ *Fire Nymph Products Ltd v Heating Centre Pty Ltd (in liquidation)* (1992) 7 ACSR 365 (NSW Court of Appeal) (asset disposition contrary to restriction on dealings other than in the ordinary course of the ordinary business of the chargor); *Company Charges* at 238, 265-266.

²⁰ *Re Bartlett Estates Pty Ltd* [1989] 2 Qd R 175 (Dowsett J); *Re Brightlife Ltd* [1987] Ch 200 (notice requiring legal mortgage pursuant to further assurance clause); *Company Charges* at 258-262.

Business Paralysis Issue

Express crystallisation requires a clause of sufficient clarity to achieve that result.²¹

The older cases stressed the need for a chargee intervention event to cause crystallisation because business paralysis would result without chargee intervention. This explanation was given in the interpretation adopted by the court in relation to "express licence until default" provisions (eg "the chargor is licensed to deal with its assets until the occurrence of an event of default"). Crystallisation occurred only when a receiver was appointed subsequent to default.²²

The business paralysis argument was also reflected in criticisms of the concept of express crystallisation made at a previous stage by commentators and in the *Cork Report* in the United Kingdom and *Harmer Report* in Australia relating to insolvency law reform.²³

Express crystallisation was said to cause prejudice to the parties to the charge and to third parties. It was supposed to be highly inconvenient that a charge could crystallise perhaps on some trivial event where the parties were unaware of its occurrence. There was no "public act", such as the appointment of a receiver, which prejudiced innocent third parties.

These criticisms were largely misconceived because:

- they misunderstood the contractual basis of implied or express crystallisation;
- they ignored the impact of the general law priority rules based on estoppel and legal purchase without notice operating in favour of innocent third parties.

The "public act" requirement was a fallacy because third parties such as a subsequent specific chargee, the purchaser of the undertaking as a whole or the purchaser under a factoring of book debts was not "innocent". Such a business party could reasonably be expected to search or enquire under the provisions of a prior registered floating charge.

In more recent cases, the court has retreated from the traditional business paralysis explanation of crystallisation without chargee intervention. In *Deputy Commissioner of Taxation v Horsburgh*,²⁴ Murphy J considered that there was no paralysis.²⁵

In *Re Woodroffes (Musical Instruments) Ltd*,²⁶ Nourse J also rejected the argument that express crystallisation causes business paralysis. The express crystallisation of a second charge did not automatically crystallise a prior first charge. If despite crystallisation the chargor continued to carry on business and deal with its assets in the ordinary course, there was a breach of the charge contract.

²¹ *Re Brightlife Ltd* [1987] Ch 200 (Hoffmann J); *Re Permanent Houses (Holdings) Ltd* [1988] BCLC 563.

²² *Governments Stock and Other Securities Investment Co Ltd v Manila Rly Co Ltd* [1897] AC 81; *Sicree v Deputy Commissioner of Taxation* [1981] VR 527; *R v Consolidated Churchill Copper Company Ltd* [1978] 5 WWR 652; *Re Caroma Enterprises Ltd* (1979) 108 DLR (3rd) 412; *Company Charges* at 242-252.

²³ See *Company Charges* at 408-412, 416-422.

²⁴ [1983] 2 VR 591.

²⁵ See *Company Charges* at 412-416.

²⁶ [1986] Ch 366.

In a charge containing the usual enforcement options on a chargee following default, continued business dealing by the chargor should be viewed in the conventional context of breach of contract and consequences flowing from the breach. There is no business paralysis.²⁷

Specific Charges over Circulating Assets

In more recent times, the chargee has frequently attempted to take a specific charge over present and future book debts, instead of a floating charge. The main motive has been to preserve priority against the purchaser of book debts under a factoring or debt discounting transaction effected in breach of restrictive undertakings on the business dealing licence contained in the charge.

In recent times, the court has confirmed on frequent occasions that it is perfectly possible legally for a chargor, by way of continuing security for future advances, to create a specific equitable charge on future assets as soon as they are received by the chargor, which prevents the chargor from disposing of an unencumbered title to the charged property, even before the chargee has taken steps to enforce its charge security.²⁸

In particular, the court has upheld in appropriate cases the effectiveness of a specific charge over circulating assets such as present and future book debts.²⁹

Frequently, a specific charge over book debts has been held to be a floating charge in substance because there was no real intention of the parties that the chargee should be required to consent to any payment or application by the chargor of the collected cash proceeds.

Convertible Charges

A more recent innovation has been the appearance of charges containing express terms that the charge should convert from a fixed charge into a floating charge or, alternatively, from a floating charge into a fixed charge, upon the conversion of an asset from one kind of property into another.

The issue is identical to express crystallisation, although the purpose or context is different. An express crystallisation clause is intended to cause a floating charge to crystallise automatically by conversion into a fixed charge upon the occurrence of a specified event of default or priority threat.

By contrast, a convertible charge may operate by converting a fixed charge into a floating charge as a matter of normal commercial routine.

²⁷ See *Company Charges* at 412-416.

²⁸ *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 L1 Rep 142 at 159 per Slade J; *Re Bond Worth Ltd* [1980] Ch 228 at 250 per Slade J; *Deputy Comr of Taxation v Lai Corpn Pty Ltd (Receivers and Managers Appointed)* [1987] WAR 15 at 24 per Burt CJ; *The 'Annangel Glory'* [1988] 1 L1 Rep 45 at 47 per Saville J; *Wreckair Pty Ltd v Emerson* (1991) 5 ACSR 576 at 580-581 per McPherson ACJ; *Northern Bank Ltd v Ross* [1991] BCLC 504 at 513 per Hutton LCJ.

²⁹ *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 L1 Rep 142; *Re Keenan Bros Ltd* [1986] BCLC 242; *Re A Company (No 005009 of 1987), ex parte Copp* [1989] BCLC 13; *Re Wogan's (Drogheda) Ltd* [1993] 1 IR 157; *Re Atlantic Computer Systems plc* [1990] BCC 859; *Re Atlantic Medical Ltd* [1992] BCC 653; *Royal Trust Bank v National Westminster Bank* [1995] BCC 128.

Floating to Fixed Conversion

In *Re CCG International Enterprises Ltd*,³⁰ Lindsay J held that a typical charge insurance covenant conferring on the chargee an option to apply insurance proceeds representing, for example, fire cover towards reinstatement or repayment created a fixed charge. The fixed charge arises even though the chargee might have only a floating charge on the stock-in-trade prior to its loss by fire.

Lindsay J also considered that a floating charge over stock could become a fixed charge on its being sold and becoming a book debt.

Fixed to Floating Conversion

The reverse effect, whereby a fixed charge can convert into a floating charge, is also clearly possible. In *Re New Bullas Trading Ltd*,³¹ the charge provided that it was to operate over book debts as a fixed charge but that, in the absence of express crystallisation provisions taking effect and in the absence of written directions from the bank chargee as to the application of the proceeds, the charge should operate as a floating charge on the proceeds when paid into the chargor's account with the bank. The English Court of Appeal held that the fixed charge over book debts, and temporarily over collections pending payment into the bank account, remained effective because the book debts could not be dealt with at the unilateral will of the chargor free of the fixed charge security.

It is open to contracting parties to provide for a fixed charge on future book debts. It is also open to them to provide that they shall be subject to a fixed charge while they are uncollected and a floating charge on realisation.

Waiver Options/De-crystallisation

The recent judicial approach is to treat continued dealing by the chargor subsequent to crystallisation as a question of contractual breach and its consequences, but not as causing business paralysis. This is also reflected in judicial treatment of express waiver of default provisions.

The efficacy of a right of express waiver of an express crystallisation event by the crystallised chargee was approved by the New Zealand Court of Appeal in *Dovey Enterprises Ltd v Guardian Assurance Publications Ltd*.³² In that case an express crystallisation clause in a floating charge was stated to operate when the secured moneys became payable by acceleration. Payment of the secured moneys was accelerated at the option of the chargee upon the occurrence of an event of default. Gault J considered that the effect of the clause, consistent with its commercial sense, was that the option when exercised related back to the occurrence of the event of default to protect the chargee in the interval between the occurrence of the event and the chargee becoming aware of it. It meant in effect that the option given to the floating chargee conferred an ability to waive its rights in respect of the crystallisation after becoming aware of the event and assessing the impact on its security. The same principle applies to an express de-crystallisation clause as to an express waiver provision.

The effect of both an express waiver and de-crystallisation is to re-convert the crystallised fixed charge back into a floating charge by means of the contractual mechanism previously agreed in

³⁰ [1993] BCC 580.

³¹ [1994] BCC 36.

³² [1993] 1 NZLR 540.

the original floating charge contract. A de-crystallised charge subsequently operates in the same manner as the floating charge in its original floating phase.

CONTRACTUAL FRAMEWORK

Freedom of Contract Principle

In approving express crystallisation clauses and convertible charges, the court has made clear that the principle of freedom of contract applies. There is no principle of public policy or judicial policy to prevent the parties from achieving these results by agreement.

The parties are free as a matter of contract to define the terms of a floating charge.³³

Hybrid Deviations

The equitable charge has been judicially described as a creature of exceptional versatility, malleable to the intentions of its creators and adaptable to the subject-matter affected.³⁴

In relation to convertible charges, there is freedom to create by express language effective specific charges outside traditional areas. Events can move property from being subject to a floating charge to being subject to a fixed charge, independent of any activity on the part of the chargee.

There is no exact set of conditions defining a floating charge, as explained in *Re Brightlife Ltd*³⁵ by Hoffmann J:

"In *Illingworth v Houldsworth* [[1904] AC 355 at 358] ... Lord Macnaghten was at pains to point out that he had not attempted in the *Manila Railway* case [[1897] AC 81] ..., to propound a 'definition' of a floating charge. He had only offered a 'description'. In making this distinction, it seems to me that what Lord Macnaghten had in mind was that a floating charge, like many other legal concepts, was not susceptible of being defined by the enumeration of an exhaustive set of necessary and sufficient conditions. All that can be done is to enumerate its standard characteristics. It does not follow that the absence of one or more of those features or the presence of others will prevent the charge from being categorised as 'floating'. There are bound to be penumbral cases in which it may be difficult to say whether the degree of deviation from the standard case is enough to make it inappropriate to use such a term. But the rights and duties which the law may or may not categorise as a floating charge are wholly derived from the agreement of the parties, supplemented by the terms implied by law. It seems to me fallacious to argue that once the parties have agreed on some terms which are thought sufficient to identify the transaction as a floating charge, they are then precluded from agreeing to any other terms which are not present in the standard case."

The floating charge is a creature of contract with the flexibility that that involves.

Express and Implied Terms

The court now analyses the traditional features of the floating charge, including the business continuity, business dealing licence and crystallisation elements, as contractual implied terms.

³³ *Company Charges* at 238-240, 410-411.

³⁴ *Re New Bullas Trading Ltd* [1994] BCC 36 at 41-42 per Nourse LJ.

³⁵ [1987] Ch 200 at 213-214.

Express crystallisation clauses and convertible charges are upheld by the court as being effective express contractual terms. Ordinary contract principles apply in relation to the making of the charge contract.

Contractual Breach Issues

The court no longer views with disfavour or suspicion the modification of a floating charge by an express crystallisation clause because of the notion of business paralysis.

Continued dealing by the chargor under an expressly crystallised charge in the absence of chargee intervention is viewed as a breach of contract.

Absence of chargee intervention can be analysed in terms of express or implied waiver of the breach.

Ordinary contract principles concerning breach of contract and its consequences apply in relation to default causing express crystallisation.

Crystallisation Equitable Interest

Recent case law has confirmed that the chargee does not obtain an equitable proprietary interest until crystallisation.³⁶

Under a floating charge, even in circumstances where otherwise in the case of a specific charge mere ownership or acquisition would constitute sufficient appropriation, the chargor is still free to appropriate property owned or acquired for purposes other than those of the security, eg by the disposal of property or payment of money free of the charge to persons other than the chargee. Final and irrevocable appropriation is intended to be deferred, so as to take effect at the later point of crystallisation and not upon mere future acquisition. Appropriation is deferred until crystallisation, when the charged assets are finally and irrevocably ascertained and identified, being all the assets, or all the assets within a specified class, in existence at the time of crystallisation or acquired subsequent to crystallisation.

A floating charge is described as a present but incomplete assignment.³⁷

It is a **present assignment** immediately in existence because, like a specific charge, no "new act" is required by the chargor to transfer an equitable proprietary interest in the charged assets subsequent to the making of the charge contract.

It is an **incomplete assignment** because, unlike a specific charge, the equitable proprietary interest does not pass automatically upon the mere acquisition subsequently by the chargor. The specific appropriation necessary to pass the interest is intended to be deferred until crystallisation when the assets subject to the charge assignment are ascertained and identified.

³⁶ *Tricontinental Corpn Ltd v Federal Commissioner of Taxation* (1987) 73 ALR 433; *Relwood Pty Ltd v Manning Homes Pty Ltd (No 2)* [1992] 2 Qd R 197; *Re Goldcorp Exchange Ltd (in receivership)* [1994] 3 WLR 199; *Lyford v Commonwealth Bank of Australia* (1995) 17 ACSR 211; *Company Charges* at 332-348.

³⁷ *Company Charges* at 92-100.

Mainstream Contract and Property Law Analysis

Recent cases have clarified that the floating charge is a contract containing express and implied terms and defers any equitable proprietary interest passing to the chargee until crystallisation.

This means that the particular characteristics of the floating charge follow the traditional principles of the general law of contract and law of property relating to the passing of title upon specific appropriation.

The floating charge need no longer be described in vague metaphor or viewed as some esoteric or anomalous conception governed by special rules peculiar to itself.

PRIORITY PERFORMANCE

Traditional Restrictive Clause

The older cases held that, as part of its freedom to continue business, the chargor could create a subsequent specific charge in priority to a previous floating charge, as well as sell assets in the course of its business free of the floating charge.³⁸

At an early stage, restrictive clauses appeared in the floating charge in the form of a negative contractual undertaking by the chargor not to create a subsequent charge ranking in priority to or equally with the floating charge. A restrictive clause was held not to be effective against a subsequent chargee, unless the subsequent chargee had actual notice of the restriction. Registration of the floating charge in the public register of company charges was held not to constitute constructive notice, or deemed actual notice, of the contents or terms of a restrictive clause.³⁹

Traditional Specific Charge Priority Advantage

Traditionally, the specific charge has been more effective in priority terms than a floating charge because of registration in the public register of company charges.⁴⁰

The judicial rule has been that registration constitutes deemed or constructive notice of the existence but not the contents of a charge.

Unlike a floating charge, a specific charge confers an immediate equitable interest when the charged assets are owned or acquired by the chargor.

Registration means that an adverse subsequent third party is deemed to know of a prior equitable interest.

The registered specific charge is effective to retain priority against a subsequent legal interest because the rule of legal purchase without notice is excluded. It is effective against a subsequent equitable interest because it is created first in time and the subsequent party has notice of the prior interest.

For example, a registered specific charge over book debts takes priority against a subsequent purchaser under a debt factoring or discounting arrangement.⁴¹

³⁸ *Company Charges* at 196-197.

³⁹ *Company Charges* at 221-231.

⁴⁰ *Company Charges* at 196-197.

Express Crystallisation Improvements

The purpose of an express crystallisation clause is to reduce the vulnerability of a floating charge to subsequent loss of priority to adverse third party interests. The effect of the older cases was that the chargee received inadequate protection from the traditional grounds of implicit crystallisation, restrictive clauses and express licence until default provisions. The draftsman modified his technique by seeking under an express crystallisation clause to accelerate the priority point at which the floating charge became effective against subsequent adverse interests. The object is to cause a full equitable interest to arise for the purposes of priority completion ahead of subsequent interests arising in favour of adverse third parties.

Acceleration of a prior equitable interest by an express crystallisation clause helps protect the floating chargee in a range of priority situations. An express crystallisation clause:

- bolsters a restrictive clause against subsequent charges or factoring assignments of book debts which is ineffective without actual notice;
- provides improved protection against dispositions of assets which are expressly prohibited under restrictive clauses or against dealings which are outside the ordinary course of business expressly defined in more restricted terms than the implied business dealing licence, for example, dispositions made by a financially distressed or insolvent chargor in the absence of actual business cessation;
- prevents execution creditors obtaining priority through processes of which the floating chargee may be unaware or where it may be commercially inexpedient to appoint a receiver;
- provides improved protection against cross-claims and rights of set-off arising through dealings by the chargor with its debtors;
- provides effective protection against statutory liens, charges or other statutory notification rights where the statutory priority is expressed to be subject to prior equitable interests.

An express crystallisation clause does not confer an absolute priority on a floating chargee. Its effectiveness depends on, and is generally co-extensive with, the priority afforded to any equitable interest under the priority rules of the general law.⁴²

A trade purchaser of goods from the company in the ordinary course of business takes clear title by virtue of purchase of the legal title without notice actual or constructive. The reverse may apply if the company sells a major part of its undertaking in circumstances of business cessation. Because the transaction is not in the ordinary course of business, the purchaser might be said to be fixed with constructive notice.

If the floating charge crystallises automatically on the attempted creation of a subsequent specific equitable charge, the floating chargee takes priority in equity on grounds of time.

Priority could be reversed in the case of book or other debts, including credit bank accounts, if the subsequent specific chargee or absolute purchaser gives first notice to the debtor under the Rule in *Dearle v Hall*.⁴³ This represents some improvement for the floating chargee, since it has been held that the floating chargee during the floating phase is incapable of giving notice under the Rule. A floating chargee under an express crystallisation clause can seek to preserve priority

⁴¹ *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 L1 Rep 142; *Company Charges* at 808-811, 815-819.

⁴² See *Company Charges* at 252-256.

⁴³ (1828) 3 Russ 1, 48.

of time by giving first notice and at the same time overcome any detrimental priority effect due to delay involved in appointing a receiver.

Priority could also be reversed in the case of shares through failure by the floating chargee to take possession of the share certificates.

Priority is not reversed by estoppel in the case of chattels, cash or negotiable instruments still in possession of the company, since continued possession by the debtor in itself has never constituted any representation by the person claiming the prior interest that such assets were unencumbered.⁴⁴

Convertible Specific Charge Protections

A convertible charge which is specific in relation to book debts but floating in relation to cash proceeds is effective to retain priority over a subsequent chargee or purchaser under a factoring arrangement.

Statutory Enhancements

Recent legislative changes have improved the relative priority effectiveness of a floating charge compared with a specific charge.

A fixed and floating charge over all or most of the assets of a company can take priority over an administrator appointed under the recent system of company voluntary administration. A featherweight floating charge taken over all the assets in support of fixed charges to block control by an administrator is fully effective.

Under the tax priorities legislation associated with the administrator system, the tax commissioner no longer takes priority over a receiver appointed under a fixed and floating charge.⁴⁵

Full Range Protection Test

A modified form of fixed and floating charge can now be created which is effective to retain first-ranking priority status against:

- subsequent charges;
- legal purchasers outside the normal course of business, such as factors under debt discounting arrangements and buyers of the business assets and undertaking;
- unsecured creditors levying execution;
- a liquidation or administrator;
- the tax commissioner.

⁴⁴ See *Company Charges* at 252-256.

⁴⁵ *Company Charges* at 1022-1024.

MODELLING OPTIONS

Project/Structured/Corporate Financing Contexts

The contractual flexibility of the floating charge which has recently been clearly approved by the court has significant implications for security for business and project financings in a wide range of contexts:

- In limited recourse project financing, charge security is frequently taken over cash flow derived from sales contracts and cash paid into dedicated bank control accounts.
- In project financing developments, there is frequently a provision that the project as a complete whole reverts to the seller subject to the bank charge in the event of development agreement termination following operator default.
- Ring fencing restrictions may prevent a chargee or its receiver selling infrastructure project assets on a segmented or liquidated basis.
- The commercial advantages of corporate negative pledge facilities might be available to a wider range of corporate borrowing groups if all assets security were available.
- New products for commercial retail stock-in-trade financing could possibly be developed if legal priority risk for security over circulating assets was eliminated.

Risk Allocation Analysis

Business and project financings inevitably involve the analysis and allocation of risks between the borrowing and lending parties.

The contractual flexibility of the floating charge is especially helpful in devising charge security arrangements tailored to fit the risk sharing requirements of a transaction. The parties are free to mould or shape their charge contract to suit their mutual interests and convenience.

The business freedom of the floating charge satisfies the interest of the borrower. The recent full range priority effectiveness of a modified floating charge satisfies the security interest of the lender.

The contractual flexibility of a modified floating charge means that the payment priority aspect of a charge can be separated from the control priority. This is a very useful security tool in devising charge security arrangements which effectively match the risk sharing requirements of a transaction.

Contractual Solutions

Different forms of modified floating charge can be devised:

- A convertible charge can be specified as floating in relation to stock-in-trade, fixed in relation to the book debts arising on sale, and floating in relation to the resulting cash collections and replacement stock-in-trade.
- Convertible specific charges provide a full priority effectiveness in relation to security over sales contracts and dedicated bank control accounts.
- Where there are restrictions on sale of a project undertaking by a receiver on a segmented basis, payment priority can be achieved by a specific charge over net revenues or on the sale proceeds of the whole of the undertaking.

- Control priority can be achieved by all assets fixed and floating security to retain first priority against subsequent adverse parties, including chargees, purchasers, unsecured creditors, liquidators and administrators.

SUMMARY

- The traditional floating charge characteristics represent contractual implied terms.
- Express contractual terms can be specified to achieve charge crystallisation and conversion.
- The parties are free to select the terms of their own charge contract.
- An equitable proprietary interest arises only on crystallisation.
- A modified floating charge can achieve full range priority protection comparable with, if not more effective than, a specific charge.
- The contractual flexibility of the floating charge enables structured charge security outcomes.