STR | Secured Transactions Law Reform Project

DISCUSSION PAPER SERIES:

THE INSOLVENCY CONSEQUENCES OF THE ABOLITION OF THE FIXED/FLOATING CHARGE DISTINCTION

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The Insolvency Consequences of the Abolition of the Fixed/Floating Charge Distinction

1 Introduction

1.1 In May 2016 the STLRP set out its current thinking in its April 2016 Draft Policy Paper[1]. Amongst other things, the paper proposed that the different types of consensual security interest in English law (the pledge, the contractual lien, the mortgage (legal and equitable) and the charge (fixed and floating)) should be replaced by one concept of a 'security interest'. The objective was to make the English system more readily understandable and accessible.

1.2 To this end the paper also highlighted a desire to abolish the 'fixed' and 'floating' charge label so that complicated questions about the degree of operational control necessary to come within the "fixed" charge categorisation would cease to be relevant, and a good deal of complex structuring of financial transactions (with all the attendant costs) would fall away.

1.3 At present the distinction between the fixed and floating charge is primarily relevant for the insolvency consequences which follow from it: so-called preferential creditors rank in order of insolvency priority ahead of floating charge, but not fixed charge, holders;[2] a portion of floating charge receipts known as "the prescribed part" is carved-out of floating charge, but not fixed charge, receipts;[3] the expenses of the insolvency rank ahead of the floating charge, but not fixed charge, holder;[4] an administrator is free to use floating charge assets without the consent of the court or the floating charge holder;[5] and an administrator (may) be able to raise new financing

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1 https://securedtransactionslawreformproject.org/draft-policy-paper/

2 Insolvency Act 1986 s.175 and Sch. B1 para. 65

3 Insolvency Act 1986 s. 176A

4 Insolvency Act 1986 s. 176ZA and Sch. B1 para. 99

5 Insolvency Act 1986 Sch. B1 para. 70

for the insolvency case ranking ahead of the floating charge.[6] Any debate about abolishing the fixed and floating charge distinction thus comes rapidly to the question of whether these priority consequences should be retained and, if they should, how they should be reflected in the new scheme.

1.4 The April 2016 Draft Policy Paper tentatively suggested that what we currently call floating charges could be replaced by charges over inventory, receivables and money, but noted the need for further work on the insolvency consequences and promised a further paper considering the insolvency issue in more detail. This paper takes up that challenge. Views presented in this paper are provisional and open to further discussion. But it is hoped that the paper will make a useful contribution to the current debate.

2 Abolish the priority consequences to attract capital

2.1 The first possibility would be to abolish some or all of the priority consequences which currently flow from the fixed/floating charge distinction. In other words, the prescribed part would be abandoned, preferential creditors and expenses would have priority over ordinary unsecured debts but not over secured claims, and an administrator would require the consent of the secured creditor or the court before using secured cash, or raising new financing for the case secured by a charge ranking ahead of pre-filing security.

2.2 There is obviously a practical question about whether English corporate insolvency law is ready for such a dramatic shift, and a detailed question of whether it is justified on domestic policy grounds. But before either of these challenges is considered, it is worth pausing to understand one of the key drivers for the suggestion which has gained some currency in the market, and to analyse whether it is as compelling as might first be thought.

2.3 Much of English corporate law (including insolvency law) dates from an era in which British businesses relied heavily on the four big clearing banks for most of their financing. There has been a growing recognition of the need for the UK economy to diversify away from these big, domestic banks. Before the financial crisis, there was a recognition that changes in the finance market, in which British banks increasingly competed on price, had profoundly changed the relationship between borrower and banker, and made it increasingly unlikely that British business would be able to rely exclusively on British banks as a source of funds. Moreover, there was a growing recognition of the problems of developing start-up businesses on bank finance alone. This issue has become more acute since the financial crisis, when it has become clear that a combination of restructuring of banks' balance sheets and the introduction of more rigorous capital adequacy and other regulatory rules has caused banks to retreat from many areas of traditional lending. Many of the so-called alternative lenders (such as hedge funds, private equity

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[6] Insolvency Act 1986 Sch. B1 para. 99(4); *Bibby Trade Finance v McKay* [2006] AER 2006; V. Finch *Corporate Insolvency Law: Perspectives and Principles* (CUP 2009 2nd ed), .409-410; G. McCormack, 'Super-priority New Financing and Corporate Rescue' (2007) JBL 701, 728

funds and bond investors) hail from the US, and persuading these US lenders to export capital to the UK has become a priority for market participants, regulators and the legislature. This is reflected in macro initiatives, such as the European Capital Markets Union project, and domestic initiatives, such as questions about the attractiveness of the English law regime for secured credit for overseas investors.

2.4 A significant issue here is that US bankruptcy law and secured credit law does not give rise to the same priority issues as English corporate insolvency law. US bankruptcy law has concepts somewhat equivalent to the English concepts of preferential debts and expenses, but whilst these have priority over ordinary, unsecured debts they do not have priority over secured claims. Whilst some US bankruptcy scholars proposed, in the 1980s, that US bankruptcy law should "carve out" a portion of the secured assets and make them available to unsecured creditors,[7] the idea does not seem to have gained any traction outside certain academic circles. US bankruptcy law imposes strict requirements which must be met before secured assets can be used in the case, and the express consent of the secured creditor or the court is required in the case of cash collateral.[8] And whilst it is theoretically possible for security granted in favour of post-petition lenders to rank ahead of (or "prime") security granted in favour of pre-petition lenders,[9] in reality the stringent tests which must be met before this can be done mean it is comparatively rare. Overall, then, the US secured creditor appears to have arrived at a position where his full priority in insolvency is pretty unassailable.

2.5 In a relatively recent article, Franken broadly divides states into dominant states (which export capital) and dependent states (which import it).[10] In Franken's thesis, a dependent state has an incentive to transplant laws from the dominant state not so much because the laws of the dominant state are preferable, but rather because they are already understood by the financiers from the dominant state, so that those financiers will not be required to due diligence and understand a new regime before investing. There is good reason to suppose that England's need to attract capital will increase for the reasons already given. Against this backdrop, the question arises as to whether Franken's thesis is implicated, and we should simply align the priority position in English corporate insolvency with the position in US bankruptcy.

2.6 The difficulty with this is that, as Roe and Ting have put it, the pursuit of priority change is "continual and multi-dimensional, fought in multiple legal forms – from the transactional lawyers' offices to the bankruptcy courts to Congress."[11] Although in recent times this fight has

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[7] A. Schwartz, 'Security Interests and Bankruptcy Priorities: A Review of Current Theories' (1981) 10 J. Legal Stud. 1

[8] 11 U.S.C. §361

[9] 11 U.S.C. §364

[10] S. Franken, 'Comparative Insolvency Laws: A Comparative Institutional Analysis' (2014) 34 Oxford Journal of Legal Studies 97

[11] M. Roe and F. Ting, 'Breaking Bankruptcy Priority: How Rent-seeking Upends the Creditors' Bargain' (2013) 99 Va. L Rev. 1235

largely been promoted by financiers and, arguably, won by them, there is no guarantee that the current position is the end of the evolutionary story. As Roe and Ting highlight, in both the US and the UK the evolution of the relationship between secured credit and insolvency priority has been complex, involving moves and counter-moves by market participants, their advisers, the courts and the legislature.

2.7 Historically, a number of factors have limited the move towards full secured creditor priority in the US, including (i) demanding perfection requirements, enabling unsecured creditors to rely on mistakes in the filing process in order to attack security; (ii) the limit on the extent to which pre-petition security interests could reach property coming into the estate after bankruptcy to "proceeds, products, offspring, profits or rent" of the original collateral and the limited concept of "proceeds" in the Uniform Commercial Code; and (iii) difficulties with using deposit accounts as security in most states.

2.8 The finance industry lobbied hard, and many of these issues were resolved in favour of the finance industry in reforms to the US Uniform Commercial Code in 2001. However, there is some disquiet about the effects of these reforms on the relationship between secured creditors and the estate in bankruptcy, and the recent American Bankruptcy Institute Commission to Study Reform of Chapter 11 expressed some concern about the position which has emerged.[12] We cannot rule out, therefore, legislative intervention. But perhaps more importantly, the US bankruptcy court continues to have a number of levers which it can pull during the course of a case which mean the actual position arrived at may be somewhat different from that which the law on the books suggests:

2.8.1 Although the 2001 reforms expanded the definition of "proceeds" in the Uniform Commercial Code, and there is some evidence that US bankruptcy courts are adopting the revised definition in determining the extent of the secured creditor's security interest,[13] nothing in the US Bankruptcy Code appears to oblige them to do so.[14]

2.8.2 Even if an expanded definition of proceeds is used, Chapter 11 expressly authorises the court to limit the reach of the proceeds security interest, "based on the equities of the case".[15] Thus, in appropriate cases, the US bankruptcy court, as a court of equity, has broad discretion to limit the scope of the proceeds rule (and in some cases has employed straightforward rules of contractual construction to arrive at the "right" result).[16]

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12 ABI Commission to Study Reform of Chapter 11 Final Report, 70-73

13 G.C. Warner, 'Article 9's Bankruptcy Proceeds Rule: Amending Bankruptcy Code Section 552 Through the UCC "Proceeds" Definition' (2010-2011) 46 Gonz. L. Rev. 521

14 Ibid.

15 11 U.S.C. §552(b)(1)

16 *In re Las Vegas Monorail Company* 429 B.R. 317 (2010)

2.8.3 Although perfection is more straightforward following the UCC reforms, it is still more complex to navigate in the US than in England and Wales, and minor errors in punctuation and abbreviation can invalidate the creditor's security.[17] Indeed, one commentator has noted, 'There is a dangerous trend toward holding secured creditors to more stringent standards with respect to perfection. *In re EDM Corporation* 431 B.R. 459 (8th Cir. BAP 2010), is as instructive as it is scary. In that case, the creditors' UCC-1 financing statement accurately recited the debtor's name, except that it also included a DBA.[18] The court held that such an alteration was enough to render the statement "seriously misleading".'[19] (It should be noted, in the context of the wider issues which the STLRP are considering, that this is not a general issue for all personal property security regimes but is very much a function of US implementation where secured creditors have other, strong priority rights).

2.8.4 Protection afforded to the secured creditor may be affected by the way in which US bankruptcy courts value the secured creditor's collateral. US bankruptcy courts are divided on this issue. In some cases, for example, the value of the secured creditor's collateral has been determined by the value which the secured creditor would achieve foreclosing on the secured assets and selling them in numerous states. In this case, even if the secured creditor is entitled to demand that its collateral value is protected before certain actions are taken in the bankruptcy case, a relatively low value may be put on what it is that must be protected. In other cases, the courts have been prepared to adopt a (more favourable) going concern approach to valuation. The point is heavily litigated.

2.8.5 There is a complex interaction between federal and state law, and concentrating only on the UCC gives a somewhat partial picture. This is because it is ultimately up to individual states to implement the UCC, and different states may take different approaches to implementation.

2.8.6 English lawyers must understand the power of the bankruptcy judge. LoPucki *et al* report that, although US bankruptcy law does not have an express carve-out for unsecured creditors from secured creditor proceeds, "A few American bankruptcy courts have imposed such a carve-out informally, as a condition of bankruptcy relief in cases the filing of which might not otherwise have been appropriate."[20] More generally, the bankruptcy judge has considerable discretion in the conduct of a Chapter 11 case, and instructions and advice may be handed down (unseen) in judges' chambers which materially affect the outcome of the case. In particular, there is some debate about the

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[17] L.M. LoPucki, A.i. Abraham and B.P. Delahaye, 'Optimising English and American Security Interests' (2012-2013) Notre Dame L. Rev. 1785 fn 85

[18] *Doing business as* or trading name

[19] S.H. Silton and T.G. Wallrich, 'Representing Creditors in a Chapter 11 Case' 100-101 in *Creditors' Rights in Chapter 11 Cases* (Aspatore 2011)

[20] Ibid, at fn 349 and accompanying text

extent to which a Chapter 11 bankruptcy case can be conducted solely to benefit the secured creditor, so that the secured creditor may need to assume responsibility for certain preferential claims or expenses in order to avoid dismissal of the Chapter 11 case and being forced back on to state foreclosure remedies.[21]

2.9 Overall, then, simply replicating the priority position from US bankruptcy law will not bring with it the other soft and hard levers which US bankruptcy judges have to balance the result. As Hoffman put it in *Brightlife*, "The public interest requires a balancing of the advantages to the economy of facilitating the borrowing of money against the possibility of injustice to unsecured creditors."[22]

2.10 Indeed, just as levers exist in the US system for US bankruptcy judges to rebalance rights and interests between secured creditors and unsecured creditors, so secured creditors have powerful control rights in the English system to rebalance matters in the other direction. There are two routes for the appointment of an administrator in England. The first is appointment by the court on an application by the company, the directors of the company or one or more of the creditors.[23] The second is an out-of-court appointment by the holder of a qualifying floating charge (essentially the holder of a floating charge which, together with any fixed charges, charges all or substantially all of the company's property),[24] the company or its directors.[25] However, crucially, the floating charge holder is given the power to control the identity of the administrator in each route.[26] Administrators are repeat players in the market, and this appointment power provides considerable soft incentive to comply with the wishes of the floating charge holder. Thus, although it may be the case that administrators have the power to raise new financing for the case which ranks ahead of the pre-administration floating charge, or to use floating charge assets without consent, in reality they have little incentive to do so. The position is different in liquidation, but a qualifying floating charge holder is likely to be able to veto liquidation by appointing an administrator and, following recent reforms which expand the power of the administrator to distribute proceeds,[27] it is increasingly likely that many large companies will not be placed into liquidation at all.[28]

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21 C.W. Mooney, Jr., 'The (Il)legitimacy of Bankruptcies for the Benefit of Secured Creditors' (2015) Univ. Ill. Law Rev. 735

22 *Re Brightlife Ltd* [1987] Ch 200

23 Insolvency Act 1986 Sch B1 para 12(1)

24 Insolvency Act 1986 Sch. B1 para. 14

25 Insolvency Act 1986 Sch. B1 para. 22

26 Insolvency Act 1986 Sch. B1 paras. 26 and 36

27 Small Business, Enterprise and Employment Act 2015 s. 128

28 And where the company is placed into liquidation, certain floating charge holder consent rights are mandated in the Insolvency Rules 1986

2.11 Furthermore, the creditor has power to challenge the administrator by application to court on the ground that he has acted or proposes to act in a way that unfairly harms the creditor's interests,[29] or to make a misfeasance application *inter alia* on the grounds that the administrator has misapplied the company's money,[30] or to make an application to court to remove the administrator.[31] Traditionally, the English courts have afforded administrators a significant margin of appreciation in managing the case, and have been extremely reluctant to interfere in the administrator's decision-making.[32] However, the exception to this has been cases where the secured creditor has made the application on the basis that the administrator has rode rough shod over his wishes. In *Clydesdale* this resulted in the successful removal of the administrator, notwithstanding the fact that David Richards J. (as he then was) had not determined that there had been any wrongdoing,[33] and in *Capitol Films* Richard Snowden Q.C. (as he then was) ordered an administrator who had sought the court's consent to a sale of assets subject to a fixed charge (under paragraph 71 of Schedule B1 to the Insolvency Act 1986) to pay costs on the application, commenting that whilst "the court will generally defer to the commercial judgment of the office-holders where what is in issue is a challenge to the office-holder's assessment of the merits of one particular bid for a company's assets over another", a paragraph 71 application "requires the court to balance the competing rights and interests of the holders of fixed charges with the rights and interests of other creditors" and that "On that type of issue, the court does not simply … defer to the administrators' business judgment provided that it is rational, the court will decide for itself how to resolve the interests of creditors".[34]

2.12 Thus, just as it is the case that the bankruptcy priority position in US bankruptcy law is amenable to some flexing by the US bankruptcy court, so too the strict position of the secured creditor in English insolvency law is amenable to some flexing through the creditor's soft and hard rights. Thus it is suggested that the administrator is unlikely to use the floating charge assets in a way which the floating charge holder wholly disapproves of, or to incur expenses which diminish the floating charge holder's return, or to raise new financing secured in order of priority before the floating charge without the floating charge holder's consent, but English insolvency law retains the flexibility to develop this area as modern finance markets continue to innovate and evolve. Domestically, and subject to the detailed points made below, it is not obvious that there is an insolvency problem to be solved. To the extent that the issue is attracting inward investment of US capital, as shown above there are real challenges in merely aligning bankruptcy priority with the US position, and it is suggested that the downsides of doing so continue to outweigh the benefits.

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[29] Insolvency Act 1986 Sch. B1 para. 74

[30] Insolvency Act 1986 Sch. B1 para. 75

[31] Insolvency Act 1986 Sch. B1 para. 88

[32] *Four Private Investment Funds v Lomas* [2009] BCLC 161

[33] *Clydesdale Financial Services Ltd v Smailes* [2009] BCC 810

[34] *Rubin v Another (Capitol Films Ltd) v Cobalt Pictures Ltd & 24 Ors* [2010] EWHC 3223 (Ch)

2.13 It is therefore suggested that the case for abolishing the prescribed part, prioritising the security interest above preferential creditors and the expenses of the insolvency and moving away from the current regime for use of floating charge assets in order to align UK security and insolvency law with the (complex) US system is not made out.

2.14 As mentioned above, there is a separate question about whether some of the insolvency priority consequences should be reformed as a matter of purely domestic review. First, commentators have queried whether the State should maintain its priority status for part of the employment payments which it makes.[35] But recent experience with protective awards for failure to consult (which can be claimed from the State but which do not have preferential status) suggests little appetite in Government for the State's priority status for employment related claims to be reduced. Secondly, there has been some suggestion that the prescribed part should be abandoned as the costs of providing for it outweigh the benefits. Yet here again recent experience suggests a dalliance with increasing the prescribed part, rather than any suggestion that it might be abolished. In any event, as shown above, these concessions to other creditors are part of English insolvency law's delicate balancing of the interests of secured and unsecured creditors. It is therefore suggested that there is unlikely to be much legislative appetite for purely domestic review.

2.15 **It is therefore suggested that we should not proceed by proposing abolition of the prescribed part, prioritising the security interest above preferential creditors and the expenses of the insolvency and moving away from the current regime for the use of floating charge assets.**

3 Align the insolvency consequences so that they apply to both fixed and floating charges

3.1 The next option which we have considered is "going the other way" and providing that the insolvency priority consequences (expense and preferential creditor priority, the prescribed part carve out and use of assets by the administrator) would apply to the single security interest, so that there would be no ongoing need to distinguish between different security arrangements in determining whether those consequences applied or not.

3.2 It will be clear, from the analysis in section 2, that we have considered in detail the complex relationship between the law of secured transactions and insolvency. In section 2 we concluded that the apparent dominance of the secured creditor who holds what a US lawyer would call a "blanket lien" over all of the assets of the company could be adjusted through various mechanisms available to the US bankruptcy judge. In the same way, we found that the vulnerability of the secured creditor in English insolvency law's priority rules was ameliorated by other rights of the secured creditor in the process. We highlighted that in each case there is a

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[35] S.I. Cantlie, 'Preferred Priority in Bankruptcy' in J.S. Ziegel and S.I. Cantlie (eds) *Current Developments in International and Comparative Corporate Insolvency Law* (OUP 1994)

delicate balance in the overall scheme, which is also capable of adaptation as markets change. We have concluded that for this reason it would not be right simply to apply the same priority consequences to fixed charge holders, who may only have security over specific assets, and who may not have the full range of controls available to them as so-called qualifying floating charge holders.

3.3 **It is therefore suggested that if the complex distinction between fixed and floating charges resting on operational control is abolished, in order to address the structuring issues highlighted in the May 2016 paper and in section 2 above, it would need to be replaced with an alternative distinction between security to which the insolvency priority consequences applied and security to which they did not apply.**

4 Capping the percentage of the floating charge proceeds susceptible to subordination

4.1 Another idea which has been raised by, amongst others, the City of London Law Society, is that the amount of the floating charge proceeds capable of subordination to expenses; preferential creditors etc. could be capped in order to introduce predictability and certainty for lenders. This can be dealt with relatively briefly. First, we are sceptical about how such a cap could be sized. Secondly, our more general point about the overall delicate balance between secured creditor rights and the rights of other creditors applies equally to this proposition.

4.2 **Thus we are not in favour of imposing a cap on the amount of the floating charge which is susceptible to subordination.**

5 Retaining the distinction and adopting the Australian concept of "circulating assets"

5.1 We therefore recommend continuing to distinguish between security which is susceptible to subordination in insolvency and security which is not, without a specific monetary cap, but in a way which does not rely on the complex question of operational control. This will reduce transaction costs and make the law in this area more readily understandable (particularly for foreign investors) and, whilst it may not be entirely "insolvency neutral",[36] would broadly preserve the insolvency priority *status quo*.

5.2 The first option which we have considered is adopting the concept in the Australian Personal Property Securities Act of "circulating assets" as a replacement for the floating charge label in insolvency legislation which, as we understand it, was intended to achieve this result. However, it is also our understanding (after having investigated the position with Australian practitioners ourselves and having read Bruce Whittaker's review of the PPSA after its first three years in

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[36] We have taken this description from D Brown, 'Personal Property Securities Act in Australia: An Early Stocktake' [2015] JIBFL 274

operation) that this concept has not proved easy to apply and has continued to lead to difficult questions for advisers and their clients.

5.3 Thus we do not suggest that the Australian concept of "circulating assets" is adopted in place of "floating charge" for the purposes of the relevant sections of the Insolvency Act 1986.

6 Retaining the distinction and adopting a different descriptive label

6.1 We are therefore in favour of finding a different descriptive label. In his review, Mr Whittaker suggested that "circulating assets" should cover inventory and its proceeds. He also highlighted that circulating assets could extend to what is known in the Australian legislation as "accounts", but that this would raise matters of policy. The concept of "accounts" has given rise to its own issues in the Australian PPSA. In particular, it is not entirely clear whether it is restricted to what an English lawyer would call "book debts" (or a US lawyer would call "receivables"), or whether it extends to loan agreements (as they relate to a monetary obligation for provision of services). In our view, if we were to aim to preserve the current insolvency priority as closely as possible, whilst avoiding the issues for finance lawyers with the current "badge" of the fixed charge of operational control, we would include book debts and their proceeds, but not loan agreements.

6.2 **We therefore suggest references to floating charges in the legislative scheme should be replaced by references to security over inventory, book debts and money, perhaps with some extension to include other types of what are sometimes called "circulating assets", such as raw materials and crops.**

7 Some difficult issues

7.1 This leaves four difficult issues.

7.1.1 First, it is not intended that the suggested change should have serious implications for the way in which banks assess secured loans for the purposes of the (more complex) capital adequacy rules of Basel III when compared with the current security regime. A detailed consideration of capital adequacy falls outside the scope of this paper, but may be an area where further input is needed.

7.1.2 Secondly, we need to consider whether secured lenders should still be able to stipulate for "control" over raw materials, inventory, book debts, money and crops in order to move their security interest up the insolvency order of priority. We are aware that this was the approach adopted in Australia, apparently as part of the effort to keep the PPSA reforms insolvency neutral. However, whilst we have concluded that there is no case for wholesale reform of the English corporate insolvency law priority position, our project has considered insolvency effects and it is not crucial for us that insolvency priorities are preserved in exactly the same way (indeed, experience in both Australia and New Zealand would seem to suggest that once new, descriptive labels are adopted some change in position is inevitable). Rather our objective has been to analyse critically the overall relationship between secured transaction law and insolvency law in determining whether fundamental reform is necessary, or something which falls short of that. It is in this context that we are recommending an approach similar to that suggested by Mr. Whittaker in his review. However, we consider that allowing lenders to stipulate for control in order to move back up the insolvency order of priority would reintroduce many of the uncertainties which we think should be addressed in the interests of lower transaction costs and simplifying the regime for the purposes, in particular, of attracting investment from foreign investors. We suggest that this should not prove too problematic if English law continues to treat sales of book debts as substantively different from a security arrangement, and remains reluctant to recharacterise sales transactions as security transactions. If this position is preserved, then lenders in specialist financing transactions who wish to contract for higher insolvency priority and for whom the requirements of control have not hitherto proved a problem, should be able to continue to achieve the same effect through a sale transaction. However, this implicates some of the questions raised in the separate priorities policy paper. That paper discusses the treatment of capital assets, and suggests that there may be a case for varying priority over capital assets according to whether the dealing with the asset can be said to be in the ordinary course of business or not so that the position of capital assets will require further discussion in due course.

7.1.3 Thirdly, notwithstanding the tentative conclusions of the April 2016 Draft Policy Paper, it is suggested that we should debate whether factoring, invoice and block discounting should be brought within the insolvency priority hierarchy. Two points are relevant here. First, there is considerable evidence of a rapid increase in the amount of factoring, invoice and block discounting following the House of Lords' decision in *Spectrum Plus* (which effectively made it very challenging for a secured creditor in England to take a fixed charge over a trading account).[37] As the April 2016 Draft Policy Paper notes, because factoring, invoice and block discounting are treated by English law as sales transactions, they fall outside the secured credit hierarchy in insolvency. Thus lenders have been able to avoid the worst effects of *Spectrum Plus* (from their perspective) by resorting to these types of transactions, and we find a classic example of Roe and Ting's "continual and multi-dimensional" fight for priority changes. As part of any review of the relationship between secured credit and the insolvency hierarchy we should ask ourselves whether we are happy with that result. Secondly, there is evidence that the structure of many of these transactions operates to deliver the same economic result as a floating charge over all of the company's book debts and proceeds.[38] Whilst a straightforward sale of book debts against a purchase price representing a discount from the face value of the debts, coupled with detailed collection procedures, may be

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[37] *Spectrum Plus Ltd (in Liquidation)* [2005] UKHL 41

[38] P. Walton, 'Fixed and Floating Charges: the Great British Fund Off?' (2015) 1 Corporate Recovery and Insolvency; F. Coulson, Asset Based Lending and Insolvency: Challenges and Opportunities' (2014) Recovery 20

unobjectionable, there is also evidence of unspecified termination and collection fees being used to sweep up any remaining cash once a company enters into an insolvency proceeding, leaving nothing for preferential creditors or unsecured creditors or to fund the insolvency case. This is more controversial and we should consider whether we are content for a transaction which is structured in this way to avoid the insolvency priority consequences of a floating charge.

7.1.4 Finally, we note that (a different) concept of "control" remains relevant for the purposes of determining whether a security interest falls within the ambit of the Financial Collateral Arrangement (No. 2) Regulations 2003 and that if the security does fall within the FCARs most of the insolvency effects discussed in this paper are dis-applied. The FCAR position is therefore important to the overall conclusion. A separate working group of the secured transaction law reform project is investigating the FCAR position, and there may be issues arising from their work which become relevant for this paper in due course.

8 Areas for Insolvency Law Reform

8.1 There are also specific areas of insolvency law which would benefit from review and reform, if we are to meet our objectives of reducing transaction costs and making the regime more accessible for overseas investors.

8.1.1 First, we should resist the temptation to tackle each emerging priority challenge by creating new classes of preferential debts. At the time of writing, the Law Commission has reported on its study of the protection of retail consumer deposits and gift vouchers by recommending a new class of preferential debt.[39] Given the different approach to preferential debts between the US and the UK, the need to continue to attract US capital, and the global trend away from the rather blunt tool of preferential status in the insolvency hierarchy, we should think carefully before moving down this path and should concentrate on other initiatives such as creditor trusts in the trading period before insolvency.

8.1.2 Secondly, the rather muddled state of the law on administration expenses would benefit from clarification through amendments to the Insolvency Rules 1986. Whilst it is the case that it is unlikely that an administrator would actively seek to incur expenses which diminish secured creditor returns without some level of acquiescence, uncertainties remain about precisely which claims fall within the expenses bucket. Although *Game Group* has clarified that the equitable principle known as the Lundy Granite principle (after the case in which it first appeared) that a claim which would otherwise have been provable as an ordinary unsecured claim in the administration should be elevated to be treated *as if* it is an expense because it would be inequitable not to do so has survived

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[39] Law Com. No 368, *Consumer Prepayments on Retailer Insolvency*

subsequent legislative intervention,[40] there is still considerable uncertainty as to whether a number of liabilities would fall within the principle or not. In *Nortel Networks* the Supreme Court clarified that a liability would be a "necessary disbursement" (for the purposes of being treated as an administration expense under Insolvency Rule 2.67) where it arose out of something done in the administration or was a liability imposed on an administrator by a statute.[41] However, it is not clear what is meant by something "done in the administration", and it is not easy to determine from many statutes whether the legislature intended particular statutory liabilities to fall on an administrator in an administration or not. This lack of clarity makes it difficult to advise investors in the primary market, and would benefit from further clarification in the Insolvency Rules. At the time of writing, the Insolvency (England and Wales) Rules 2016 have been laid before Parliament and are to come into force with effect from 6 April 2017. The new rules replace the Insolvency Rules 1986 and the 28 amendments which have been made to them. They thus consolidate, modernise and implement various legislative changes. But regrettably they do not tackle amending the statutory provisions relating to administrative expenses, because this proved too difficult to do in the time frame of the project. It is hoped that this will not mean clarification of the expenses regime permanently falls by the wayside.

We must also clarify carefully the expenses position in any future reform of the corporate insolvency framework. The Insolvency Service has recently consulted on some (potentially radical) reforms to the corporate insolvency framework,[42] including the introduction of a preliminary moratorium as a gateway to rescue and restructuring attempts, and provisions designed to compel the continuation of a wider range of supply to financially distressed companies than is currently the case. The responses to the consultation indicate a considerable amount of confusion about the effects of the proposals on insolvency priority. We will not assist matters if, as part of the reform of secured transaction law reform, we conclude that we are content to leave the priority of expenses over some secured creditor claims but we then muddy the waters still further as to the precise ambit of secured creditor subordination.

8.1.3 Thirdly, we should decide where the boundaries lie in the administrator's ability to raise new finance for the case. The statutory scheme in US bankruptcy for the trustee or debtor-in-possession to raise new finance (known as DIP financing) is frequently highlighted as a significant difference between US Chapter 11 and English administration. It was common for existing secured lenders to provide US DIP finance

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40 *Jervis v Pillar Denton Ltd* [2014] EWCA Civ 180

41 *Bloom v Pensions Regulator* [2013] UKSC 52

42 'A Review of the Corporate Insolvency Framework' available at https://www.gov.uk/government/consultations/a-review-of-the-corporate-insolvency-framework

in the 1990s,[43] but there was also an active market for this sort of lending if the existing lenders were unwilling to lend or were thought to be extracting unpalatable concessions. Indeed, certain players in the market built up significant businesses in providing DIP loans in US Chapter 11. However, it is also the case that during this period, for the reasons identified in paragraph 2.7 above, there were usually unencumbered assets available to secure this new financing. Although much is made of the ability to "prime" existing security, this is subject to stringent conditions precedent and, at least insofar as external finance is concerned, appears to be comparatively rare.[44] After the 2001 reforms it is more usual for existing lenders to have a complete security package, so that it is more difficult to identify unencumbered assets for a third party DIP finance provider. At the same time, regulatory changes have made DIP financing less attractive.[45] As a result, DIP finance now appears to be almost exclusively provided by the existing lenders, who are often motivated by the ability to use the new loan to refinance or "roll-up" pre-petition lending so that perfection challenges fall away and, sometimes, higher priority may be obtained for pre-petition financing, and as a method of imposing contractual restrictions on the debtor in order to control the case.[46] There would thus appear to be little for England to learn from the US DIP finance market at the current time.

However, it must also be acknowledged that there is considerable uncertainty around the ability of an administrator to raise finance which ranks ahead of the floating charge holder and preferential creditors as an expense of the case. This confusion is amply illustrated by responses to the Insolvency Service's recent review of the corporate insolvency framework in which the possibility of a statutory scheme for priority for rescue finance was raised again.[47] Some respondents were clearly of the view that priority financing is currently only available where existing secured creditors agree or where unsecured assets are available to provide new security,[48] whilst others appeared to be of the view that the expenses regime in administration enabled priority to be achieved, at least over the floating charge holder. It would appear that a loan agreement

43 For example, because the existing lender had better information about the company and was convinced of the restructuring case

44 In the LyondellBasell case, existing lenders did provide the DIP financing, but "primed" lenders who did not participate and roll-up part of their existing secured claim into a higher level of priority see M.N. Berman, 'Chapter 11 Trends: A Creditor's Perspective' 44-45 in *Creditors' Rights in Chapter 11 Cases* (Aspatore 2011)

45 P.H. Zumbro, 'DIP and Exit Financing Trends and Strategies in a Changing Marketplace' Aspatore Special Report 2016

46 Roe and Ting (n 10)

47 It had already been raised in the Department of Trade and Industry review of company rescue mechanisms which preceded the Enterprise Act 20o2

48 A view which was indeed echoed in the Parliamentary debates on the Enterprise Bill –see McCormack (n 2), p. 702

entered into by an administrator should benefit from priority as an expense by virtue of paragraph 99(5) of Schedule B1 to the Insolvency Act 1986, but difficult questions arise as to the impact of any negative pledge in pre-administration lending. There are a number of considerations. Paragraph 99(5) gives rise to a statutory charge over the assets which may not be caught by the negative pledge. The administrator, in acting as agent for the company in administration, may be protected by the rule in *Said v Butt* from a claim in tort for inducing a breach of contract,[49] or the defence of justification may be available to both the administrator and the company in administration. Insofar as the new financier is concerned, she may be able to rely on paragraph 59(3) of Schedule B1 to the Insolvency Act 1986 which provides that, "A person who deals with the administrator of a company in good faith and for value need not inquire whether the administrator is acting within his powers", but is also perhaps more likely to be fixed with notice of the negative pledge following the 2013 amendments to the Companies Act requirements for registration of company charges, so may also be concerned to understand the negative pledge analysis. It is tentatively suggested here that provided the administrator considers it in the interests of the creditors as a whole that the new financing is obtained, and that the existing lenders have shown themselves unwilling to provide it,[50] the court should be able to come to her aid on issues of the negative pledge in any pre-administration loan agreement on an application for directions under paragraph 63 of Schedule B1 to the Insolvency Act 1986 so that this issue can be left to develop through the courts should future circumstances in the finance market demand it. But it is recognised that this will be controversial. The issues raised in paragraph 7.4 about the extent to which invoice and block discounting and factoring should be brought within the insolvency hierarchy scheme are also relevant here.

8.1.4 Finally, a point which falls somewhat outside this paper, and which has not been touched on so far, is the status of section 245 of the Insolvency Act 1986. This is a special vulnerable transaction regime which currently applies to floating charges. The existence of a special regime for floating charges is itself controversial,[51] and there may be developments in the finance market which could make it ripe for review. Whilst this paper suggests simply that the current regime would henceforth apply to security over raw materials, inventory, book debts, money and crops, there may be a case for reviewing the operation of the regime from an insolvency policy perspective.

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49 *Lictor Anstalt v MIR Steel UK* [2011] EWHC 3310 (Ch) (but see also *SCI Games Ltd v Argonaut Software* [2005] EWHC 1403 (Ch) and views expressed in G. Lightman and G, Moss, *The Law of Administrators and Receivers of Companies* (OUP 2011 5th edition))

50 We are grateful to David Milman and Kayode Akintola of Lancaster University for their suggestion that the existing secured creditors should be provided with what they call a "right of first refusal" to provide rescue financing and we agree that this is something the court should take into account before giving directions which set the administrator at liberty to raise external finance secured on floating charge assets.

51 See, for example, G. McCormack, 'Swelling Corporate Assets: Changing What is on the Menu" [2006] Journal of Corporate Law Studies, 39

9 Conclusion

9.1 Setting to one side the point about factoring, invoice and block discounting, most of the areas identified for further consideration are areas of insolvency law which would benefit from greater clarification. This paper has not proposed a radical overhaul of the English law approach to the insolvency priority of secured credit. But it echoes the demands of the April 2016 Draft Policy Paper paper that English law should be as clear and comprehensible to investors as possible. It therefore supports the suggestion in the April 2016 Draft Policy Paper that the distinction between fixed and floating charges, built on degrees of operational control, should be abolished to make the system more readily understandable. It supports the (bracketed) suggestion in the May 2016 paper that references to floating charges in the legislaftive scheme could be replaced by references to security over inventory, receivables and money, perhaps with some extension to include other types of what are sometimes called "circulating assets", such as raw materials and crops. At the same time, it highlights two difficult questions around the ability for lenders to stipulate for control to move up the insolvency priority hierarchy and the ability for receivables financiers to use unliquidated termination and collection fee arrangements to sweep up all of the cash in the business. Furthermore, it identifies various areas of insolvency law which would benefit from clarification for the purposes of supporting the raising of secured finance. It leaves open detailed consideration of the implications of Basel III for the analysis, and the FCAR position which is subject to separate review by a dedicated working group of the project.

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