CROSS-BORDER FINANCE ESSAY

Floating Charges: the Good, the Bad and the Ugly

The Evolution of the Floating Charge

BY LERIKA LE GRANGE AND FIONA COADY

Earlier this year, SFNet announced its second Cross-Border Finance Essay Contest, sponsored by Goldberg Kohn Ltd. Members of SFNet's International Finance and Development Committee judged the essay submissions on content, originality, clarity, structure and overall contribution to furthering and expanding understanding and discourse within the field of cross-border finance. This essay won first place.

The authors of the winning essays have been invited to participate on a panel at SFNet's 79th Annual Convention in Orlando, FL, November 15-17.

The capacity for a lender to take effective security over a changing pool of assets is of critical importance to the asset-based lending market. In England and Wales, floating charge security, developed by English case law in the 19th century, has long been the secured lender's security interest of choice when it comes to cash, inventory, receivables and other fluid asset classes.

What was once a robust security interest has, over the course of nearly 150 years of challenge through case law and adjustment through statute, evolved into a far more complex beast.

In this article we explore the virtues of the English law floating charge (the "Good"), will demonstrate some of the lesser-known dangers of this security interest for secured lenders (the "Bad") and will show that, for the unwary secured lender, the floating charge can be downright "Ugly."

We will also focus on practical steps asset-based lenders can take to improve their position and will look at potential for reform.

First… the "Good"

Fixed security over assets under English law requires a secured creditor to exercise a level of control over such assets which is often incompatible with the operational requirements of a borrower. A floating charge offers an easy and effective way for an English company to grant security while allowing it to continue operating its business normally until the occurrence of a crystallisation event. A floating charge holder enjoys some priority over unsecured creditors with respect to the assets subject to a floating charge (although perhaps not the degree of priority one might expect – more below).

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A further key benefit of a floating charge is that it gives a secured lender the ability to appoint an administrator. Provided a secured lender's charge extends to the whole or substantially the whole of the UK company's property[1], such lender will be a "qualifying floating charge holder" which will enable it to appoint an administrator out of court. This is considered to be a meaningful advantage to a secured creditor in exerting some control over an insolvency process.

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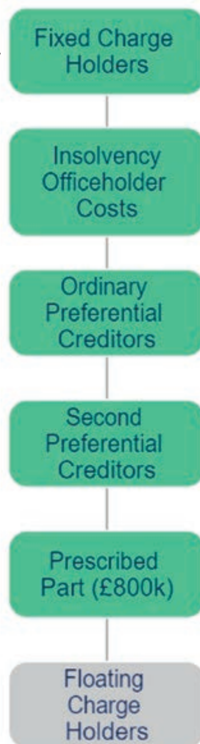
Next… the "Bad"

Two fundamental (and reasonable) expectations of any secured lender are that their debt will be serviced by the value of the assets subject to their security before other unsecured creditors receive payment and that a subsequent secured creditor cannot jump ahead of them in the insolvency queue.

As originally conceived, and until the late 19th century[2], a floating charge broadly met these expectations and the distinction in practice between fixed and floating security was minimal. However, since then, and particularly over the last 50 years, case law developments have occurred and statutory provisions have been introduced, which have had the effect of materially watering down the value of floating charges for

secured lenders.

Before a secured lender is entitled to receive any floating charge realisations, considerable sums may have to be paid to prior ranking creditors and/or the insolvency practitioner, namely:



- **Fixed Charge Holders** – a subsequently taken fixed charge will generally take priority over an existing floating charge, provided both are registered at the UK Companies House (although this risk can largely be addressed by the inclusion of a negative pledge in the floating charge documentation).
- **Insolvency Officeholder Costs** - these will reduce the pot available to floating charge holders; for the insolvency of a complex corporate group these costs can easily run to millions and represent significant value leakage.
- **Ordinary Preferential Creditors** – these will include certain specified items such as contributions to pension schemes and certain salary payments, subject to specified limits.
- **Second Preferential Creditors** - the recent re-introduction of the crown preference on 1 December 2020[3] has added to those that rank ahead, elevating HMRC to *"second preferential creditor status"* for certain priority taxes[4] which have been collected by the company on behalf of its employees and customers but not yet accounted for.
- **Prescribed Part** - floating charge holder recoveries have further been diminished by the increase to the amount which must be set aside from floating charge realisations for the benefit of unsecured creditors, from £600,000 to £800,000 on 6 April 2020[1].

The result of these factors is that the holder of a validly created and fully perfected floating charge may find that the value it receives on realisation of the floating charge assets is vastly less than expected.

And... the "Ugly"

Whilst eroded recoveries are certainly not good news for a secured creditor, the "ugliest" scenario for a floating charge holder is for that creditor to find that it is actually unsecured. This can be a very real risk, if not well managed.

Like many jurisdictions, English law provides various routes for an insolvency practitioner to "look back" and challenge transactions entered into pre-insolvency and, in doing so, increase the pot of assets available to the general body of creditors. These are principally enshrined in the Insolvency Act 1986 (the "Act") and include powers to challenge transactions at an undervalue and transactions preferring certain creditors above others. These provisions do not generally unduly trouble an arm's length commercial lender acting in good faith.

However, sitting alongside its less-offensive siblings is section 245 of the Act ("S.245") which creates the possibility that a floating charge may be determined to be wholly or partly invalid, potentially leaving a secured lender unexpectedly unsecured. This risk merits closer inspection.

Assuming the relevant parties are unconnected[6], S.245 is relevant if the floating charge is granted within 12 months prior to the onset of insolvency[7] and the company was unable to pay its debts at the time of creation of the floating charge or became unable to pay its debts as a result of it. The solvency status of the grantor of a floating charge is of critical importance and, as outlined below, should be aggressively interrogated by a prospective lender in order to determine the extent to which that lender should be engaging with the possibility of a S.245 invalidity. If the insolvency requirements are met, the floating charge will be invalid save to the extent of the aggregate value directly provided to the grantor of the floating charge in consideration for the creation of the floating charge, which consideration must be provided at the time of or after creation of the floating charge.

Just last year, Simon Gleeson in Manning v Neste AB (Re Bitumina Industries Ltd)[8] (**"Manning v Neste")** summed up these requirements stating that *"we need to know the date of the Charge's creation, the date of the provision of any consideration to the Company, whether that consideration falls within the limited range of consideration which can be recognised as such by the section, and what the value of that consideration should be taken to have been."* This exposition provides helpful clarity as to the three key questions a secured lender should consider in order to assess its S. 245 risk:

i) Is consideration of the right "type" being advanced to the grantor of the floating charge?

ii) Is that consideration being advanced at the right time?

iii) What is the value of the consideration?

Is consideration of the right "type" being advanced to the grantor of the floating charge?

S.245 and subsequent case law make it clear that not all consideration is good consideration in this regard. The Act contemplates the inclusion of money paid, goods or services supplied, and the discharge or reduction of debt as being consideration of the right "type". Critically, in each case the value must move to the grantor of the floating charge and not to a third party, and it must be given specifically in respect of the grant of the charge[9].

In the context of a secured loan advanced to a corporate group where the UK subsidiary may be one of many security providers and not the principal borrower, there is a clear risk

that, as a factual matter, the UK subsidiary has not (itself) received value of the requisite type as consideration for the grant of the floating charge. Whilst it may be tempting to address this risk by simply funnelling loan proceeds through the UK subsidiary (en route to their final destination elsewhere in the group), it is clear from existing case law that the courts will concern themselves with the substance of the transaction and not just the form. Therefore, simply adding the UK subsidiary as a borrower is unlikely to be a panacea. In Manning v Neste the court considered previous authorities on this point, concluding that it is critical that genuinely "new resources" became available to the company itself.

Is the consideration being advanced at the right time?

The consideration must be provided at the time of or after creation of the floating charge. This requirement was analysed in *Re Shoe Lace Ltd*, which concluded that the language of the statute should be construed in accordance with its ordinary meaning. Consideration must be advanced "*at the same time as, or after, the creation of the charge*" and consideration advanced before the creation of the floating charge will be ignored for the purposes of S.245 - irrespective of the commercial rationale for such consideration preceding the creation of the floating charge.

The timing of consideration is a factor which requires particularly careful analysis when security is re-taken as part of an amendment process or granted as a condition subsequent to funding.

What is the value of the consideration?

Leaving aside commercial issues which may arise in valuing consideration other than where it takes the form of cash, the issue of value of consideration is relevant to a secured lender in that S.245 does not operate on a binary basis (i.e. a floating charge does not pass/fail these requirements). Instead, S.245 operates such that a floating charge which falls within its scope will be invalid save to extent of the aggregate value of the requisite consideration. In the context of a secured loan advanced to a corporate group where a portion of the loan proceeds can be rightly considered to be consideration advanced to the UK floating charge grantor, this amount can effectively operate as a cap on the value of the floating charge to the secured lender.

Although market practice has evolved to mitigate many of the "Bad" and "Ugly" aspects of the English law floating charge, it is unsurprising that a legal construct which is founded on 19th century case law is not optimised for modern day cross border financing deals. It is interesting therefore to look to other (and dare we say younger?) jurisdictions for points of comparison.

Practical Tips for Lenders – grappling with the "Bad" and the "Ugly"

Although the floating charge is not without its pitfalls, there are many practical steps that a well-advised lender can take to mitigate these risks.

i) Establish jurisdictionally specific reserves in the borrowing base

It is unwise to apply a one-size-fits-all approach to the calculation of reserves in a cross-border transaction. Although the legislation concerning preferred creditors in floating charge recoveries is now a complex area of English law, these items are capable of being mapped out on a line-item basis.

In the case of some preferred creditors, the Act provides for a cap on leakage from floating charge recoveries but in many instances the quantum of leakage will vary significantly from business to business and may vary over the lifetime of a loan agreement as a group evolves. Therefore, it is critical that the lender is afforded a degree of discretion in calculating these amounts. A well-negotiated reserves provision will, in the case of an English incorporated security provider, leave significant room for a lender to prudently calculate the borrowing base.

ii) Establish the solvency of the floating charge grantor

Demonstrating solvency is key, as a S.245 challenge will only succeed if the company was unable to pay its debts at the time of creation of the floating charge or became unable to pay its

debts because of it. Some key items to consider requiring are:

Solvency statement and certificate: As an absolute minimum, a secured lender should incorporate solvency representations into the credit agreement, and a secured lender may also require a separate certificate of solvency signed by two directors. However, the operation of S.245 turns on the factual question of solvency and although representations and certificates are helpful (and drive a constructive level of dialogue between lenders and borrowers) they are far from curative in this regard. An action for misrepresentation will be of cold comfort to a lender which finds their floating charge on the wrong side of S.245.

Solvency searches: Whilst basic solvency searches are common in the context of provision of legal opinions, lenders may wish to carry out more enhanced solvency searches in the context of S.245 concerns.

å By far the most meaningful tool a secured lender has to de-risk its exposure to S.245 is the undertaking of robust commercial and financial due diligence of a borrower.

In the context of a secured loan advanced to a corporate group where the UK subsidiary may be one of many security providers and not the principal borrower, there is a clear risk that, as a factual matter, the UK subsidiary has not (itself) received value of the requisite type as consideration for the grant of the floating charge.

iii) Carefully consider the use of proceeds

Particularly in the context of lending to any group suffering some level of financial distress, a secured lender should give thought to the ultimate beneficiaries within the borrower group of the funds the lender is advancing. In circumstances where the grantor of a floating charge is receiving (whether directly or indirectly) the economic benefit of loan proceeds, there is a wisdom in clearly documenting the same. Where the grantor of a floating charge is not receiving any economic benefit from the lending arrangements, a lender should carefully consider the possible ugly consequences of this feature.

iv) Fixed charge security

Given the issues we have identified in relation to security taken by way of floating charge, the possibility of taking fixed security could be explored. The lender would need to exercise the requisite control throughout the life of the security, or the security may be re-characterised as floating. It should be noted that strict control mechanisms are often incompatible with the way such assets are dealt with day to day by the security provider, therefore this is not always a useful option.

The Case for Reform, a US Comparison

Although market practice has evolved to mitigate many of the "Bad" and "Ugly" aspects of the English law floating charge, it is unsurprising that a legal construct which is founded on 19th century case law is not optimised for modern day cross border financing deals. It is interesting therefore to look to other (and dare we say younger?) jurisdictions for points of comparison.

The position taken in relation to security interests in the US under Article 9 of the US Uniform Commercial Code is particularly interesting by comparison. Security in the US is not mired in the historic fixed versus floating charge debate from which English law suffers and therefore there is significantly less focus on the degree to which a secured lender controls assets subject to security. Additionally, Article 9 expressly recognises that a collateral provider may have rights to freely dispose of collateral assets without adversely impacting the establishment of security (which as a matter of English law would almost certainly render security purporting to be a fixed charge reduced to a floating charge). With less focus on the nature of the security interest created, in the US priority is principally determined on a "first to file" basis, providing significantly greater certainty to lenders.

There is certainly a case to argue that aspects of the Act and the case law surrounding the floating charge could be adjusted to materially unlock opportunities for increased asset-based lending activity within the UK market. There is some precedent under English law for exempting certain types of transactions from some aspects of insolvency legislation in the

interests of facilitating liquidity in the financial markets. The Financial Collateral Arrangements (No. 2) Regulations 2003 effectively ousts the strictures of the Act in certain specified respects (including the disapplication of S. 245) in order to smooth the way for financial collateral transactions, and one wonders whether an analogous argument should be made for asset-based lending transactions.

That said, there are no live proposals for reform and so for now, lenders favouring the floating charge will need to ensure that their floating charges are supported by a robust reserves mechanic, confirmation of solvency and clarity as to the distribution of loan proceeds to security providers to mitigate the shortcomings of English law in this regard.

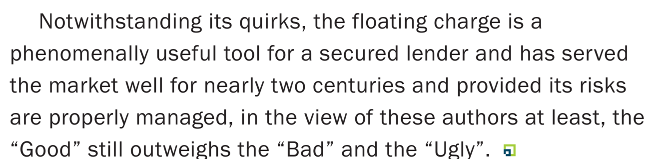
Conclusion

If the only option for an asset-based lender in the UK were floating charge security, lenders may have pause before engaging with certain borrowers. However, the complexity of English law is both its virtue and its vice. English law recognises a wide variety of security interests including fixed and floating charges, pledges, security assignments and mortgages; and this multiplicity facilitates creativity in the secured lending market.

In practice, a well-put-together asset-based lending security package will be a tailored combination of almost all of the security interests listed above, such that each asset class can be best secured, balancing the lender's requirement for reliable security with the operational needs of an underlying business. The possibility for constructing bespoke solutions is virtually limitless.

Howsoever constructed, a floating charge will feature in almost every English law governed security package. Although certain aspects of the floating charge may appear unpalatable, in reality it saves its ugliest face for lenders who are unwary or unprepared. For cross-border lenders with more limited experience of the English market or lenders with a particular appetite for supporting distressed businesses, time spent understanding the peculiarities of the floating charge will likely prove to be time very well spent.

Notwithstanding its quirks, the floating charge is a phenomenally useful tool for a secured lender and has served the market well for nearly two centuries and provided its risks are properly managed, in the view of these authors at least, the "Good" still outweighs the "Bad" and the "Ugly".



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[1] The requirements for the creation of a qualifying floating charge are laid down by paragraph 14 of Schedule B1 of the Insolvency Act 1986 (the "Act"). A floating charge qualifies if created by an instrument that (1) states that paragraph 14 of Schedule B1 of the Act applies to it; (2) purports to empower the holder of the floating charge to appoint an administrator under the charge or (3) purports to empower the holder of the floating charge to make an appointment which would be the appointment of an administrative receiver within the meaning of section 29(2) of the Act. A person will be a qualifying floating charge holder if he holds one or more debentures of the company secured (1) by a qualifying floating charge which relates to the whole or substantially the whole of the company's property or (2) by a number of qualifying floating charges which together relate to the whole or substantially the whole of the company's property or (3) by charges and other forms of security which together relate to the whole or substantially the whole of the company's property, where at least one of them is a qualifying floating charge. This must be coupled with the inclusion of the required wording in the security document i.e. (1) that paragraph 14 of Schedule B1 of the Act applies to it; (2) that it purports to empower the holder of the floating charge to appoint an administrator under the charge or (3) that it purports to empower the holder of the floating charge to make an appointment which would be the appointment of an administrative receiver within the meaning of section 29(2) of the Act.

[2] With the introduction of the Preferential Payments in Bankruptcy (Amendment) Act 1897.

[3] The Finance Act 2020 (which became law on 1 December 2020) restored HMRC as a preferential creditor in respect of certain taxes.

[4] For example, VAT, PAYE Income Tax, employee National Insurance contributions, Construction Industry Scheme deductions and student loan payroll deductions.

[5] Under the Insolvency Act 1986 (Prescribed Part) (Amendment) Order 2020 (SA 2020/211).

[6] There is a separate stricter regime concerning transactions

between “connected parties”. A connected party of a company would be a director or a shadow director of that company or an associate of a director or shadow director of that company (associate of a director may include another company of which that director is a director) or an associate of the company. A company is an associate of another company if the same person has control of each company/ a person has control of the company and associates of that person have control of the other company or a group of two or more persons has control of each company and the groups either consist of the same persons or could be regarded as consisting of the same persons by treating (in one or more cases) a member of the group as replaced by a person of whom he is an associate. A company is an associate of another person if that person has control of it or if that person and persons who are his associates together have control of it (sections 249 and 435 of the Act).

[7] “Onset of insolvency” is determined by the type of insolvency proceedings that are instituted in relation to the company and the precise timing will depend on how the liquidator or administration is appointed Section 240(3)(e) of the Act – In a liquidation this is the date on which (1) the winding up petition is presented to the court (in a compulsory liquidation); or (2) the date on which the company passes a resolution for its winding up (in a voluntary liquidation). Section 240(3)(a)-(c) – in an administration this will be the date on which (1) an application to court for an administration is issued; (b) a notice of intention to appoint an administrator is filed at court or (3) the date on which the appointment of an administrator takes effect.

[8] [2022] EWHC 2578 (Ch).

[9] Re Shoe Lace Ltd [1993] BCC 609.