Feature

KEY POINTS

- The floating charge still features in corporate finance transactions; it is taken by the financier as a management displacement and realisation mop-up device.
- There seems to be a steady shift towards factoring in receivables financing; yet, factors usually take fixed and floating charges as appendages to factoring agreements.
- Many institutional floating charge creditors scarcely use their power to appoint an administrator due to reputational factors.
- The Parliament's effort to redistribute in favour of unsecured creditors through the prescribed part fund seems to be yielding marginal fruits for this class of insolvency claimants.

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What is left of the floating charge? An empirical outlook

This article provides some empirical insight into the impact of current English insolvency law on: (i) the continued role of the floating charge in corporate finance transactions; (ii) contemporary lending practices; and (iii) insolvency outcomes. The issues addressed cast a spotlight on how Parliament should legislate for the rationalisation of company security interests in insolvency.

EMPIRICAL BACKGROUND

The following analysis is based on data collected from 2,129 companies that entered into administration (1,129) or creditors' voluntary liquidation (CVL) (1,000) between 2006 and 2011. These companies have been selected at random. Further, around 1,600 companies in the sample are small companies. The views of industry experts shared at interviews have also been incorporated into the data. Lastly, the term "factoring" is used in this article as a generic reference to receivables finance agreements that are based on the sale and purchase of a company's receivables. Thus, the term also covers invoice finance agreements which may properly be described as invoice discounting.

THE FLOATING CHARGE LIVES ON

It is well documented that for over a century, the floating charge played a cardinal role in the provision of debt finance to companies. Over the same period, the charge has undergone several statutory metamorphoses raising doubts on the ability of financiers to rely on the charge as a basis for extending and securing credit. Nevertheless, few will doubt that it is essential for a legal system to recognise the ability of financiers to take security over assets which the borrower can dispose of in the ordinary course of its business.

The empirical data bears out the importance of such security as 1,160 companies in the sample had given a floating charge security to their financier; 704 of these charges were created after the Enterprise Act. The bulk of floating charges were seen in the administrations (858); this may be due to the fact that secured creditors are more willing to explore administration than CVLs because it is now easier for a qualifying floating charge holder to initiate an administration procedure, and there is no requirement to hold a creditors' meeting as is the case in CVLs. It may also be that some administrations are initiated in the hope of trading – even where there is only a distinct prospect of realisation. However, this raises the issue of whether certain administration cases are *in fact* liquidations with no reasonable prospect of rescue or trading.

The position of these floating charges in the companies' capital structure is instructive. Around 90% of these charges were taken with fixed charges as part of a debenture. It was observed that this achieved two things for a financier. The first, and perhaps more apparent, is the utilisation of such floating charges to appoint an administrator. As will be shown in this article, the use of floating charges in this manner by financiers is more discreet than overt.

The second is the utilisation of the floating charge as a mop-up debt realisation device. Indeed, a realisation was recorded against no less than 244 floating charges in the empirical data. While this number may appear to be a fractional amount of the total number of floating charges recorded in the sample, it is important to note that the majority of those floating charges were taken as an add-on to other security or factoring arrangements. Therefore, it seems that the opportunity to rely on floating charges for realisation in insolvency is significantly hampered by pre-insolvency lending practices devised as a response to current insolvency law. In any event, such floating charge realisations challenge the school of thought that insolvency law has reduced the utility of the charge to a control/management-displacement device. In spite of insolvency legislation, the floating charge is still capable of performing one of the cardinal functions of security – debt realisation.

FACTORING GROWS

Often enough, small companies have more current assets than fixed assets. Receivables are a major part of a company's current assets. It is therefore hardly surprising that between the decisions in *Siebe Gorman & Co Ltd v Barclays Bank Ltd* and *Re Spectrum Plus*, we saw financiers striving to take the most effective security possible over what is sometimes a company's most viable asset. Post-*Re Spectrum Plus*, the conventional view is that it is unclear how to take an effective fixed charge over receivables in certain transactions, or, alternatively, the exercise of substantive control by the financier over such assets could cripple a company's business.

It was predicted that the response to this quandary would be a shift towards factoring (see J Armour, *Should We Redistribute in Insolvency?* in J Getzler and J Payne (eds), *Company Charges: Spectrum and beyond* (OUP, 2006), ch 9). A total of 528 factoring agreements were observed in the empirical data. While the sale of receivables meets the basic desire of companies for finance, it introduces fragmentation into a company's capital structure as factoring typically co-exists with a loan or overdraft facility provided by a bank.

Perhaps, such fragmentation is not ideal for the insolvency-rescue ideology as the office holder will have to deal with more influential stakeholders. If this is the case, the root-cause is not judicial decisions on the taking of fixed charges over receivables. Rather, it is the treatment of floating charges in insolvency. This is so because there would have been no demand for fixed charges over receivables if the floating charge (which is more suited to the financing of current assets than fixed assets) was not vulnerable in insolvency to liquidation/administration expenses, preferential claims, and the prescribed part fund.

Another development that was observed empirically is that in addition to the master factoring agreement, a factor usually takes a fixed charge over the purchased receivables, and a floating charge over other assets. Given that most factors (over 70%) realised the amounts due to them by relying on the master agreement, the floating charge was often used by them to facilitate the appointment of an administrator. What is less clear is the rationale behind the taking of a fixed charge over assets which have already been assigned to the same financier by way of sale. *Prima facie*, it weakens a factor's claim to a valid outright assignment, and strengthens the case for re-characterising the agreement as a secured transaction. However, the perceived wisdom is that such fixed charges are taken to catch debts which may fall outside the agreement due to a ban on assignment clause in the contracts that gave rise to the debts.

It was also observed that many factors routinely return surplus receivables to an office holder in insolvency. Typically, such surplus is the proportion of purchased receivables outstanding after the factor has recovered the purchase price (finance provided) and other agreed charges such as interest and termination fees. One interviewee, who is a member of the factoring industry, gave the following explanation for the return of surplus receivables:

> "Invoice financiers have an obligation under the debt purchase agreements with their clients to pay an initial percentage – say 85% – of invoices and then to pay the remaining percentage up to 100% less charges once customers have paid the invoices… Anything collected over and above this must, under the terms of the agreement, be passed on to the administrator or liquidator. We cannot keep more than we are due.
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> So for example if they have advanced £80,000 and recover £95,000 from the book debts, they will keep £80,000 plus any charges – let's say £4,000 – and pass on the remaining £11,000 to the administrator to go into the pot for other creditors in the administration."

While parties are free to contract as they wish within the confines of the law, from a conceptual standpoint, the return of surplus receivables also weakens a factor's claim to a valid assignment by way of sale. This is because it resembles the realisation of an equity of redemption by the debtor which is a component of any secured transaction.

The final point to be considered in this section is the allegation that certain factors force vulnerable companies into insolvency (see Treasury Committee, *Oral Evidence: SME Lending*, HC, 204). It was difficult to substantiate this allegation empirically. The reasons for this are varied. For example, only 77 companies with a factoring agreement entered into insolvency within one year of the factoring agreement. There was no indication that these insolvencies were precipitated by a factor's improper pressure. Indeed, no office holder complained about a factor's conduct or the terms of the factoring agreement. Furthermore, the appointment of an administrator by a factor is the factor's statutory right as a qualifying floating charge holder. It is also worth bearing in mind that certain factors are subsidiaries of clearing banks; thus, it will not be unusual to find that clearing banks and the factoring industry have a similar approach to the treatment of their customers.

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THE STRATEGY IN ADMINISTRATOR APPOINTMENTS

In many respects, the *quid pro quo* for the abolition of administrative receivership was the provision of a simpler means for secured creditors to initiate an administration procedure through the instrument of a floating charge (see Department of Trade and Industry, *Productivity and Enterprise: Insolvency – A Second Chance* [White paper, Cm 5234, 2001]). The question that follows is whether the streamlined administration procedure has encouraged secured creditors to seek enforcement by appointing an administrator where they would hitherto have appointed an administrative receiver?

A total of 1087 administrator appointments were observable in the empirical data. This is broken down as follows: 852 appointments were made by the company or its directors; 210 appointments were made by a floating charge holder; and 25 appointments were made by the court. At first blush, the picture that emerges from this data is that there is a low use of the power to appoint an administrator by floating charge holders. However, this should not be taken as a suggestion that secured creditors have not come to see administration as their

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remedy of choice for maximising value. A closer inspection of the 852 administration appointments that were made by the company or its directors revealed that secured creditors were actively involved in such appointments. Once it was perceived that the company's business was running into difficulty, the secured creditor – usually a clearing bank – engaged an insolvency practitioner to conduct an audit of the company's business. The verdict of the audit being insolvency, the secured creditor then encouraged the company to appoint the insolvency practitioner as administrator. In other words, where the appointment was not made by the secured creditor, the company would have appointed an insolvency practitioner the creditor approved of.

The rationale behind this discreet approach to administration appointments by secured creditors is the reputational risk of making such appointments. According to one interviewee who advises clearing banks:

> "My experience of most lenders is that they do not want to appoint because it will come into their figures and will be seen to be doing things the government might not want them to do. So far better to say to the company, 'I am going to pull your finance, so you have a real problem with wrongful trading, so you are going to have to appoint and as long as you appoint MR B, then that will be fine; if you do not appoint Mr B, then we will appoint Mr B.' And I think most companies will do that."

This strategy is perhaps justified by the scrutiny the bank-lending industry came under through the recessionary period. What is more important, however, is that in so far as lenders do not put improper pressure on otherwise viable companies to appoint an administrator, this strategy seems to have a neutral effect in terms of insolvency outcomes.

DOES THE PRESCRIBED PART LOOK THE PART?

The Enterprise Act introduced the prescribed part fund against the backdrop of the abolition of Crown preference as a means to divert insolvency value to unsecured creditors. The office holder creates this fund by redistributing assets secured by floating charges taken after the commencement of the Enterprise Act. It is worth considering whether this provision delivers any meaningful insolvency value to unsecured claimants.

704 post-Enterprise Act floating charges were observed in the empirical data. Of this number, only 95 prescribed part funds were established by office holders. Indeed, while there was a gross return of around £120,367,305 to unsecured creditors, the prescribed part fund contributed around £5,430,834 to gross unsecured creditors' returns (less than 5%). The prescribed part distribution pales even further when the actual return to each unsecured creditor is considered. It is however more convenient to analyse the reasons for the low use of the prescribed part provision. In any event, case law suggests (more on principle than pragmatism) that regard should be hard to the position of the general body of unsecured creditors as opposed to the fact that the distribution to each creditor would be a pittance (see *Re International Sections Ltd* [2009] EWHC 137 (Ch)).

The fragmented capital structure of many companies meant that the floating charge was not primarily relied upon by financiers for realisation. Thus, where the financier is paid in full under a master factoring agreement or fixed charge, he would not have a claim under the floating charge, and as a result, there would not be any net property within the meaning of s 176A(6), Insolvency Act, 1986. This is a clear example of how insolvency legislation affects lending practices thereby creating inefficient insolvency outcomes. Further, it is not unusual to find lenders having pre- and post-Enterprise Act floating charges; the former which is immune to the prescribed part provision being used as a realisation mop-up device.

Other reasons encountered for the low use of the provision are insufficient floating charge assets held by these small companies, and applications by office holders not to apply the fund on the ground that the cost of making a distribution to unsecured creditors would be disproportionate to the benefits. It is arguable that lack of 'floating charge assets' would have a knock-on effect on the ability of administrators to trade meaningfully. Thus, administrators who want to trade would have to scale the hurdle of obtaining a court order to dispose of non-floating charge or hire-purchase assets where such assets exist.

CONCLUDING THOUGHTS

This article has provided selected evidence on the impact that redistributing assets covered by a floating charge in insolvency could have on the behaviour of financiers pre-insolvency, and insolvency outcomes. For example, where the fragmentation of a company's capital structure prevents the operation of the prescribed part provision, it would seem that the redistributive policy under the Insolvency Act is self-defeating. Surely, such policy needs to be revisited.

Finally, the prevalence of factoring agreements in a company's capital structure can no longer be ignored in insolvency. It is suggested that there is a need for office holders and their advisers to start taking a closer look at the veracity of these agreements as they routinely do when faced with a security agreement. As discussed in this article, the operation of such agreements, particularly the return of surplus receivables, raises the issue of whether as a matter of law, such transactions are in fact secured transactions. The practical difficulty with this proposition is that the returned surplus improves the prospects of recouping insolvency expenses and meeting the claims of other creditors. Nevertheless, it is accepted that in deciding whether a transaction should be re-characterised as a secured loan, it is not enough to look at what was agreed between the parties; it is also important to consider the substance or operation of the agreement. ■

Further Reading

- Fixed and floating charges: the Great British Fund-Off? [2015] 1 JIBFL 3.
- Ban the ban: prohibiting restrictions on the assignment of receivables [2015] 3 JIBFL 136.
- LexisNexis Loan Ranger blog: Reforming the law of security.