

1. Introduction

While lenders would seek to include as many assets of the company as possible within the domain of a fixed charge, they also need to allow the company to trade as freely as possible. It would not be in the interests of either party if the company becomes so constrained that its efficiency is substantially impaired. *National Westminster Bank plc v Spectrum Plus Ltd* [2005] 3WLR 58 has shown that it is not always practically achievable for lenders to seek the best of both worlds i.e. a fixed charge on the book debts while allowing the company the same freedom to use the proceeds. The case is significant as it finally provides legal certainty over the distinction between fixed and floating charges.

2. Fixed and Floating Charges

A fixed charge is generally a charge over assets of the company which are ascertained and definite, or capable of being ascertained and defined.¹ Under a fixed charge, the company is restricted from managing and disposing of the charged assets freely.

A floating charge is a charge that ‘hovers’ over a class of assets present and future and those assets can change from time to time in the company’s ordinary course of business.² Under a floating charge, the company remains free to carry on business in the normal way in relation to those assets until there is crystallisation of the charge³. Crystallisation arises when some event occurs such as default by or the insolvency of the company. The

¹ Philip Smart et al, Hong Kong Corporate Insolvency Manual, Hong Kong Society of Accountants 2002, page 126

² Philip Smart et al, Hong Kong Corporate Insolvency Manual, Hong Kong Society of Accountants 2002, page 127 – Romer LJ in *Re Yorkshire Woolcombers’ Association Ltd* [1903] 2 Ch. 284

³ Philip Smart et al, Hong Kong Corporate Insolvency Manual, Hong Kong Society of Accountants 2002, page 127 - Romer LJ in *Re Yorkshire Woolcombers’ Association Ltd* [1903] 2 Ch. 284

chargee may then terminate the company's permission to deal with the charged assets and affirm his security rights over them.

3. Importance of the distinguishing fixed and floating charges

A distinction between a fixed and a floating charge is important given the implications for the order of payment to creditors from the assets of a company in liquidation. A fixed charge has priority over preferential creditors and unsecured creditors while a floating charge holder will rank before the unsecured creditors but only after the preferential creditors.⁴

In particular, book debts have posed as a main area of dispute relating to the characterisation of a charge as fixed or floating. As lenders, banks would be concerned with realising their security and would argue that the restrictions in their debentures have established their charges as fixed. Conversely, the liquidators would seek to strike such charges down as unregistered floating charges.

4. The Developments

Siebe Gorman & Co Ltd v Barclays Bank Ltd [1979] 2 Lloyd's Rep 142 had previously been the authority for the creation of fixed charges over book debts. In that case, the charge provided restrictions on the company not to dispose of the book debts without the chargee's consent and the proceeds to be paid into its account with the chargee. The chargee was a clearing bank. However, the company was free to draw funds from the

⁴ Goode, RM, *Legal Problems of Credit and Security* (3rd Ed.) Sweet and Maxwell, London 2003, page 120. Also Sections 79 & 265 of the Companies Ordinance (Cap 32)

account into which book debts were paid. It was held that the restrictions would be sufficient for the purposes of constituting a fixed charge. The court also found that the chargee being a bank could, whilst the security was in force, assert its lien over the proceeds of book debts. From *Siebe Gorman*, it was possible for a charge to be fixed even if the charge did not prohibit the debtor from withdrawing money from the account receiving the deposit of the proceeds provided that other restrictions were present.

However, the decision in *Seibe Gorman* was not devoid of controversy and diverging opinions ensued. In *Re Brightlife* [1987] Ch. 200, it was held that the absence of control over the proceeds and the freedom of the company to deal with the proceeds would characterise the charge as a floating charge despite being described to the contrary. Under *Re Brightlife*, control over the proceeds was a vital element in the characterisation of a fixed charge in addition to the restrictions on the sale of book debts.

But in *Re New Bullas Trading* [1991] 1 BCLC 485, it was held that the creation of a fixed charge as opposed to a floating charge depended on the intention of the parties. In that case, the court treated the charge as fixed when it was created and then floating in terms of dealing with the assets. The decision was overruled in *Agnew v Commissioners of Inland Revenue* [2001] 2 AC 710, in which the Privy Council rejected the proposition that a charge over book debts could be characterised independently of the contractual provisions governing the application of the proceeds. In *Agnew*, “A restriction on disposition which nevertheless allows collection and free use of the proceeds is

inconsistent with the fixed nature of the charge.”⁵ From this, the issue relating to the characterisation of a fixed charge was whether sufficient control mechanisms were in place, in practice, to prevent the company from dealing with book debt proceeds in the ordinary course of its business.

5. The Current Position

In *National Westminster Bank plc v Spectrum Plus Ltd* [2005] 3WLR 58, the House of Lords retrospectively overruled *Siebe Gorman*. The facts in both cases were similar with the debenture expressed to include a specific charge over the company’s book debts and the company could not dispose of or charge the uncollected debts and was obliged to place the proceeds of those debts into a designated account with the bank. The company was, nevertheless, free to draw on the account, which was a normal bank account with overdraft facility.

In *Spectrum Plus*, it was held that the debenture was only sufficient to create a floating charge over the book debts. As the company could draw on the account at will (subject to the overdraft limit), the debenture did not exert enough control over the proceeds of the debts once paid in and this was inconsistent with the charge being a fixed charge. To attain a fixed charge, the chargor must not have the freedom to deal with the charged assets and the chargee must establish that it has actual control over the charged assets.

The judgment in *Spectrum Plus* confirms that it would be conceptually possible in law to create a fixed charge over book debts, both present and future. However, it did not

⁵ *Agnew and Another v. Commissioner of Inland Revenue* [2001] UKPC 28; [2001] 3 W.L.R. 454, para. 36

explain how this could be achieved but discussed that a fixed charge would be effective where the company is prevented from all dealings with the book debts so that they are preserved for the benefit of the chargee's security or other than their collection and to require⁶:

- (i) the proceeds to be paid to the chargee in reduction of the company's outstanding debt;
- (ii) the collected proceeds to be paid into an account with the chargee bank;
- (iii) the collected proceeds to be paid into a separate account with a third party bank.

6. Likely Implications of *Spectrum Plus*

In Hong Kong, book debts are required to be registered⁷ but charges are not defined in the Companies Ordinance⁸. Hong Kong has generally followed the English position on the distinction between fixed and floating charges. *Spectrum Plus* is likely to have a persuasive effect on Hong Kong courts.

The retrospective overruling of *Siebe Gorman* would mean that the ruling applies in all cases, whether past or future, subject only to defences of general application such as limitation. This decision may cause challenges on the distributions made according to the decision in *Siebe Gorman*. Nevertheless, limitation and defence of change of position may be used to argue that the cases should not be reopened.

⁶ National Westminster Bank plc v *Spectrum Plus* Ltd [2005] 3WLR 58, para. 54

⁷ Section 80(2) of the Companies Ordinance (Cap 32)

⁸ Cap.32 of the Laws of Hong Kong

Banks should take extra care when taking charges as security and ensure that the appropriate forms of debentures are properly drafted. It is likely that factoring or invoice discounting will be more commonly used. However, the disadvantage of such methods for banks is that they would have to take on the buyers' credit risks associated with the book debts.

Contrary to the UK, it is possible for a charge to be created over a deposit in Hong Kong⁹. However, section 15A of LARCO¹⁰ does not determine whether a credit balance of the company at its bank account should be considered as a book debt. If the deposit is a book debt then any charge over it (fixed or floating charges) would be a charge on book debts of the company which would require registration, the failure of which would render it void against the liquidator and every creditor of the company¹¹. The generally held view is that such moneys do not constitute a book debt.¹² If such a view holds true, then a fixed charge may be created over the credit balance of a bank account relating to the proceeds provided that there exists sufficient control according to the *Spectrum Plus* decision.

7. Conclusions

The *Spectrum Plus* decision represents a more general realignment of secured lending with a view to fostering an enterprise culture and is likely to lead to both lenders and

⁹ Section 15A of s15A of the Law Amendment and Reform (Consolidation) Ordinance 1991 (Cap 23)

¹⁰ the Law Amendment and Reform (Consolidation) Ordinance 1991 (Cap 23)

¹¹ Sections 80(1) and 80(2)(e) of the Companies Ordinance (Cap 32)

¹² Philip Smart et al, Hong Kong Company Law, Cases, Materials and Comments, Butterworths, 1997. page 420

borrowers to explore other methods of debt financing. The decision should be welcomed in terms of legal certainty.

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Reference Materials

Books

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2. Vick Thompson, Insolvency Law & Practice, Vol. 20, No. 3 2004 “Book debt charges: round two to the banks” pp99-101

Cases

1. Agnew and Another v. Commissioner of Inland Revenue [2001] UKPC 28; [2001] 3 W.L.R. 454 – taken from Westlaw

2. National Westminster Bank plc v Spectrum Plus Ltd [2005] 3WLR 58 - taken from Westlaw

Ordinances

1. Companies Ordinance (Cap 32)
2. Law Amendment and Reform (Consolidation) Ordinance 1991 (cap 23)