

# KEY FACTS COMPANY LAW

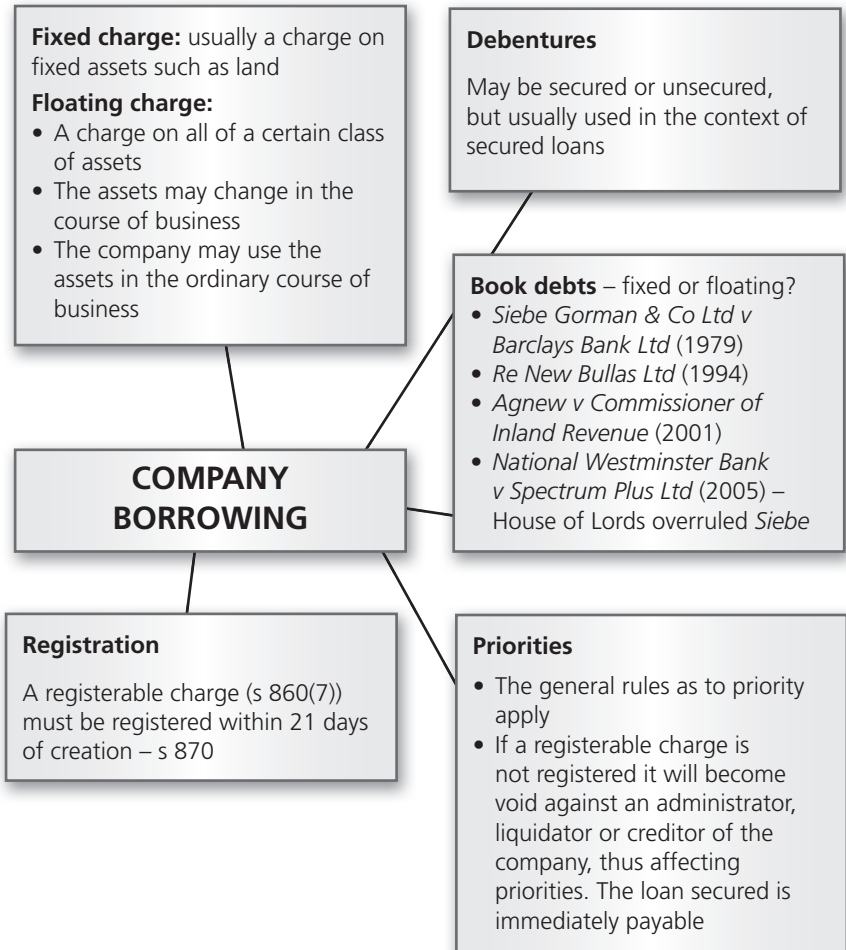


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 **HODDER**  
EDUCATION

## Company borrowing



## 9.1 Company charges

### 9.1.1 Debentures

1. It is very common for companies to raise capital by borrowing. This can take many forms, including bank overdrafts, promissory notes, mortgages on property and debentures. But note that a company's power to borrow may be limited by the articles of association.
2. The term 'debenture' has a very wide usage: it has been held to mean any document issued by a company acknowledging a debt (see for example *Lemon v Austin Friars Investment Trust Ltd* (1926)). It is defined in s 738 of the Companies Act 2006 (CA 2006): 'Debenture includes debenture stock, bonds and any other securities of a company, whether or not constituting a charge on the assets of the company'.
3. A debenture may be secured or unsecured. However, banks will usually require security for loans to companies and the term is generally used in the context of secured borrowing.
4. Security may be by means of a fixed or floating charge:
  - a **fixed charge** may be created over specified identifiable company property not dealt with by the company in its day-to-day business, for example its land and buildings;
  - a **floating charge** may be created over fluctuating assets, such as stock in trade, book debts, machinery, tools and other chattels, allowing the company to deal with the property in the ordinary course of business until crystallisation (*Re Yorkshire Woolcombers Association Ltd* (1903)).
5. There are significant differences between shares and debentures:
  - shares create rights of membership, for example the right to attend general meetings and vote; a debenture holder is a creditor of the company, whose rights are fixed by contract;
  - a shareholder is entitled to a dividend if one is declared; a debenture holder is entitled to payment of interest in accordance with the contract.

### 9.1.2 Fixed and floating charges

1. Whether a charge is fixed or floating is a matter of substance rather than form. Neither the words used by the parties nor their intentions will necessarily be conclusive in deciding how a charge

should be categorised (*Street v Mountford* (1985), *Re ASRS Establishment Ltd* (2000)). The distinction is important for a number of reasons:

- In applying the principles relating to priority of payment, a fixed charge will generally take precedence over a floating charge.
  - Under provisions introduced by the Enterprise Act 2002, for charges created from 15 September 2003 a proportion of the assets of a company subject to a floating charge must be set aside for unsecured creditors. This is not the case with fixed charges, which makes fixed charges more attractive to banks and other chargees.
2. The main features indicating a floating charge have been expressed as:
- it is a charge on all of a certain class of assets, present and future;
  - the assets may change in the ordinary course of business;
  - the company is able to carry on its business using the assets in the ordinary way (*Re Yorkshire Woolcombers Association Ltd* (1903)).

### 9.1.3 Book debts

1. Cases involving book debts have raised a number of issues in relation to the distinction between fixed and floating charges. Until the House of Lords decision in *Re Spectrum Plus Ltd* (2005) there had been some confusion as to how book debts and their proceeds should be treated.
2. In *Re Brightlife Ltd* (1987) the company was not restricted from dealing with either the debts or the proceeds and it was held that this arrangement created a floating charge.
3. More difficult situations arise in cases where there are restrictions on assigning the book debts, but the company has freedom to draw on the account into which the proceeds of the debts are deposited. This was the case in *Siebe Gorman & Co Ltd v Barclays Bank Ltd* (1979): there were restrictions on the company's use of its book debts and the proceeds were paid into an account held by the lender, although the company was free to draw on the account. It was held that this arrangement created a fixed charge. This case was followed, and relied upon by banks, until it was overruled by *Re Spectrum Plus Ltd* (2005).
4. In *Re New Bullas Ltd* (1994) while the book debts were expressed as a fixed charge, the proceeds were released from the charge and paid into a bank account controlled by the company. It was held that a distinction could be made between the book debts, which were subject to a fixed charge, and the proceeds, subject to a floating charge.

5. The Privy Council case *Agnew v Commissioner of Inland Revenue* (2001) clarified the law in this area. In this case a charge similar to that in *New Bullas* had been created in favour of a bank. The court held that *New Bullas* had been wrongly decided and expressed the opinion that separating the debt from the proceeds 'made no commercial sense'. Lord Millett set out a two-stage process for categorising fixed and floating charges:
- first the court must consider the intention of the parties as to their respective rights and obligations;
  - the second stage requires the court to determine whether the charge is fixed or floating as a matter of law.
- In *Agnew* the company was able to realise the debt and to pay the proceeds into an account which it controlled. This was held to be a floating charge.
6. In *Re Spectrum Plus Ltd* (2005) the proceeds of the debts were paid into a current account held by the bank but the company was able to draw on the account and make use of the overdraft facility, so this could not be a fixed charge. The commercial reality of the situation must be taken into account. *Siebe* and *Re New Bullas Ltd* were overruled, resolving many of the uncertainties in the law.

### 9.1.4 Crystallisation

1. A floating charge crystallises and becomes fixed on the occurrence of certain events. The chargee takes possession or appoints an administrator or receiver.
2. A floating charge crystallises:
  - on cessation of the company's business (*Re Woodroffes (Musical Instruments) Ltd* (1986));
  - when the security is enforced by virtue of a clause in the debenture (*Re Brightlife Ltd* (1986));
  - when the company goes into administration or receivership;
  - when the company goes into liquidation.

## 9.2 Registration and priorities

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### 9.2.1 Legal and equitable charges

1. A charge may be legal or equitable:
  - a legal charge must be recognised by anyone who gains title to the charged property after the charge is created;
  - an equitable charge must be recognised by anyone other than a person who acquires the property *bona fide* and for value, without notice (actual or constructive) of the charge.

### 9.2.2 Effect of registration

1. A charge must be registered at Companies House in accordance with s 860 CA 2006. Section 870 provides that a registerable charge, as listed in s 860(7), must be registered within 21 days of its creation. Registration provides actual notice of the charge to anyone who consults the register and constructive notice to others (*Wilson v Leland* (1910)). The register is open to public inspection. The requirement of registration ensures that a subsequent creditor seeking security by way of a floating charge (which is an equitable charge) has either actual or constructive notice of any existing charges on the property.
2. Failure to register a charge may result in the company and its officers being fined.

### 9.2.3 Priorities

1. Charges created by a company are subject to the general rules governing priority.
2. A legal charge will rank in priority over an equitable charge. Thus a legal mortgage will rank in priority before a floating charge, even if the mortgage was created after the floating charge.
3. Between two floating charges the order of creation will determine priority, with the charge created first ranking ahead of the second, unless there is an express provision in the first charge that the company may create a second charge taking priority: *Re Automatic Bottlemakers Ltd* (1926).
4. Registration affects priority. If a charge is not registered within the required 21 days it will lose all priority.

5. Under s 874, if a registerable charge is not registered, it will be void against an administrator of the company, a liquidator of the company and a creditor of the company. When a charge becomes void under this section, the money secured by it immediately becomes payable (s 874(3)), but it will no longer be treated as a secured debt.

## 9.2.4 Reform

1. The current law on registration of charges, as set out in the CA 2006, has been the subject of criticism for some time and a consultation on the registration of charges created by companies and limited liability partnerships was issued in May 2010.
2. The consultation makes proposals to revise the current law and is based on recommendations made in 2001 in the course of the Company Law Review and on advice of the Law Commission. Consideration is given to:
  - which charges must be registered;
  - how charges may be registered including the possibility of electronic registration;
  - the consequences of registering or not registering a registerable charge.
3. It is intended to publish draft regulations in 2011 and change is likely to be implemented in 2012 or 2013.