Back to the future – old legal techniques for modern transactions

Georgia Quenby looks to the past to answer modern questions about the capability of English law to handle security in different forms under the latest insolvency and finance legislation.

This article examines firstly the different outcomes between a receivables purchase arrangement and revolving credit facilities with security over receivables in the context of the Corporate Insolvency and Governance Act 2020 (CIGA), and secondly the use of more traditional forms of security (pledges and chattel mortgages) instead of, or alongside, floating charges, to structure financings in the context both of the CIGA and the Finance Act 2020.

Sweeping changes

As we know, the CIGA has been widely heralded as introducing the most sweeping changes to UK insolvency law for a generation (see *RECOVERY Autumn 2020, Corporate insolvency: bringing balance to the force*, page 9). In addition, the Finance Act 2020 reintroduced Crown preference in respect of certain tax liabilities where the company in effect collects taxes on behalf of the UK government (such as PAYE and VAT), which has created potentially very large liabilities to HMRC which will now rank ahead of recoveries to floating charge creditors in any insolvency after 1 December 2020.

The characterisation of charges as fixed or floating has therefore assumed an even greater significance than before and there is likely to be litigation to resolve some of the areas of ambiguity in the distinction, particularly as it relates to charges over receivables. English law also has more 'old-fashioned' forms of security that can produce a different result from the ubiquitous floating charge for certain classes of collateral.

Receivables as collateral

A lot of working capital financing is provided to companies in the UK that use receivables (also known as book debts) as collateral. Sometimes these transactions are structured as receivables purchase arrangements that use an assignment to transfer rights to the funder (a receivables purchase transaction) and sometimes they are structured as a revolving loan backed by security over the pool of receivables (a secured receivables finance transaction). One of the reasons there is some interest in reforming English security law is that the legal form of a transaction (like a receivables purchase transaction) having the same commercial effect as another legal form of transaction (like a secured receivables finance transaction) can produce different legal effects. A prime example of this is that a receivables purchase transaction is not registrable at Companies House and so is invisible to other creditors or interested parties other than those with actual notice whereas the security for a secured receivables finance transaction must be registered at Companies House within 21 days after creation otherwise the security is void against a liquidator.

Now with the CIGA we have additional contrasting outcomes for the two types of receivables transaction, despite the fact that both types of transaction constitute 'financial services contracts' under the new law. For the purposes of this article, we are assuming that the lender under the secured receivables finance transaction has purported to take a fixed charge over receivables and controls the bank account into which the receivables are paid in a spectrum-plus compliant way.

CIGA moratorium *Ipso facto* clause preventing termination of supply	Receivables purchase transaction outcome N/A – it is a financial services contract	Secured receivables finance transaction outcome N/A – it is a financial services contract
Acceleration	Amounts due to the receivables purchaser are no longer superpriority under a post-moratorium administration	Amounts due to the secured receivables lender are no longer superpriority under a post-moratorium administration
Stop funding	Permitted, without losing superpriority status for accrued debt	Permitted, without losing superpriority status for accrued debt
Use of receivables by a company in a moratorium to fund their business without consent	Not if sold to a receivables purchaser	Not if subject to a fixed charge but see recharacterisation risk table below. If recharacterised to a floating charge then the company can use the receivables without consent
Collect receivables to reduce exposure	Not restricted as it is not a step to enforce security	Restricted because it is a step to enforce security. It is even arguable that retaining the receipts for subsequent application is restricted but the law is unclear
Recharacterisation as a floating charge	Very limited risk	High risk unless the spectrum-plus tests are clearly met
Priority position to HMRC's 'secondary preference' under the Finance Act 2020	Not affected	Not affected if subject to a fixed charge but see recharacterisation risk table below. If recharacterised to a floating charge then HMRC ranks ahead of recoveries

If we follow on from there we should look at recharacterisation risk and the implications for secured receivables finance transactions that are intended to be loans on fixed security over receivables but the spectrum-plus tests are failed for factual reasons:

> **"The characterisation of charges as fixed or floating has assumed an even greater significance than before."**

	Fixed Charge No	Floating Charge Yes
Use of receivables by a company in a moratorium to fund their business without lender consent		
Collect receivables to reduce exposure	Restricted because it is a step to enforce security, but not available to the company	No: available to company to spend, any purported crystallisation has no effect
Priority position to HMRC's 'secondary preference' under the Finance Act 2020	Ranks ahead of HMRC	Ranks behind HMRC

Back to the future

If we look back into the long history of English commercial law there are many forms of security which can be used for various classes of asset. Once the floating charge to provide flexible security for lenders and borrowers hovered into view in the 19th century, a creature of the English commercial courts, it gained traction as a desirable form of quasi-security, floating over a pool of assets, and crystallising on insolvency. In the Insolvency Act 1986 the legislature put a stop to the rights of a floating charge holder to prime all other creditors by providing that a charge is fixed or floating as created when the company enters insolvency. Bit by bit the recoveries of the floating charge holder have been eaten away, with the expense of funding an insolvency process ranking ahead of floating charge recoveries, the prescribed part for unsecured creditors in the Enterprise Act 2002, and now HMRC's secondary preference for VAT, PAYE and certain other taxes under the Finance Act 2020. As noted above there are differing outcomes for transactions of equivalent commercial effect both under the CIGA and the Finance Act 2020, both with respect to receivables purchase versus loans on security of receivables, and with respect to different forms of security.

Traditional methods

So, what options are there in a world where a lender would like to take security over tangible personal property with limited recharacterisation risk?

English courts are reluctant to recharacterise security other than to dig into whether a charge is fixed or floating: in that case the courts regard it as their duty to carry out a characterisation exercise based on the conduct of the parties after the grant of the security, which is highly unusual as a matter of contract construction under English law. This generally disregards post-contractual conduct in the assessment of the true meaning of a contract.

Of course the 'all-assets debenture' is ubiquitous, with its laundry list of fixed charge assets, most of which will not stand up to recharacterisation risk because the accompanying facility agreement contains permissions to deal with or otherwise dispose of some or all of those assets, and with its 'qualifying floating charge' which, again, may not leave the holder in the position they expect to be because of sponsor-driven carve-outs of excluded assets. Sometimes the lenders even purport to take a fixed charge over inventory/stock in trade despite the fact that such a charge is certainly correctly characterised as a floating charge because of the chargor's express and implied rights to deal with their inventory to run their business.

However, we can consider the use of more traditional forms of security (pledges and chattel mortgages) instead of, or alongside, floating charges, to structure financings in the context both of the CIGA and the Finance Act 2020. These forms of security apply to tangible personal property, which constitute a chattel. Chattels are defined in the Bills of Sale Act 1878 as 'goods, furniture and other articles capable of complete transfer by delivery and include documents of title such as bills of lading'. Goods attached to real property, financial instruments, cash and choses in

action are specifically excluded from the definition of chattels.

The traditional way of granting security over tangible movable property is by way of a chattel mortgage or a pledge. While under an all-assets debenture, chattels are usually swept up under the floating charge or, sometimes, a fixed charge, separate chattel mortgages remain a valid and effective way of creating security over identifiable assets that are not sold or dealt with in the ordinary course of business. And so, for example, where a business has construction equipment or equipment used to transport inventory, this equipment could readily be secured using a legal or equitable chattel mortgage. Under a chattel mortgage, the owner (the mortgagor) assigns its legal and beneficial ownership in the property at issue to the lender (the mortgagee). Although ownership transfers to the mortgagee, the mortgagor typically retains the right to possess the item for its own use.

A chattel mortgage is different from an outright sale because the assignment of ownership is on the condition, which may be either expressed or implied, that the legal and beneficial ownership in the property will be transferred back to the mortgagor upon payment or discharge of the amount secured. If the mortgagor defaults on its obligations to the mortgagee, the mortgagee may take possession and, following notice to the mortgagor, sell the subject property and apply any proceeds against the underlying obligation.

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In addition to a chattel mortgage, security can be created over tangible movable property using a pledge. Under a pledge, the debtor transfers possession of the property to the secured party but the debtor retains ownership in the property. Pledged property can either be delivered actually or constructively. If the debtor defaults on the obligation which is secured by the pledge, the security holder can, following adequate notice to the debtor, sell the asset and apply the proceeds to discharge the debt. The pledge over the property will end as soon as the pledged property is returned to the debtor. A pledge is perfected upon either actual or constructive delivery of the asset to the secured party.

A pledge does not constitute a registrable security interest at Companies House. Registration is considered not to be necessary because the pledgee's position is protected by its possession of the underlying collateral, and removal of the asset from the debtor's possession protects third parties because the security interest is (arguably) sufficiently transparent.

As a result, the mortgaged or pledged asset can be used as security for lending and the security interest is not a floating charge with the vulnerabilities mentioned above in relation to other claims (such as expenses and the Crown preference) ranking ahead of the secured party. In the case of both a pledge and a chattel mortgage, an administration moratorium or a CIGA moratorium would prevent enforcement of the security without the consent of the monitor, administrator or the court, and the usual *Re Atlantic Computers* balancing test would apply to such requests for consent, but the assets would not be available to the company in the moratorium to fund its moratorium or the administration and recoveries would not be primed by expenses and HMRC.

> **Bit by bit the recoveries of the floating charge holder have been eaten away.**

One final point, noting the benefits of being able to appoint an administrator as the holder of a qualifying floating charge, nothing would prevent the lender from taking a floating charge over the other (non-funded) assets of the business and, following the 12-month vulnerability period, being able to appoint an administrator while maintaining the secured creditor rights under the pledge or chattel mortgage.

Reforms

Inevitably this is a nuanced area and one which the government may look at addressing with anti-avoidance measures if it thinks these forms of security are being used to avoid the negative consequences of a floating charge, but in the absence of full reform of the laws relating to secured transactions under English law it seems likely to the writer that the courts will uphold the form of security expressed to be used by the parties to a consensual commercial transaction.

It is worth adding that the Law Commission reported on proposed root-and-branch reform of English security law in its 2005 Company Security Interests Report with a view to addressing some of the sorts of divergent results you get with commercially identical transactions using different forms (of the types laid out in this article). There are current moves to advocate for such reform again, but there are significant impediments to reform including the need to determine who funds insolvencies if it is not (in effect) the floating charge holder, and a lack of desire to recharacterise receivables sales as loans against security, not to mention the rather thorny issue of how to deal with ROT in a reformed single security interest regime. ◻

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