Charges over Book Debts - Implications of *Spectrum Plus*

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> *In my opinion, the essential characteristic of a floating charge, the characteristic that distinguishes it from a fixed charge, is that the asset subject to the charge is not finally appropriated as a security for the payment of the debt until the occurrence of some future event. In the meantime the chargor is left free to use the charged asset and to remove it from the security ... Moreover, recognition that this is the essential characteristic of a floating charge reflects the mischief that the statutory intervention to which I have referred to was intended to meet and should ensure that preferential creditors continue to enjoy the priority that s 175 of the [Insolvency] Act and its statutory predecessors intended them to have.*[1]

The House of Lords in the case of *National Westminster Bank plc v Spectrum Plus Limited and others*[2] had decided in favour of preferential claimants. In doing so, their Law Lords placed a strong attachment to conceptual and public policy grounds. This article examines the characterization of fixed and floating charges over book debts in the light of this decision and whether it is viable to remove such characterization.

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[1] Per Lord Scott of Foscote in *National Westminster Bank plc v Spectrum Plus Limited and others* [2005] 4 All ER 209 at para 111, [2005] UKHL 41 at para 111.

[2] [2005] 4 All ER 209, [2005] UKHL 41. This case will hereafter be referred to as "*Spectrum Plus*".

I. Introduction

On 30 June 2005, the House of Lords delivered their decision in the long-awaited test case of *Spectrum Plus*. The Law Lords unanimously found that a charge over book debts which required the company to pay the proceeds into its account with the chargee bank upon which the company was then free to draw, was in effect a floating charge. This overrules the decision of Slade J in *Siebe Gorman Limited v Barclays Bank Limited*[3] which had been relied on by financiers as a standard form of security agreement for over 25 years. The unusually large panel of seven Law Lords sitting in the case were Lord Nicholls of Birkenhead, Lord Steyn, Lord Hope of Birkenhead, Lord Scott of Foscote, Lord Walker of Gestingthorpe, Baroness Hale of Richmond and Lord Brown of Eaton-under-Heywood.

Given the severe criticism on the correctness of the Court of Appeal's decision[4] and the weight given to the Privy Council's decision in *Agnew v Commissioner of Inland Revenue and others, re Brumark Investments Limited*,[5] the House of Lords' decision was not surprising. Indeed, in February 2002, following the decision of the earlier Privy Council's decision, the Crown Department of England had issued a public statement to the effect that distributions made by insolvency practitioners after 5 June 2001 to banks in respect of charges, where the chargor had been allowed unrestricted freedom to draw on the proceeds of the book debt, were opened to challenge from the Crown.[6] Consequently, over 500 post-Brumark insolvency distribution had been frozen. On hindsight, this was perhaps an indication that distributions

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[3] [1979] 2 Lloyds Rep 142.

[4] *National Westminster Bank plc v Spectrum Plus Ltd & Ors* [2004] EWCA Civ 670, [2005] 2 BCLC 30, [2004] Ch 337. The unanimous decision of the Court of Appeal was delivered by Lord Phillips MR, with the concurrence of Jonathan Parker and Jacob LJJ. See also *infra*, n 19 and the discussion which follows.

[5] [2001] UKPC 28, [2001] 2 AC 710. See also *infra*, n 14 and the discussion which follows.

[6] Statement on behalf of Inland Revenue, HM Customs & Excise and Redundancy Payments Service (the Crown Departments): Distribution of proceeds of book debts subject to debentures where the Crown Departments are creditors.

effected earlier to the banks were incorrectly made, although they were made validly under the then decided case authorities.

II. Background to the Decision - Position before *Spectrum Plus*

In English law, the question whether a charge over book debts should be characterized as a fixed charge or a floating charge has been brought before the court, not less because of the preferential creditors provisions of the Insolvency Act 1986. Under those provisions, a fixed charge will rank ahead of preferential creditors, and on a winding-up, ranks ahead of the expenses of the liquidation. In contrast, the position of a floating charge is inferior and is subject to the claims of the preferential creditors. The preferential creditors and the liquidation expenses have priority over the floating chargee's claims.

When considering the question whether a charge over book debts is fixed or floating, the conventional starting point for the English courts has always been Romer LJ's three characteristics of a floating charge in *Re Yorkshire Woolcombers Association Ltd*,[7] where his Lordship said:

> (1) If it is a charge on a class of assets of a company present and future; (2) If that class is one which, in the ordinary course of business of the company, would be changing from time to time; and (3) If you find that by the charge it is contemplated that, until some future step is taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way as far as concerns the particular class of assets I am dealing with.

In setting out the three characteristics, Romer LJ said that he did not intend to attempt to give an exact definition of the term "floating charge", nor did he attempt to lay down an exhaustive definition of a floating charge. In many cases concerning charges over book debts,

[7] [1903] 2 Ch D 284 at p 295.

there will be no difficulties in finding the existence of the first two characteristics because:

i. Book debts are debts arising in the ordinary course of business and are changing in nature. In an ongoing business, old debts are constantly collected while new debts continue to be incurred. Although the aggregate value of the book debts may remain relatively constant over time, the identity of the various debtors necessarily changes.

ii. For obvious practical reasons, the borrower will have no desire to enter into a separate assignment each time a new debt is incurred. Neither does the borrower want to take the trouble to collect the debts, so long as the trader's book debts are sufficient to repay the debts incurred. Hence, it is natural for borrowers to prefer their charge to cover not only the company's existing book debts, but also its future book debts.

The debates have largely centred upon Romer LJ's third requirement, namely, whether the company has exercised sufficient control in collecting and using the proceeds of the book debts to justify the creation of a fixed charge over book debts.

The first leading case in this area of law is *Siebe Gorman & Co Ltd v Barclays Bank Ltd.*[8] In that case, the debtor company executed a debenture and granted the bank a fixed charge over its book debts. The company was free to collect its book debts but was required to pay the proceeds into its designated account (which was its running business account) with the bank. The court noted that the debenture imposed a restriction on the ability of the company to charge or assign the proceeds of the book debts without the consent of the bank. The debenture, however, contained no express provision against the chargor drawing on the account. Slade J held that the bank had a valid fixed charge by virtue of the control the bank had exercised over the account into which the proceeds of the book debts were paid. The chargor was

[8] [1979] 2 Lloyds Rep 142.

not allowed to assign or charge the book debt whilst they remained uncollected. However, upon collection, the chargor was obliged to pay the proceeds into the designated account. Despite the absence of any express prohibition against the chargor drawing on the account, Slade J found an "implied restriction" against withdrawal in the sense that the charge holder could, if it so chose, "assert its lien under the charge on the proceeds of the book debts, even at a time when a particular account into which they were paid was temporarily in credit".[9] The learned judge went on to hold that if the chargor had an unrestricted right of withdrawal, then he would be inclined to hold the charge to be merely a floating charge.

A similar line of reasoning was adopted in the case of *Re Keenan Bros Ltd.*[10] However, in that case, the debenture was more stringent than the *Siebe Gorman* type debenture in its control over collected proceeds. Not only did it require the chargor to pay all proceeds into an account designated by the chargee, it also restricted the chargor from drawing on those proceeds after their payment into the designated account. On the facts, the Supreme Court of Ireland held that a fixed charge had been created, having regard to the degree of control exercised by the chargee over the book debt. This decision was adopted with approval by the Privy Council in *Agnew v Commissioner of Inland Revenue*[11] and the House of Lords in *Spectrum Plus*.

In contrast, in *Re Brightlife Ltd*,[12] the court held that a purported grant of a fixed charge over book debts had in fact created a floating charge over book debts. The debenture merely restricted the chargor against selling, factoring or discounting the book debts, but left the chargor free to collect the debts for its own benefit and pay the proceeds into an account maintained by it. A significant factor that distinguished this case from the *Siebe Gorman* case was that there had been no post-collection control over book debts.

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[9] *Id* at p 159.

[10] [1986] BCLC 242.

[11] *Supra*, n 5.

[12] [1986] BCLC 418.

Taken together, the *Siebe Gorman* case and the *Re Brightlife* case stood for the proposition that, in order to create a fixed charge over book debts, the charge holder must restrict the chargor's freedom in alienating the book debts as well as in the use of the realised proceeds.

Having regard to the previous authorities and, with a view to maximizing their security interests, in *Re New Bullas Trading Ltd*,[13] book debts were segregated from their proceeds and treated as distinct and independent assets. The debenture purported to create a fixed charge over uncollected book debts and a floating charge over proceeds of book debts once they had been collected. The chargor was prohibited from alienating the debts, but was allowed to collect the debts and pay the proceeds into a designated account with the chargee bank. The chargee was empowered to give direction to the chargor as to how to operate the account, but in the absence of the chargee's direction, the proceeds would then be released from the fixed charge and become subject to a floating charge. On its facts, the chargee never gave any direction as to the operation of the account.

It would therefore appear that the debenture did not provide for post-collection control on the part of the chargee. Nevertheless, the Court of Appeal sanctioned the arrangement of the parties to create a fixed charge over uncollected book debts and a floating charge over their realised proceeds based on the parties' freedom to contract. This reasoning and conclusion were disapproved by both the Privy Council in *Agnew* and the House of Lords in *Spectrum Plus*. Moreover, the Court of Appeal drew a distinction between book debts and their proceeds when recognising the existence of separate charges over them. This has been criticised as untenable in practical terms and as flouting the legislative will to put preference creditors ahead of certain types of chargee. As a result of its conceptual faults, *Re New Bullas* was subsequently overturned by the House of Lords in *Spectrum Plus*.

[13] [1994] BCLC 485.

An exposition of the fixed and floating charge distinction cannot be more powerful than that given by Lord Millet in *Agnew v Commissioner of Inland Revenue*[14] This case involved an appeal from the New Zealand Court of Appeal to the Privy Council. The debenture in question was substantially similar to the *New Bullas* type of split charges. However, the Privy Council, whose opinion was delivered by Lord Millet, had come to a different conclusion from the Court of Appeal in *New Bullas*. It was held that the *New Bullas* type of debenture was, in its nature, a floating charge notwithstanding the label given by the parties. In coming to such a conclusion, the Privy Council adopted a two-stage enquiry. The first stage involved a construction of the charge in question to ascertain the rights and obligations which the parties intended to grant to each other. The second stage is the categorisation stage. This is a matter of law. At law, a critical factor in the fixed and floating charge issue is the control exercised by the chargee over the charged assets. In emphasising the chargee's control over the uncollected book debts and the proceeds of collection, Lord Millet followed the reasoning in *Re Brightlife Ltd* and *Re Keenan Bros Ltd* and echoed his own reasoning in the Court of Appeal in *Royal Trust Bank v National Westminster Bank.*[15] Lord Millet held that it was not possible to segregate book debts from their proceeds for the purpose of seeking to create a fixed charge, even if there was a possible theoretical distinction between the assets represented by the uncollected book debts and that represented by their proceeds. This is because the entire value of book debts lies in its realisation, either by assignment or by collection or by use of its proceeds. On the facts, by permitting the chargor to collect the debt and use the proceeds freely for its own benefit, the debenture in effect allowed the chargor to extinguish the charged assets and remove them from the charge without the chargee's consent and without having to account to the chargee for the proceeds. Such an arrangement falls short of the requisite control required by law.

But that does not mean that it is never possible to have a fixed charge over book debts. In cases where money is required to be paid

[14] *Supra*, n 5.

[15] [1996] BCC 613.

into a designated account with the chargee bank, Lord Millet approved the model provided by the *Re Keenan Bros Ltd* case. It was pointed out that the chargor could be required to undertake the collection process on behalf of the chargee by paying the proceeds of collection into a block account maintained by the chargor with the chargee bank. That account should be separated from any other accounts maintained by the chargor with the chargee bank and subject to the day to day control of the chargee. Lord Millet did not specifically say that the chargor must be restricted from drawing against the designated account, but his Lordship clearly envisaged that the proceeds must be paid into a "blocked account". The blocked account requirement would suggest that the chargor should be prohibited from drawing on the account except with the chargee's consent. Such restriction was clearly absent in the *Siebe Gorman* case. However, the Privy Council did not specifically overrule *Siebe Gorman* except to raise doubts as to whether *Siebe Gorman* had been decided correctly on its facts. Nonetheless, Lord Millet expressly approved the New Zealand High Court's decision in the case of *Supercool Refrigeration and Air Conditioning v Hoverd Industries*[16] where Tompkins J found a floating charge on the facts which were almost indistinguishable from *Siebe Gorman*.

This brings us closer to the *Spectrum Plus* case. In that case, the court was asked to examine a standard form debenture which was, in all material substance, similar to that in the *Siebe Gorman* case. The *Spectrum Plus* case is discussed below by reference to the various levels of court decisions.

III. The *Spectrum Plus* case

A. *The Court at First Instance*[17]

At first instance, the Vice-Chancellor, Sir Andrew Morritt, held that the charge created by the debenture was a floating charge. Following

[16] [1994] 3 NZLR 300.

[17] [2004] EWHC 9 (Ch), [2004] 1 BCLC 335, [2004] Ch 337.

the reasoning of Lord Millet in *Agnew*, the Vice-Chancellor stated that the test was whether the rights and obligations conferred and imposed by the debenture "disclosed an intention that the company should be free to deal with the book debt and withdraw them from the security without the consent of the Bank."[18]

On the facts, it was the intention of the parties to allow Spectrum to use the proceeds of the debt by drawing against the overdraft account in the normal course of business. Such intention was inconsistent with the nature of the charge which the debenture purported to create, namely, a fixed charge over the debtor's book debts. The Vice-Chancellor's decision effectively overruled the decision of Slade J in *Siebe Gorman*. Such decision to overrule was an inevitable result of following Lord Millet's reasoning in *Agnew*. It sought to reassert the importance of post-collection control over proceeds of book debts by prohibiting the drawing on the designated account. In other words, the parties must implement a blocked account as envisaged by Lord Millet.

B. *The Court of Appeal*[19]

The Court of Appeal reversed the decision of the Vice-Chancellor. Lord Phillips MR's judgment was concurred by Lord Justices Jonathan Parker and Jacob. Lord Phillips MR did not follow the Privy Council's decision in *Agnew* as it was in direct conflict with the English Court of Appeal's decision in *New Bullas* and the rules of precedent required the court to follow the latter. As seen above, *New Bullas* case held that a fixed charge could be created over a book debt, if that was a result of clear agreement of the parties, notwithstanding that the chargor was entitled to collect and use the proceeds of the debt in the ordinary course of business. In approving Slade J's decision in *Siebe Gorman* that the charge was a fixed charge, Lord Phillips MR held that there had been sufficient control over the proceeds because the account remained overdrawn at all material times and all proceeds paid into the bank account were then immediately applied to reduce the chargor's overdraft.

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[18] *Id* at para 39.

[19] [2004] EWCA Civ 670, [2005] 2 BCLC 30, [2004] Ch 337.

With regard to the right of withdrawal on the account enjoyed by the chargor, Lord Phillips MR thought it was "wholly artificial" to consider the question whether the chargee could restrict withdrawal in the event the account went into credit. To his Lordship, such restriction on withdrawal was irrelevant for the purpose of categorising the charge. Once the proceeds were paid into the account, title to the proceeds passed absolutely to the chargee with the result that the proceeds were extinguished at law and were replaced by a chose in action. In other words, all that was left was an obligation by the chargee bank to repay an equivalent sum to the chargor when the chargor sought to withdraw from the account. Whether the chargor was permitted to withdraw on the account depended entirely on the banker-customer contract. However, the extent of Spectrum's contractual right to withdraw was, in Lord Philllips MR's opinion, an entirely separate issue.

Finally Lord Phillips MR, in *obiter dicta,* held that since the banks had relied on the decision of *Siebe Gorman* for 25 years, he would be inclined to hold that this form of words had, by customary usage, acquired the meaning and effect that Slade J in that case attributed to it even if Slade J's construction of the debenture had been erroneous.

C. *The House of Lords*

Not surprisingly, this conceptually weak structure of secured financing was rejected by the House of Lords on appeal. In doing so, the House of Lords had also expressly overruled the decision of Slade J in *Siebe Gorman* and that of Nourse LJ in *Re New Bullas.*

In overturning Lord Phillips MR's decision, the House of Lords held that:

i. Although the Court of Appeal was right on the doctrine of precedent, it was wrong to reverse the Vice-Chancellor's decision on the issue of substance.

ii. Where the chargor cannot dispose of or charge the uncollected book debt, but can deal with its debtor and collect its debts, and

can freely draw on the account for its business purpose and, where the chargor is obliged to place the proceeds of debts collected in a designated account with the chargee bank, the charge is a floating charge whatever the label was.

iii. The case of *Siebe Gorman* in which the chargee bank relied upon should be overruled on its facts. Even though the banks had relied on the *Siebe Gorman* decision for 25 years, Slade J's decision in that case was a first instance decision and not immune from correction by the appellate court.

iv. *Siebe Gorman* was to be overruled retrospectively as well as prospectively. It did not fall within the exceptional category of cases in which prospective overruling alone would be legitimate.

IV. Reasoning and Conclusions of the House of Lords in *Spectrum Plus*

A. *Distinction between Fixed and Floating Charges*

On appeal to the House of Lords, all parties conceded that the rules of precedent could deliver only an "ephemeral victory" and an appeal to the House of Lords would inevitably overrule *New Bullas*. Hence, the focus of the House of Lords appeal was whether the debenture in question should properly be characterized as a floating or a fixed charge. The leading judgment in the *Spectrum Plus* case on the characterization issue was delivered by Lord Scott of Foscote, followed by Lord Hope of Craighead and Lord Walker of Gestinghope. The remaining Law Lords concurred.

B. *Blocked Account Requirement*

The House of Lords has now settled the basis of the requirements to create a fixed charge by confirming the necessity of the chargee's control over the debts prior to the collection, the process of collection and the use of the proceeds of collection. In doing so, the House of

Lords followed largely the reasoning of Lord Millet in the *Brumark* case and adopted cases such as *Re Brightlife Ltd* and *Re Keenan Bros Ltd.* According to Lord Scott:

> " ... the essential characteristic of a floating charge, the characteristic that distinguishes it from a fixed charge, is that the asset subject to the charge is not finally appropriated as a security for the payment of the debt until the occurrence of some future event. In the meantime, the chargor is left free to use the charged asset and to remove it from the security."[20]

To his Lordship, mere restriction on the chargor's right to deal with its uncollected book debts does little to support the creation of a fixed charge if the chargor was not restricted to deal with the collected proceeds. In such a case, the book debt could hardly be said to be preserved for the benefit of the chargee because of the following:

i. Prior to collection, the bank was not empowered to realise and/or to sell the uncollected book debt for repayment.

ii. The essential value of a book debt as security lies in the money that can be obtained from the debtor in payment. If the chargor is allowed to deal freely with the proceeds once collected, the chargee bank could not be said to have the book debt as a possible source of repayment for the allegedly secured debt.

C. *Post-collection Control: The Nature of an Account*

On the facts, the critical question was whether by merely requiring the chargor to pay the proceeds into an account with the chargee bank, but allowing the chargor to continue to use the proceeds as a source of cash flow, the chargee bank can be said to have sufficient post-collection control to justify the creation of a fixed charge. The House of Lords answered this question in the negative. In line with the view of

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[20] *Supra*, n 1.

Lord Millet in *Agnew* case, Lord Hope held that, to characterize the charge on book debts as a fixed charge, the proceeds must be segregated in a blocked account, frozen and unusable by the chargor without the chargee bank's consent. An account from which the customer is entitled to withdraw funds whenever it wishes within the agreed limit of any overdraft is not a blocked account. However, Lord Hope disagreed with Lord Millet's assumption that the account in *Siebe Gorman* case was a blocked account. In reaching this conclusion, Lord Hope examined the relationship between a banker and its customer, and expressly disapproved Lord Phillips MR's suggestion that it was not appropriate for categorization of a charge created by a debenture to turn upon the precise details of a bank's relationship with its customer.

On the facts, the arrangement was to pay the proceeds of collection into a current account held by the chargor with the chargee bank. By contract, a current account allows the chargor to continue to be free to operate for its own business purpose within the agreed limit of its overdraft. The bank is bound to honour its customer's cheques so long as the account is in credit, or within the agreed overdraft limit. The bank may determine the contract at any time upon giving notice of termination. However, prior to that, the bank is not to refuse any cheques drawn. Hence, the account in question was not a blocked account and the chargor's continuing right to draw out a sum equivalent to the amount paid in was wholly inconsistent with the characterization of the charge in question as a fixed charge. Lord Hope also rejected Slade J's holding that the bank never had a lien over its customer's money in a bank account. The relationship is one where, if the account is in credit, the banker is indebted to his customer. Thus, it is a misuse of the word "lien" to say that the bank could assert a right over the proceeds.

D. *The Relevance of Overdraft*

Slade J in the *Siebe Gorman* case made a distinction between an account which was in credit or in debit. In the Court of Appeal, Lord Phillips MR did not expressly deal with the question whether the company

was entitled to freely withdraw if the account was in credit. The Master of Rolls made much of the fact that the account with the chargee bank was always overdrawn and monies paid into the account were bound to reduce the indebtedness of the company to the bank. To his Lordship, whether or not there existed any restriction against withdrawal was irrelevant in categorising the charge over book debts.

In overruling Lord Phillips MR's holding, Lord Scott said that no distinction should be made between an account which was in credit or in debit. Each payment into the account will always give rise to the chargor's right to withdraw from the account a corresponding amount for its business purposes. The chargor is not barred from withdrawing when the account was in debit and is allowed to borrow up to the overdraft limit. Hence, the money paid in is not appropriated to the payment of the debt owing to the chargee bank but is made available for drawings on the account by the chargor.

E. *Intention of the Parties*

The House of Lords agreed with the Vice-Chancellor at the Court at first instance, and with Lord Millet in *Agnew* that the label which the parties had chosen to attribute to the charge was not decisive. According to Lord Walker, it is the court's duty to characterize the debenture according to the true legal effect of its terms. In each case, public policy overrides unrestrained freedom of contract. Public policy required that preferential creditors obtained the measure of protection which Parliament intended them to have and this remained the case even after changes were made in the classes of preferential creditors by the Enterprise Act 2002.

On the facts, the intention of the parties was to allow the free use of proceeds by the chargor through the ordinary operation of its bank account. This was wholly inconsistent with the nature of the charge the debenture purported to create, namely, a fixed charge. Thus, the purported charge created must necessarily be characterized as a floating charge regardless of how it was labelled in the debenture. There-

fore, the Vice-Chancellor was correct in declining to follow *Siebe Gorman* and the case should be overruled.

F. *Subsidiary Issue: Prospective Rulings*

The bank had a second string to its bow. It contended that as clearing banks had drafted their standard form debenture in reliance of the *Siebe Gorman* case for over 25 years, the overruling of Slade J's decision should only have a prospective effect. In rejecting the bank's submission, Lord Nicholls of Birkenhead held that the House of Lords, in exercising its judicial function, would not be trespassing outside its proper functions under the constitution if it decided in a particular case to depart from a normal principle of retrospectivity and engaged in prospective overruling. Despite this, his Lordship said that in appropriate circumstances, the court would permit prospective overruling. Moreover, the bank and others who lent money on the security of a charge on a company's undertakings were sophisticated operators. There was no reason to suppose that the *Siebe Gorman* decision lulled them into a false sense of security. It was a first instance decision and could not have been regarded as definitively settling the law in the field.

V. Some Comments

The final chapter in this long-running debate has now ended in favour of the Crown. There is no doubt that the House of Lords' judgment has corrected the conceptual shortcoming of the *New Bullas* approach in distinguishing book debts and their proceeds.

It is trite law that a characteristic of a fixed charge is that the chargee must be in sufficient control over the charged assets to make sure that they are unconditionally appropriated to meet the secured obligations. The requirement of control over the debt proceeds of the charged book debts stemmed from this characteristic. The only way a fixed chargee could assert its security interests in the charged book debt was through the proceeds. This is because the book debt is a chose in action, not capable of physical possession and cannot be

enjoyed *in specie*. Its economic value is in its realisation, either by disposal or by collection of the proceeds. As such, it is necessary to impose restrictions against the chargor in alienating the debt by factoring, assigning or otherwise disposing of the debts. Also, there must be control imposed on the collection and use of the realised proceeds. Otherwise, the chargor may, by an act of collection, extinguish the debt and thus withdraw them from the charge, without having to account to the chargee for the proceeds.

In the event where the proceeds were required to be paid into a bank account, the proceeds would inevitably be used to repay an existing overdraft (as in *Siebe Gorman* case where it was held that a fixed charge had been created because of this) or, if the designated account was in credit, to give rise to a contractual right on the part of the debtor to demand repayment of the account balance from the bank.

Nevertheless, the distinction between whether the account is in credit or in debit cannot stand. The status of the charge in book debts cannot be left to fluctuate depending on the state of the accounts as it would undermine commercial certainty. Hence, having regard to the peculiar nature of book debts (that book debts cannot be separated from their proceeds) and how control can be effectively exercised over the charged assets, it would appear that the House of Lords' decision had a strong conceptual basis to extend post-collection control beyond requiring payment of all proceeds into a designated account, by also requiring the chargor to be restricted from drawing on the account.

Nonetheless, many have criticised the decision as being uncommercial and questioned the practical wisdom of requiring post-collection control over the proceeds in the form of a restriction against drawings on the designated account. The House of Lords' decision necessarily means that the bank cannot take priority over preferential creditors in claiming the book debt, without paralysing the power of the chargor to make use of the proceeds as his working capital.

The blocked account requirement not only imposes undue burden on bank chargees who must constantly monitor the operation of the

account, it will necessarily increase administrative costs which may well increase borrowing costs indirectly. Furthermore, a blocked account will inevitably deny a chargor access to its main sources of cash flow. In fact, the effect of the House of Lords' decision will have its biggest impact on small and medium-sized businesses which have little to offer to the banks but their book debts. Businesses will be put to a grinding halt if banks were determined to take a first ranking security over the chargor's book debts and require consent for each and every withdrawal out of the designated account into which the proceeds are paid. In most cases, this will be quite contrary to the parties' intention; after all, loan facilities are usually extended with a view to financing the enterprise's continued business operation.

Conceptual faults apart, the decision in *New Bullas* and Lord Phillips MR's decision in *Spectrum Plus* case produced a more satisfactory commercial result. The courts, in enforcing the freedom of contract principle, sanctioned a device by which a lender could take a valid first ranking security interest in receivables without the parties incurring the significant costs of a policing arrangement.

The more interventionist approach taken by the House of Lords in the *Spectrum Plus* case sees the reluctance of English law to allow individual creditors to maximize their advantages at the expense of other unsecured creditors, especially the vulnerable employees in the event the company goes into liquidation. This echoed statutory intervention that took place as early as 1897 when the English Parliament enacted ss 2 and 3 of the Preferential Payments in Bankruptcy Amendment Act 1897. The provisions, which are now re-enacted, with refinement as to timing, as ss 175(2)(b) and 40(2) respectively of the Insolvency Act 1986, provide for the claims of the preferential creditors to rank ahead of those secured by a floating charge. They are enacted to avoid the mischief pointed out by Lord Walker whereby:

> The widespread use of floating charges over trading stock, book debts and other circulating capital produced a situation in which a company's business might appear to be thriving and prosperous, with goods on its shelves and customer at its doors, until a sudden

> and unexpected crystallisation of a floating charge revealed that nothing at all was left for the company's unsecured creditors, even if they were preferential creditors.[21]

If it is Parliament's intention to give protection to preferential creditors, such legislative will cannot be flouted by whatever label the parties give to the transactions. As Lord Walker stated:

> In each case there is a public interest which overrides unrestrained freedom of contract. On the lease/license issue, the public interest is the protection of vulnerable people seeking living accommodation. On the fixed/floating charge issue, it is ensuring that preferential creditors obtain the measure of protection which Parliament intended them to have.[22]

Thus, public policy gives rise to the need for the English courts to maintain the fixed and floating charge distinction by recharacterising arrangements where the parties have not maintained such distinctions. This is in contrast with the system of law derived from Article 9 of the United States Uniform Commercial Code. Article 9 adopts a unitary conception of transaction and respects the parties' bargains as they intended. Under such a system of law, there is no need to determine priority outcome by resorting to the characterization of a fixed or a floating charge. What is important is whether the elements of the transaction fall within the regulatory regime of the Article 9 model.

VI. The Uniform Commercial Code

In the United States of America, the Uniform Commercial Code (UCC) represents a comprehensive reform of almost the entire commercial law of the United States. Article 9 of the UCC governs the law of secured transactions. Article 9 on secured transactions is widely regarded as the most innovative and successful provision of the UCC. It has been adopted by 50 states of the USA and its influence has been

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[21] *Spectrum Plus* case, *supra*, n 1 at para 132.

[22] *Id* at para 141.

equally remarkable in countries following the English common law tradition. In both Canada and New Zealand, the Personal Property Security Act (PPSA) is adapted from the Article 9 model. Further afield, regions such as Gaza and the West Bank have signalled their commitment to follow the USA approach. Moreover, Article 9 has proved to be influential in the drafting of international conventions on security on movables.

Prior to the implementation of the UCC, there was no adequate financing device for circulating assets in the USA. Unlike England, where the courts had given life to the floating charge to accommodate commerce, the American courts held that there was no true security in a transaction where the debtor was free to deal with the purportedly charged assets in the ordinary course of business. A leading case was *Benedict v Ratner*,[23] where the debtor granted the lender, as security for the loan, a right over "all account receivables then outstanding and all which should thereafter accrue in the ordinary course of business". In the meantime, the debtor was to be free to continue to collect the receivables from its customers and use the proceeds. Justice Louis Brandeis, applying the law of New York at that time, held that no true security existed because "under the law of New York, a transfer of security which reserves to the transferor the right to dispose of the same, or to apply the proceeds thereof, for its own uses, is, as to creditors, fraudulent in law and void".[24]

The restrictiveness of *Benedict v Ratner* spawned a lot of debates and led to the adoption of Article 9 of the UCC. Subject to certain qualifications, Article 9 gives effect to the security agreement according to the terms between the parties. A security interest is not invalid or fraudulent simply because the debtor has the right to use, commingle or dispose of all or part of the collateral or its proceeds. In addition, Article 9 expressly validates the "floating lien" concept on shifting collateral and does not prevent the parties from agreeing to an arrangement by which the secured party polices or monitors or restricts the debtor's dominion.

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[23] (1925) 268 US 353.

[24] *Id* at p 360.

Under Article 9, filing is the key to obtain priority, so that the first to file wins. This precludes a later purchaser from being subordinated to a prior interest which he or she has no notice. Thus, under this first-in-time priority approach, no categorization of security is necessary. Neither will the extent over such security maintained by the secured party, affect the rank and/or validity of the security interests.

The central concepts of Article 9 are attachment and perfection. Attachment is the time when the collateral comes into existence and becomes subject to the security interests. A security interests, including the security in nature of a floating charge, will attach when (i) value is given, (ii) the debtor has a right in the property, and (iii) except for the purpose of enforcing rights between the parties to the security agreement, the security interests becomes enforceable within the terms of the legislation.

Despite this, the parties may agree to postpone the attachment time. But once the security becomes attached, it will continue to do so until the security provider disposes of or otherwise deals with the property in a manner which the secured party has authorised, either expressly or impliedly.

A security is perfected when it has attached and when the security holder has taken all steps required for perfection under Article 9. These steps include the filing of financing statement or taking possession of the collateral. Taken together, the acts of attachment and perfection establish the existence of security interests and the rights and priorities of the parties, to the effect that a fixed charge can be taken without prejudicing the rights of the chargor to the proceeds of the book debts in the ordinary course of business.

VII. Common Law Systems Adopting Article 9 of the Uniform Commercial Code

A. *Canada*

Article 9 of the UCC has been adopted by the common law provinces of Canada through the enactment of the Personal Property Security Act (PPSA). Under all the Canadian PPSAs, all security interests are subject to the same attachment requirements, that is, that the secured party extends value, that the debtor has rights in the collateral, and (for the purposes of third party enforceability) that the security interest be evidenced by possession by the secured party or the execution of a written security agreement. In line with the UCC, failure to perfect, by possession or filing, subordinates the security interest to competing perfected security interests, the interest of a buyer or lessee of the collateral, the interest of the unsecured judgment creditor and the debtor's trustee in bankruptcy.

Thus, as long as the security interest is attached and perfected, it will have priority over subsequent parties. For the purpose of determining priority, it is no longer necessary to make a distinction between fixed and floating charges. A fixed security interest may be allowed with a freedom on the part of the debtor to dispose of the charge assets in the ordinary course of business. In the Canadian case of *Royal Bank of Canada v Sparrow Electric Corp*,[25] the Supreme Court of Canada acknowledged that, for practical purposes, the distinction between fixed and floating charges as well as between legal and equitable security interests had been swept away.

B. *New Zealand*

The passing of the Personal Property Securities Act in 1999, based on Article 9 of the UCC regime, was regarded as one of the most important developments in New Zealand commercial law for some decades.

[25] (1997) 143 DLR (4th) 385.

Were it not for this Act, the Privy Council decision in the *Brumark* case, which rejected the liberal English approach to floating charges over book debts typified by the *New Bullas* case, would have been the governing law relating to charges over book debts. Substantially similar to the Canadian PPSA, ss 43 and 44 of the New Zealand PPSA 1999 provide that a security arrangement may grant security interests in after-acquired property and that interests attach in most cases without any specific appropriation of the property.

VIII. Uniform Commercial Code – A Desired Solution for the Common Law System?

Consistent with the overall objective of facilitating secured financing transactions and minimising their costs, the first-in-time priority recognised by the Article 9 model expressly rejected any distinction between fixed and floating charges for the purpose of determining priority. As such, the difficult conceptual problems generated by the characterization of charges over book debts based on distinctions, such as the legal nature of the debtor, the form of transaction and the nature of the property, will now be rendered unnecessary. Under the Article 9 model, the law needs only provide that the debtor grants a security interests over all of their account receivables and their proceeds with a liberty to the grantor to deal in the book debts and proceeds in the ordinary course of business. This will be sufficient to achieve what was rendered impossible under the common law. In the context of charges over book debts, this means a fixed charge over book debts whilst leaving the chargor free to collect its debts and use the proceeds of collection in the course of business. Nevertheless, the result of a uniform approach under Article 9 is not without problems. It is disadvantageous to preferential creditors as it gives priority to all secured creditors who filed first in time, including revenue claims. This in turn, imposes a heavy onus on common law systems implementing the Article 9 model that seek to provide more protection to preferential creditors in the distribution of an insolvent debtor's estate.

In Canada and New Zealand, the legislatures have responded to the increasing propensity of lenders taking fixed charge over debts. In New Zealand, preferential creditors are given priority over security interests that encompass circulating assets. The legislative change was by way of amendment to the Personal Property Securities Bill then going through the Parliament.

In Canada, this problem is addressed by giving the Revenue priority over prior secured parties holding the book debt by way of security, but not over an assignee who had purchased the account. In the case of *Alberta (Treasury Branches) v MNR*,[26] the court was asked to interpret those provisions. On the facts, the assignment purported to effect an absolute transfer of the accounts, rendering the debtor an agent for collection and trustee of the proceeds. Yet the debtor was simultaneously empowered to use the proceeds of collection in the ordinary course of business pending default. Most significantly, the debtor was entitled to redeem unqualified beneficial ownership in the account upon payment of the obligation secured by the assignment.

The Supreme Court of Canada made a characterization between assignment by way of sale and assignment by way of security, based on the residual right of the debtor to recover the assets. It was said that as long as that redemption right persisted, the assignee remained a secured party whose interests were subordinated to Revenue Canada.

The *Alberta* case thus shows that the embrace of Article 9 model might not have profound implications for the security characterization. Security characterization based on proprietary rights given to the parties may well have continuing relevance in common law jurisdictions adopting the Article 9 model.

[26] [1996] 1 SCR 963, heard together with *TorontoDominion Bank v MNR.*

IX. Conclusion

A unitary approach on security transactions may prove attractive to institutional lenders after *Spectrum Plus*. However, one might wonder whether in the event the Article 9 model were to be adopted in England and other common law jurisdictions like Australia, Hong Kong, Singapore and Malaysia where characterization of fixed and floating charges remains necessary, such adoption might have a profound impact on the government's policy to protect preferential creditors. As Lord Millet said in *Agnew*:

> A curiosity of the case is that the distinction between fixed and floating charge which is of great commercial importance in the United Kingdom, seems likely to disappear from the law of New Zealand when the Personal Property Securities Act 1999 comes into force.[27]

But now that *Spectrum Plus* case has settled the law, banks and other lenders which have taken securities over debts will need to reconsider the nature of their securities. They may seek alternatives, such as factoring or invoice discounting facilities. If they are determined to have a first ranking security, they may need to retake the security by following the block account requirements laid down by the House of Lords. In doing so, it is also necessary to bear in mind Lord Millet's warning in *Agnew* that formal provision for block account is not enough "if it is not operated as one in fact" [28].

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[27] [2002] 1 NZLR 30 at p 16.

[28] *Id* at p 57.

Consulting the Conference of Rulers under the Federal Constitution

Dato' Cyrus Das[*]

I. Introduction

The Conference of Rulers has been described as the most prestigious body in the country.[1] This observation by Tun Suffian is understandable from the standpoint of the status of the body because it comprises of the nine Sultans and the four Governors who are the constitutional heads of government in their respective States. However, its importance in the constitutional scheme of things tends to be misunderstood, if not, underestimated. This was reflected in the judgment of the Court of Appeal in *Re An Application By Dato' Seri Anwar Ibrahim*[2] (hereafter referred to as "the Judgment of the Court of Appeal" or "the Judgment" as the case may be) which sought to deal with the question of consulting the Conference of Rulers in respect of the appointment of judges to the higher judiciary under Article 122B(1) of the Federal Constitution. In brief, Article 122B(1) declares that the Chief Justice of the Federal Court, the President of the Court of Appeal, the two Chief Judges andthe Judges of the Court of Appeal and the High Court " ... shall be appointed by the Yang di Pertuan Agong, acting

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[1] See Tun Mohd Suffian, "Parliamentary System Versus Presidential System: The Malaysian Experience" (1979) 2 MLJ lii at p lvi.

[2] *In the Matter of An Oral Application by Dato' Seri Anwar Ibrahim to Disqualify A Judge of the Court of Appeal* [2000] 2 MLJ 481; reported also as *Dato' Seri Anwar Ibrahim v PP* [2000] 2 CLJ 570; and as *The Appointment of Judges to the High Court, Court of Appeal and the Federal Court* [2000] 2 AMR 1423. For the purposes of this article, the pages from the MLJ citation are referred to.