Fixed and Floating Security

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Introduction

Whether a mortgage or charge is fixed or floating may be of considerable importance to a lender. This short briefing paper explains the distinction. It refers to the person granting the security as “borrower” and the person taking it as “lender”, and to the security as being a “charge”.

Why it matters whether a charge is fixed or floating

The main advantages for a lender of a fixed rather than a floating charge are as follows.

- If a borrower company is in liquidation, provisional liquidation, administration or receivership, unsecured creditors are entitled to a proportion of recoveries (a “prescribed part”) under a floating charge. The prescribed part is 50% of the first £10,000 and 20% of any assets over that figure, up to a maximum prescribed part of £600,000. This formula means that no deduction is made from floating charge assets over £2,985,000.

- In contrast to a fixed charge, a floating charge ranks behind preferential claims if the borrower goes into liquidation or administration. Preferential creditors are now mainly certain employee claims; in particular up to four months’ unpaid remuneration. The same applies if a lender takes possession of the charged property, or appoints a receiver.

- Again in contrast to a fixed charge, a floating charge ranks after the expenses of a liquidator or administrator. These may be considerable.

- A floating (but not a fixed) charge over a company’s undertaking or property is invalid if created within 12 months before the commencement of liquidation or administration, if the company was insolvent at the time it was created. The period is two years if the charge is to a “connected person”. There is an exception to the extent of new money advanced or services provided on or after the creation of the charge.

- An administrator may dispose of assets subject to a floating charge without the leave of the court, although the charge holder retains the same priority to the proceeds. Leave of the court is required for the disposal of assets subject to a fixed charge.

- A floating charge requires registration at Companies House if created by a company registered in the UK, including a registered overseas company. A fixed charge only requires registration when taken over particular classes of asset.

- A floating charge will, with some exceptions, and in the absence of agreement between the lenders to the contrary, rank after all prior and subsequent charges and other interests arising before it crystallises. The exceptions include a later floating charge, and a later charge which breaches a restriction (or negative pledge) in the earlier floating charge on the creation of security, which the lender holding the later charge was aware of at the time it took the security.

- Whether a charge is fixed or floating may affect whether the borrower can set off against the secured debt liabilities owing to it by the lender.

- The holder of a floating charge which has not crystallised (as explained below) may lose priority to unsecured creditors if the borrower’s assets are included in a company voluntary arrangement containing a trust for the benefit of unsecured creditors.

- Certain unsecured creditors have priority over a floating (but not a fixed) charge. These include an execution creditor if the execution is completed, or payment is made to avoid execution, before crystallisation, and also a landlord levying distress for rent.

Advantages of a floating charge

There are of course also advantages to a floating charge, which is why a debenture will typically include a floating charge over all assets which are not also subject to effective fixed security under the debenture.

A lender holding a “qualifying floating charge” over substantially all a UK corporate borrower’s assets may appoint an administrator in respect of the borrower as a means of enforcement. In certain limited circumstances it may also appoint an administrative receiver. The most important of these is the so-called “capital market exemption” which, in short, is available for bond and stock issues of at least £50 million which involve security granted to a trustee and are designed to be rated, listed or traded (within certain defined meanings).

A lender with a qualifying floating charge may also block the appointment of an administrator by another creditor (other than one holding a prior ranking qualifying floating charge) or by the company itself, by appointing an administrator or, where this is still possible, an administrative receiver.
Despite its relative disadvantages compared to fixed security, a floating charge remains a very flexible and valuable form of security in its own right. It is also likely to give the lender considerable influence in any insolvency of the borrower. Moreover, for the reasons explained below, it is not always practicable to take a fixed charge over certain types of asset.

The characteristics of fixed and floating charges

In the case of a fixed charge, the rights of the lender attach immediately to the charged assets, and the borrower may only deal with those assets subject to the charge. Put another way, if the lender is to have a fixed charge, the borrower cannot be left free to treat the charged asset as its own.

The three main characteristics of a floating charge are that:

- it is over all of a class of assets of the borrower, present and future;
- the assets in the class change from time to time in the ordinary course of the borrower’s business; and
- the borrower is free to deal with the assets in the ordinary course of its business without the consent of the lender, until some step is taken or event occurs which “crystallises” the charge.

The lender’s rights attach only to a shifting pool of assets until the charge crystallises, which turns it into a fixed charge over the relevant assets. It is, however, whether the charge was fixed or floating when it was created that matters so far as most of the distinctions between a fixed and a floating charge are concerned.

Following the decision of the House of Lords in National Westminster Bank plc v Spectrum Plus Limited [2005] UKHL 41 – in which the court held that a then commonly used form of “fixed charge” over book debts only created a floating charge – the last of the three characteristics mentioned above is seen as the crucial one. The “label” the parties use in the charging document to describe the charge is no more than indicative.

Receivables

The distinction between a fixed and floating charge is particularly relevant in the case of a charge over book debts or other receivables. It is not possible to take a fixed charge over receivables while leaving the borrower free to collect and use the proceeds of the receivables (for example to fund its working capital needs). This does not mean that a fixed charge cannot be taken over receivables. To do so, however, the lender must exercise real control over the receivables and their proceeds.

There are a number of possible ways to do this, but in practice the borrower must be required to pay the proceeds of receivables into a blocked “collection” or “receivables” account with the lender. An alternative is to require them to be paid into a separate account with a third party bank over which the lender has a fixed charge, of which notice is given to that bank, and which cannot be drawn on without the lender’s consent. In either case there must also be a restriction in the charge to prevent the borrower disposing of or charging its receivables to another person.

The relevant account must then be operated as a blocked account in practice. There must be no automatic “sweep” of funds from a collection to a current account. The safest approach from the lender’s point of view is for its consent to be required for each release from the blocked account, for it to have an unfettered discretion to refuse consent, and for the arrangement to be actively operated. There should also be a good paper or e-mail “trail” showing that the lender has exercised its discretion each time funds were transferred from the collection account. Releases need not, however, be on a debt by debt basis. There should be no arrangement which suggests that the lender will always exercise its discretion in a particular way.

Other assets

A charge or mortgage over assets other than receivables may also be vulnerable to challenge as being only a floating charge, particularly in the case of assets which are turned over in the normal course of business.

Any charge is likely to be floating where the borrower is free to remove the charged assets from the security (even for heavy plant and machinery), or where it has an unrestricted right to substitute other assets as security. “Fixed” charges over assets such as stock, uncalled capital, plant and machinery, goodwill, licences, and shares and other securities are all at risk of being classified as floating charges. Certain structured finance products may also be vulnerable.
In the case of land the risk of a successful challenge to a fixed charge is slim, even when the borrower is free to receive and use rental income until default. The distinction between a capital asset (the property interest) and income from it (in the form of rent) is well established in the case of land.

A charge over specified shares or other securities will, the cases suggest, be fixed if there is a restriction on disposals, even if the borrower is free to enjoy the income and voting rights until default. The charge is likely to be floating if the borrower is free to dispose of and substitute the charged shares, so that they are in effect a fluctuating pool of assets, particularly if the chargor’s business involves trading in shares.

In the case of assets such as leasing agreements, a charge is likely to be floating if the borrower is free to deal with the income in the ordinary course of its business and the leasing agreements are a class of circulating assets.

The Financial Collateral Regulations

If the charge is over “financial collateral” (cash and most types of marketable securities) within the Financial Collateral Arrangements (No.2) Regulations 2003, requirements such as registration, and the entitlement of unsecured creditors to a share of floating charge assets, are disapplied, and the importance of the distinction between a fixed and floating charge is reduced. However, the application of the Regulations remains uncertain in some respects. In particular, despite recent amendments to the Regulations, a floating charge may not meet the requirement that, in order to fall within the Regulations, the securities must be in the possession or under the control of the lender.

Alternatives for creditors

One result of the Spectrum Plus case has been to encourage the provision of finance to companies by factoring, invoice discounting, or similar arrangements. Under a factoring arrangement, the body providing finance purchases and collects trade debts, with or without recourse to the company if the third party debtors fail to pay. Invoice discounting involves the financier purchasing the debts, but the company collects them and the third party debtors are not notified.

For further advice please speak to your usual contact at Field Fisher Waterhouse.