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CHARGE CHARACTERISATION IN ENGLISH LAW: A SETTLED DEBATE?

In re Spectrum Plus Ltd.

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I. INTRODUCTION

Among other features, the speeches of the Law Lords in *In re Spectrum Plus Ltd.*[1] are notable for the conviction with which they set out to end commercial uncertainty, and to quell a range of legal questions, about company charge characterisation. The extent of labour and the quality of thought and skill applied by their Lordships and all involved in the litigation give hope that the decision will achieve its ambition of clarity. Some sense that this has already been achieved is undoubtedly felt in the offices of liquidators and creditors in the "hundreds" of liquidations the House was informed were held up pending their Lordships' decision.[2]

At the same time, company charge litigation will not suddenly end, as Mr Nolan points out.[3] The decision was on a particular form of contract: findings on that form of contract might not readily transpose to charges in other forms. Further, human nature and the nature of commercial enterprise combine to make it likely that any difficulties thrown up by *Spectrum* will be explored fully by contract drafters and, in turn, litigators. Nolan writes:

> After all, this is nothing more than a contemporary iteration of the very processes which created floating charges in the first place: that is, developments by innovative practitioners, in response to their clients' commercial demands and the existing state of the law, followed by a reaction from a judiciary largely composed of those who were, a mere decade or so earlier, amongst those very practitioners.[4]

Allowing for the possibility that different minds will react differently to this prediction of boundary-pushing, this note discusses the extent to which *Spectrum* will settle the law in this area. Perhaps controversially, it will be argued that while the result in

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1 [2005] A.C. 680, [2005] UKHL 41 [*Spectrum*].

2 *Spectrum*, *supra* note 1 at para. 76.

3 R. C. Nolan, "A *Spectrum* of Opinion" [2005] C.L.J. 554 [Nolan, "*Spectrum* of Opinion"].

4 *Ibid*. at 555–556, citing R.C. Nolan, "Property in a Fund" (2004) 120 Law Q. Rev. 108 [Nolan, "Property"].

Spectrum is correct, the supporting reasoning departs from basic legal principles of general application in ways to be outlined in the following section. The result is that *Spectrum* will not settle the basic questions in security law that their Lordships sought to resolve.

II. The Dispute

Spectrum Plus, a manufacturer of dyes, paints and related products, operated current and overdraft accounts with NatWest. To secure its indebtedness on the overdraft, the company issued a debenture expressed to create a fixed charge over the company's book debts and a floating charge over the current account, into which proceeds of the book debts were paid. The company later went insolvent. Its assets were insufficient to meet the creditors' claims. Hence a competition to £16,136 remaining in the current account arose between NatWest, as a secured creditor, and preferential creditors.

The preferential creditors relied on *Insolvency Act 1986* (U.K.)[5], s.175, which provides:

> (1) In a winding up the company's preferential debts (within the meaning given by section 386 in Part XII) shall be paid in priority to all other debts.
> (2) Preferential debts—(a) rank equally among themselves after the expenses of winding up and shall be paid in full, unless the assets are insufficient to meet them, in which case they abate in equal proportions; and (b) so far as the assets of the company available for payment of general creditors are insufficient to meet them, have priority over the claims of holders of debentures secured by, or holders of, any floating charge created by the company, and shall be paid accordingly out of any property comprised in or subject to that charge.

"Floating charge" is defined by section 251 to mean "a charge which, as created, was a floating charge". The preferential creditors' basic position was that the £16,136 was subject to a charge that attracted section 175, giving them priority under subsection (2)(b). NatWest argued the contrary.

The first issue for the House was therefore whether the charge over the book debts and proceeds had the character of a fixed or a floating charge "as created", for the purposes of section 175(2)(b) (read with section 251). It was held, following the Privy Council in *Agnew v. Commissioner of Inland Revenue*,[6] that the charge was floating at the time of its creation for section 175 purposes. Prior authority[7] said to support the contrary result was overruled, raising a secondary issue: ought the earlier decision to be overruled only "prospectively"? The focus here will be on charge characterisation.[8]

Lord Scott of Foscote and Lord Walker of Gestingthorpe delivered the leading speeches on charge characterisation. Lord Hope of Craighead delivered reasons

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5 1986, c. 45 [*Insolvency Act 1986*].

6 *Agnew v. Commissioner of Inland Revenue* [2001] 2 A.C. 710, [2001] UKPC 28 (P.C. from New Zealand) [*Agnew*].

7 *Siebe Gorman & Co. Ltd. v. Barclays Bank Ltd.* [1979] 2 Lloyd's Rep. 142 (Ch.).

8 For commentary on the treatment of prospective overruling in *Spectrum*, see Nolan, "*Spectrum* of Opinion", *supra* note 3 at 557–558; D. Sheehan & T.T. Arvind, "Prospective Overruling and the Fixed/Floating Charge Debate" (2006) 122 Law Q. Rev. 20.

focusing mainly on the Scottish position, and otherwise agreed with Lords Scott and Walker.[9] The other Law Lords[10] also agreed with both leading judgments.

Through an examination of the leading judgments, it will be argued in turn that the reasoning correctly identifies the approach to charge characterisation, but:

1. misapplies accepted principles of contractual and statutory construction at each stage of the characterisation process;
2. misidentifies the nature of debt as obligation and property and, consequently, the role of equitable doctrine in relation to company charges; and
3. rests on certain doubtful assumptions.

III. Charge Characterisation

A. *A "Two-Stage Process"*

In *Agnew* Lord Millett restated the method of company charge characterisation as a "two-stage process".[11] The first step is to ascertain the terms of the charge over property (in *Spectrum*, book debts and proceeds). The second is to construe the statutory expression "floating charge" to ascertain whether that expression applied to the charge at the time of its creation.[12]

It follows from Lord Millett's restatement that, in taking these steps (to adapt words of the High Court of Australia), *a priori* assumptions as to the nature of floating charges under the general law and principles of equity do not assist and are apt to mislead. All depends on the terms of the particular charge. "Floating charge", in the absence of an applicable statutory definition, does not have a constant, fixed normative meaning that can dictate the application to particular facts of section 175 of the *Insolvency Act 1986*.[13]

Only Lords Scott and Walker gave detailed reasons showing how they applied the two-stage approach of characterisation in *Spectrum*.[14] Does examination of their Lordships' speeches show that this process was convincingly applied?

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9 *Spectrum*, *supra* note 1 at paras. 53, 57–58.

10 Lord Nicholls of Birkenhead, Lord Steyn, Baroness Hale of Richmond and Lord Brown of Eaton-under-Heywood.

11 *Agnew*, *supra* note 6 at para. 32. The approach was applied in *Spectrum* at the High Court level, [2004] Ch. 337 at paras. 35, 37–38, [2004] EWHC 9 *per* Morritt V-C, and at the Court of Appeal level, [2004] Ch. 337 at para. 34, [2004] EWCA Civ. 670 *per* Lord Phillips of Worth Matravers M.R. It was also applied in *Arthur D. Little Ltd. v. Ableco Finance LLC* [2003] Ch. 217 at para. 39, [2002] EWHC 701. It has sound pedigree, particularly in relation to much revenue legislation: *e.g.*, *Countess of Bective v. Federal Commissioner of Taxation* (1932) 47 C.L.R. 417; *Gartside v. I.R.C.* [1968] A.C. 553 at 614; *MacNiven v. Westmoreland Investments Ltd.* [2003] 1 A.C. 311 at paras. 2–6 and 77, [2001] UKHL 6 [*MacNiven*]. See also *Lloyds & Scottish Finance Ltd. v. Cyril Lord Carpet Sales Ltd.* [1992] B.C.L.C. 609 (H.L.) at 615–616 [*Lloyds & Scottish Finance*]; *Associated Alloys Pty. Ltd. v. A.C.N. 001 452 106 Pty. Ltd. (in liq.)* (2000) 202 C.L.R. 588 at paras. 2–5, [2000] HCA 25 [*Associated Alloys*].

12 *Insolvency Act 1986*, ss. 175(2)(b) and 251.

13 *C.P.T. Custodian Pty. Ltd. v. Commissioner of State Revenue* (2005) 79 A.L.J.R. 1724 at paras. 14–16, [2005] HCA 53 (meaning of "unit trust").

14 Lord Scott expressly accepted Lord Millett's two-stage process to charge characterisation in *Smith v. Bridgend County Borough Council* [2002] 1 A.C. 336 at para. 53, [2001] UKHL 58 [*Smith*]. In *Spectrum* he implicitly accepted it, while Lord Walker explicitly did so: *Spectrum*, *supra* note 1 at para. 141.

B. *Lord Walker—A Contractual Focus*

In outline, Lord Walker's approach was to modify the agreed terms of the *Spectrum* charge at the first stage of characterisation, giving the charge the features of a "traditional" floating charge. Interpreted using accepted methods of statutory interpretation, section 175 then operated on the modified charge, to the advantage of preferential creditors. The passage in Lord Walker's speech encapsulating that approach will now be considered.

The passage commences with Lord Walker saying that the character of an occupation agreement as lease or licence depends on the respective rights of the parties.[15] If the agreement has the indicia of a lease, labelling the agreement "licence" cannot be decisive of the agreement's true character, and vice versa. Likewise with charges: giving a charge the label "fixed" will not mean that the charge has that character if the terms of the charge disclose a floating character, and vice versa. Lord Walker continues:

> Whether or not it is appropriate to describe this [labelling practise] by some disparaging term such as camouflage, it is the court's duty to characterise the document according to the true legal effect of its terms, as has been very clearly explained by Lord Millet in *Agnew's* case.[16] In each case *there is a public interest which overrides unrestrained freedom of contract*. On the lease/licence issue, the public interest is the protection of vulnerable people seeking living accommodation. On the fixed/floating issue, it is ensuring that preferential creditors obtain the measure of protection which Parliament intended them to have. This public interest is unaffected by the changes in the classes of preferential creditors made by section 251 of the *Enterprise Act 2002*.[17]

Implicit in this passage are certain fundamental propositions: the object of contractual interpretation is to collect the parties' intentions from the contract as a whole, referring to the relevant context. Those intentions turn upon what the parties' words and conduct would be reasonably understood to convey, not upon actual beliefs or intentions. And parties will generally be taken to mean what they say and to say what they mean.[18] There is also explicit approval in the passage of Lord Millett's approach to characterisation, as noted above. Nothing in this is problematic.

The intended relationship in this passage between "camouflage" or sham[19] and the "public interest" idea, however, creates difficulty. Sham refers to "steps which take the form of a legally effective transaction but which the parties intend should not have the apparent, or any, legal consequences".[20] Unlike Lord Walker's "public interest" idea, it is a function of the parties' intentions, not a limit on freedom of

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15 *Spectrum*, *supra* note 1 at para. 141, referring to *Street v. Mountford* [1985] A.C. 809.

16 *Agnew*, *supra* note 6 at para. 32.

17 *Spectrum*, *supra* note 1 at para. 141 [emphasis added].

18 *Gissing v. Gissing* [1971] A.C. 886 at 906; *Ashington Piggeries Ltd. v. Christopher Hill Ltd.* [1972] A.C. 441 at 502; *Equuscorp Pty. Ltd. v. Glengallan Investments Pty. Ltd.* (2004) 218 C.L.R. 471 at paras. 33–34, [2004] HCA 55 [*Equuscorp*].

19 It is reasonable to infer that Lord Walker used "camouflage" in this passage to refer to sham.

20 *Equuscorp*, *supra* note 18 at para. 46.

contract.[21] The passage quoted does not equate the sham and "public interest" ideas, but sham seems mistakenly to be given independent force as a limit on contractual freedom.

More pronounced is the difficulty thrown up by the "public interest" ground Lord Walker identifies. Lord Walker arguably formulates it as a ground of statutory illegality, found in the *Insolvency Act 1986*, that limited the efficacy of the agreed contractual terms of the *Spectrum* charge. Is this view supportable? On one classification,[22] four categories of illegal contracts are recognised:

1. those whose formation is prohibited;
2. those that require performance of a prohibited act;
3. those whose performance statute otherwise makes unlawful; and
4. those that, although not directly contrary to any express or implied statutory prohibition, are associated with or in furtherance of illegal purposes as disclosed by the "policy of the law".[23]

Lord Walker's "public interest" ground falls outside the first three classes: the only relevant constraint under the *Insolvency Act 1986*, imposed by section 175, concerns application of floating charge proceeds. Nothing in the provision's words prohibits the formation or execution of any sort of charge, nor any step in a charge's execution.

That leaves the possibility that Lord Walker's "public interest" ground belongs in the fourth class listed. As already mentioned, illegality in this category is found not in any direct legislative prohibition but in the "policy of the law"—a concept seemingly equivalent to Lord Walker's "public interest". For the purposes of this category of illegality, the policy of the law is found in the scope and purpose of the particular statute as revealed by its words. The required task of construction reflects the largely historical doctrine of "the equity of the statute"—historical because, while originally wide, it was narrowed in response to Bentham's attacks and the nineteenth century rise of legal positivism.[24] But construction reveals an "equity" in section 175 (as amplified by section 251) of protecting preferential creditors using the proceeds of charges that were floating upon creation. Lord Walker's "public interest" goes well beyond this, and no other provision seems to support it. That includes section 251: it gives no support to Lord Walker's "public interest" because its terms and the policy it reflects apply only to charges that were floating as created, not to every charge avoiding section 175. *Spectrum* therefore is not a case in any of the four classes of illegal contract on the classification of illegality adopted here. Indeed, the case falls outside other accepted classifications of illegal contracts as well.[25] If Lord Walker instead based himself on public policy doctrines independent of illegality, a

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[21] B. McFarlane and E. Simpson, "Tackling Avoidance" in J.S. Getzler, ed., *Rationalising Property, Equity and Trusts: Essays in Honour of Edward Burn* (London: LexisNexis, 2003) at 139–143.

[22] There are other classifications of illegal contracts: G.H. Treitel, *The Law of Contract*, 11th ed. (London: Sweet & Maxwell, 2003) at 429–430.

[23] *Fitzgerald v. F.J. Leonhardt Pty. Ltd.* (1997) 189 C.L.R. 215 at 229–230.

[24] *Nelson v. Nelson* (1995) 184 C.L.R. 538 at 553–554; P.B. Maxwell, *On the Interpretation of Statutes* (London: Maxwell & Son, 1875) at 226–236.

[25] See also *In re Brightlife Ltd.* [1987] Ch. 200 (Ch.) at 214–215. An alternative reading of the passage quoted above is that Lord Walker treats s. 175 not as making part of the charge unenforceable for illegality, but as implying a term or terms into the charge to give the charge a "traditional" floating form. However, Lord Walker did not speak this way, and it is difficult to see how s. 175 could be read as authorising that view.

similar difficulty arises of identifying a relevant public policy. Whichever ground Lord Walker had in mind, nothing indicates that the relevant provisions of the charge in *Spectrum* were void, unenforceable or both.

In terms of Lord Walker's reasoning, it was possible once the *Spectrum* charge was recast in line with the "public interest" of section 175 to construe section 175 using accepted interpretive techniques to conclude that the section had operation. But the reasoning is clouded by its use, at the first stage of characterisation, of methods of contractual interpretation that are inconsistent with accepted legal principle.

C. *Lord Scott—A Statutory Focus*

Lord Scott's approach in a sense was the converse of Lord Walker's. In brief, Lord Scott interpreted the *Spectrum* charge using conventional methods of contractual interpretation at the first stage of characterisation. He then construed section 175 at the second stage using *un*conventional methods, so that the section applied not only to a charge that was floating as created, but also to any charge with the practical features of a floating charge.[26] The outcomes of the two approaches are the same, but the approaches individually are quite distinct.

The passage setting out Lord Scott's approach suggests that section 175 applies to particular charges because they have the "substance" of a floating charge, although perhaps not the legal form of one. Hence Lord Scott said that, while legislation has never exhaustively defined "floating charge", the expression:

> … bears the meaning attributed to it by judicial decision. But the judicial process over the years whereby the concept of a "floating charge" has been developed must, in my opinion, keep in mind the mischief that these statutory reforms were intended to meet and, in particular, that on a winding up or receivership preferential creditors were to have their debts paid out of the circulating assets, sometimes referred to as "ambulatory" assets, of the debtor company in priority to a debenture holder with a charge over the assets.[27]

Just as the passage quoted earlier from Lord Walker's speech supports certain orthodox principles of contractual construction, this passage from Lord Scott's speech bears out certain accepted principles of statutory construction: a court must give statutory words the meaning that Parliament is taken to have intended. That meaning ordinarily corresponds to the words' grammatical meaning. But context, the purpose of a provision and the canons of statutory construction may require a reading to be given that is not strictly literal or grammatical.[28] Again, none of this is problematic.

Other aspects of the passage from Lord Scott's speech, however, are troublesome. The central assertion is that the meaning of "floating charge" is guided by the mischief of the reforms behind section 175 (read with section 251): that preferential creditors should have priority over a floating chargee's rights to circulating assets. The trouble

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[26] *Spectrum*, *supra* note 1 at paras. 107 and 111.

[27] *Ibid*. at para. 98.

[28] *Attorney-General v. Prince Ernest Augustus of Hanover* [1957] A.C. 436 at 461; *Project Blue Sky Inc v. Australian Broadcasting Authority* (1998) 194 C.L.R. 355 at para. 78, [1998] HCA 28; *Wilson v. First County Trust Ltd. (No. 2)* [2004] 1 A.C. 816 at para. 56, [2003] UKHL 40 [*Wilson*].

with stating the mischief this way is that the statement is both too narrow and too wide. It is too narrow because it does not account for the facts that a charge may be floating although it is not over circulating assets and that preferential creditors have rights to proceeds of such a charge, where section 175(2)(b) is attracted.[29] It is too wide because even if it were an essential feature of a floating charge that it operate over circulating assets, only some floating charges attract section 175(2)(b)—those that are floating as created.

This points to more fundamental difficulties with the process of construction used to identify the alleged mischief. First, applying the accepted propositions of statutory construction mentioned earlier reveals a narrow mischief of giving preferential creditors priority over floating chargees *where the charge was floating at the time of its creation*. No element in the context Lord Scott examined in his reasons—including legislation upon which section 175 is based and cognate legislation, and cases discussing the defects of the prior law[30]—reveals an extended mischief.[31] Second, while the "mischief" doctrine may be another remnant of the broad "equity of the statute" doctrine,[32] its role today is narrow. "The court cannot attach a meaning to [statutory] words which they cannot bear".[33] The alleged mischief that Lord Scott identifies in the quoted paragraph rests on a meaning that overlooks these propositions and that the words of section 175 cannot sustain. Revival of a wide form of "mischief" doctrine under the "equity of the statute" rubric to support Lord Scott's approach would be a kind of atavism unsuited to modern notions of government.[34]

The other troubling aspect of the quoted passage is the implication that the meaning of "floating charge" has no formal legal content.[35] One recognises with Lord Scott that statute has never exhaustively defined "floating charge", and that the term is not "a term of art".[36] However, the expression does not have unlimited meaning. A "floating charge" is a kind of "charge". And "charge" is a technical term denoting two forms of equitable security: the equitable mortgage and the "simple charge"[37] or "equitable charge not by way of mortgage".[38] So much was made clear in Buckley

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29 *Agnew*, *supra* note 6 at para. 13; *Spectrum*, *supra* note 1 at para. 107 *per* Lord Scott; R.M. Goode, *Legal Problems of Credit and Security*, 3rd ed. (London: Sweet & Maxwell, 2003) at 115–116 [Goode, *Legal Problems*].

30 *Spectrum*, *supra* note 1 esp. at paras. 95–98, 101 and 111.

31 See *Lloyds & Scottish Finance*, *supra* note 11; *Associated Alloys*, *supra* note 11 at paras. 3–5 and 48–51; *Buchler v. Talbot* [2004] 2 A.C. 298 at paras. 23, 34 and 53, [2004] UKHL 9.

32 W.M.C. Gummow, *Change and Continuity: Statute, Equity, and Federalism* (Oxford: Oxford University Press, 1999) at 21.

33 *Pepper v. Hart* [1993] A.C. 593 at 635. See *Dossett v. T.K.J. Nominees Pty. Ltd.* (2003) 218 C.L.R. 1 at para. 57, [2003] HCA 69 *per* Kirby J.; *MacNiven*, *supra* note 11 at para. 6 *per* Lord Nicholls; at paras. 29 and 58 *per* Lord Hoffmann; *Wilson*, *supra* note 28 at para. 67 *per* Lord Nicholls.

34 *MacNiven*, *supra* note 11 at para. 29; *Wilson*, *supra* note 28 at paras. 54–56, 111 and 139. To the extent Lord Walker's "public interest" limitation on contractual freedom rests on a wide form of "mischief", the same remark applies.

35 *Cf. Spectrum*, *supra* note 1 at para. 116.

36 *Ibid*. at paras. 98 and 116 *per* Lord Scott and para. 134 *per* Lord Walker.

37 *Tennant v. Trenchard* (1869) L.R. 4 Ch. App. 537 at 542–543. There are other meanings of "charge" not relevant to the present discussion e.g. *Hall v. Richards* (1961) 108 C.L.R. 84.

38 *Swiss Bank Corp. v. Lloyds Bank Ltd.* [1982] A.C. 584 (C.A.) at 594–595 *per* Buckley L.J. [*Swiss Bank Corp.*].

L.J.'s influential judgment in *Swiss Bank Corp. v. Lloyds Bank Ltd*.[39] As Buckley L.J. also pointed out, an equitable charge in either of these forms may have a floating character.[40] That character is present if the chargor has the right during the ordinary course of business to deal with charged property free of the security.[41]

Buckley L.J.'s construction therefore recognises two limits on the meaning of "floating charge" in the context of section 175: only certain *forms* of security fall within the term; and only those *forms* of security with certain practical characteristics are "floating" charges. Thus, a fixed charge in the form of a legal mortgage coupled with a power for the chargor to deal with charged assets is not a "floating charge", even though that arrangement might be economically equivalent to one. An earlier Buckley L.J. famously held the same view.[42] "Floating charge" is therefore not a legally normative term, but it has legally normative content. In the passage quoted, Lord Scott apparently accepts that these limits once existed, but says that they have disappeared or ought to. Again, construction of the statute by ordinary means can give no support. Had Parliament intended to give section 175 expansive operation, the definition of "floating charge" could have been amended with relative ease by further extending section 251.

To summarise, the terms of a security arrangement were not modified on Lord Scott's approach. They were relatively unimportant because, at the second stage of characterisation, section 175 was construed to apply to charges not identified by its wording, despite that wording being rather precise. The latter reasoning is suspect in its departure from accepted principles of statutory interpretation.[43]

D. *Conclusion on Charge Characterisation*

A compelling inference emerging from the above analysis is that Lords Scott and Walker sought to ensure that the parties to the *Spectrum* charge did not avoid the operation of section 175 through adopting sophisticated drafting techniques.[44] That is a valid approach if supported by some legal rule. However, the relevant principles of contractual and statutory construction disclose no such support, and alternative support is difficult to locate. A consequence that must also be faced is that the approaches applied by Lords Scott and Walker impair the chargee's vested property rights despite the common law's general unwillingness to do so.

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39 *Ibid.* See also *London County & Westminster Bank Ltd. v. Tompkins* [1918] 1 K.B. 515 at 528–530.

40 *Swiss Bank Corporation*, *supra* note 38 at 594–595; *cf.* Goode, *Legal Problems*, *supra* note 29 at 152.

41 *Spectrum*, *supra* note 1 at paras. 102, 104, 112 and 139; *Barns v. Barns* (2003) 214 C.L.R. 169 at para. 152, [2003] HCA 9 *per* Callinan J. Despite its apparent clarity, the test for distinguishing between fixed and floating charges is not always simply applied. Questions of degree may arise but will not be pursued here. For instance, will a charge permitting debt factoring but prohibiting all other dealings with debts be fixed or floating? How, if at all, does the answer depend on the nature of the chargor's business?

42 *Evans v. Rival Granite Quarries Ltd.* [1910] 2 K.B. 979 at 999. *Cf. In re Armagh Shoes Ltd.* [1982] N.I. 59 at 69; *Smith*, *supra* note 14 at para. 63; *Spectrum*, *supra* note 1 at para. 107.

43 See Lord Hoffmann's speech in *MacNiven*, *supra* note 11.

44 In Professor McCormack's words, this is "an unarticulated major premise" of the reasoning: G. McCormack, "Lords Hoffmann and Millett and the shaping of Credit and Insolvency Law" [2005] L.M.C.L.Q. 491 at 496.

Also important is that while Lords Scott and Walker agreed with one another's views, to an extent their approaches are contradictory. The fact that both sets of reasons were agreed with by the other members of the House does not diminish the conflict in views or the likelihood of continued uncertainty about the correct approach to characterisation as a result of the unconvincing application of Lord Millett's "two-stage process".

IV. The Relationship Between Book Debts and Proceeds and the Role of Equitable Doctrine

Characterisation aside, it is suggested that the treatment in *Spectrum* of the relationship between book debts and proceeds misidentified the nature of the relationship and will not settle debate. The point merits discussion because it has been said that book debts and proceeds are "indivisible" such that a charge is either fixed over book debts and proceeds, or floating over both.[45] Though discussed on several occasions, a settled view has not been reached. The role of equitable doctrine also arises. It is thought that a solution requires a fresh approach, which the following discussion attempts to provide.

The debt-proceeds relationship was directly addressed in *Spectrum* by Lord Scott only, relying on Lord Millett's analysis in *Agnew*.[46] Lord Scott said:

> Essentially Lord Millett challenged the notion that the security rights granted over a book debt could be any greater than the rights, if any, granted over the money received in payment of the debts. … As Lord Millett said, [such a security] would be worthless. … Since the essential value of a book debt as a security lies in the money that can be obtained from the debtor in payment it seems to me that Lord Millett was right in concluding that such a security should be categorised as a floating security….[47]

Reading this with the relevant part of Lord Millett's judgment,[48] it is seen that Lord Scott argues thus: A Ltd. cannot legally assign particular book debts to B and the proceeds of those book debts to C; therefore, A Ltd. cannot grant to B security over book debts and proceeds that vests in B greater rights in respect of proceeds than book debts.

The first part of the argument is generally correct. A debt cannot be assigned without the right to payment proceeds, because a debt *is* a right to payment. A debtor tendering payment to anyone other than the creditor or the creditor's legal assignee cannot thereby satisfy the debt. However, it is not clear why this prevents A Ltd.

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45 See *Agnew*, *supra* note 6 at para. 35 and discussion in the articles cited there.

46 *Spectrum*, *supra* note 6 at paras. 110–111; *Agnew*, *supra* note 6 at para. 46. Lord Millett cited (at para. 35), and may have relied on, Professor Goode: see R.M. Goode, "Charges over Book Debts: A Missed Opportunity" (1994) 110 Law Q. Rev. 592 at 599 [Goode, "Charges over Book Debts"].

47 *Spectrum*, *supra* note 1 at para. 110; *Agnew*, *supra* note 6 at para. 46. On the "essential value" of debts, see J.E. Penner, "Hohfeldian Use-Rights in Property" in J.W. Harris, ed., *Property Problems: From Genes to Pension Funds* (London: Kluwer Law International, 1997) at 173-174 [Penner, "Hohfeldian Use-Rights"]; J.E. Penner, "Ownership, Co-Ownership, and the Justification of Property Rights" in T. Endicott, J.S. Getzler and E. Peel, eds., *Properties of Law: Essays in Honour of Jim Harris* (Oxford: Oxford University Press, 2006) at 160 note 11.

48 *Agnew*, *supra* note 6 at para. 46.

granting to B greater charge security over proceeds than over book debts. The security is equitable: the creditor remains "owner" of the debts, so no question arises of attempting to deny the creditor its right to payment. Also unclear is why the economic worth of such a security has legal significance. If the value of a security affects whether it is legally valid—which is a tenet of Lord Scott's argument—would not every security carrying a risk of realising insufficient proceeds to satisfy secured obligations be legally invalid?[49]

Rather than reflecting the debt-proceeds relationship, the reasoning of Lord Scott (and that of Lord Millett, which Lord Scott adopted) reflects the conventional *expectation* that the equitable charge will give a chargee rights to proceeds equivalent to or greater than his or her rights to book debts. Considerations of the equitable doctrines governing the charge enter the picture. Chief among these, as noted earlier, is that *a priori* assumptions or expectations about the nature of floating charges under the general law and principles of equity are apt to mislead. Here the expectation is that, by contract, parties will shape the charge to bring about that result. Parties contracting otherwise displace the expectation.[50] The *Agnew* and *Spectrum* debentures were such agreements: it was agreed that the chargee's rights to proceeds did *not* equal its rights to book debts. The debt-proceeds relationship does not prevent this result, and it misrepresents the equitable principles governing the charge to suggest that they alternatively do so.

A final point about the debt-proceeds relationship is that in *Agnew* Lord Millett admitted that book debts and proceeds are "separate assets", but said that the parties could not have intended to grant the creditor greater rights over book debts than over proceeds because the security would be "worthless" and "contrary to commercial sense".[51] Using ordinary methods of contractual interpretation, the words purporting to create a fixed charge on book debts could be ignored as absurd. However, it is doubtful that there was real absurdity. Security in this form may have many commercial benefits[52]—most obviously, that of giving the chargee priority over preferential creditors while reserving to the chargor freedom to deal with secured assets in the ordinary course of business. Lord Millett recognised that the charge in *Agnew* sought precisely that benefit.[53] To have reasoned then that book debts and proceeds "are not different assets" because the parties could not have intended to treat them as different assets is problematic.

Viewed in the ordinary way, the book debt-proceeds relationship and the equitable principles governing the charge contain no impediment to a charge expressed to be fixed on book debts and floating on proceeds. Lord Scott's treatment seems incapable

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[49] See *ibid*. at para. 37; *Associated Alloys*, *supra* note 11 at paras. 19–24. Note that a trust where personalty is held for A and realty for B, subject to a discretionary power for the trustee to convert realty into personalty, to A's advantage, can be valid. The analogy between that situation and the treatment of book debts and proceeds by the *Spectrum* charge also suggests that value-based arguments about charge validity are misplaced. See Nolan, "Property", *supra* note 4 at 113-114, discussing *Rich v. Whitfield* (1866) L.R. 2 Ex. 583.

[50] Nolan, "Property", *supra* note 4 at 124–135, esp. at 125.

[51] *Agnew*, *supra* note 6 at paras. 36 and 46.

[52] *Whitton v. A.C.N. 003 266 886 (in liq.)* (1996) 42 N.S.W.L.R. 123 at 145.

[53] *Agnew*, *supra* note 6. Lord Scott recognised that the *Spectrum* charge sought the same benefit: *Spectrum*, *supra* note 1 at paras. 101–104 and 108. See also at paras. 52 and 55 *per* Lord Hope; paras. 135–136, *per* Lord Walker, and, in the tax context, *MacNiven*, *supra* note 11 at para. 79, *per* Lord Hope.

of creating legal certainty on this aspect of charge characterisation. Although it has been argued that book debts and proceeds behave differently in the charge context from other contexts,[54] firm statutory or general law justification for that view has yet to be identified by its proponents.

V. Questionable Assumptions?

The final object of this note is to query three assumptions made in the *Spectrum* judgments (and much judicial and scholarly discussion in the area generally).

First, the judgments assumed that the charge in *Spectrum* avoided section 175 if effective according to its terms. That would be true if: the charge's operative terms at the time of creation gave it a fixed character; those terms afterwards ceased to be operative; and terms giving the charge a floating character then took effect. A charge of this description is a "convertible" charge, and on principles outlined earlier is not illegal. However, the *Spectrum* charge was not convertible.[55] Upon collection of the book debts, the fixed terms of the charge did not cease to operate. They continued to operate alongside the floating charge, which operated only over a different asset, the debt representing proceeds in the current account.[56] Hence the charge had both a fixed and a floating character from the time of its creation.[57]

An argument can be made that section 175 of the *Insolvency Act 1986* therefore applied to the class of assets subject to "floating" terms from the time of the charge's creation, namely the current account representing proceeds of the book debts. Parliament might not have envisaged section 175 applying to charges of this kind, so construction of the section depends on guessing what Parliament would have intended on a point not present in its mind, had the point been present.[58] But the construction suggested here seems satisfactory: it would be disingenuous to maintain that the *Spectrum* charge did not have a floating character *as to proceeds* from the time of its creation. The upshot is that, if this argument is correct and the two assumptions to be discussed below are not fatal, the House of Lords was justified in concluding that the charge on proceeds in *Spectrum* fell within section 175 *in its application to proceeds*.[59]

Next, it was assumed in *Spectrum* that a charge over a bank account is necessarily fixed if the account is blocked. Lord Walker made the more limited assumption that

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54 *Agnew*, *supra* note 6; Goode, "Charges over Book Debts", *supra* note 46 at 599.

55 *Cf. Agnew*, *supra* note 6 at para. 53.

56 *Spectrum*, *supra* note 1 at para. 108.

57 Trusts under which different asset classes are concurrently held for different classes of beneficiary have long been recognised. It is suggested that mere novelty—assuming that there is novelty—ought not to prevent recognition of a charge operating concurrently as both a fixed and a floating charge in respect of different assets or asset classes.

58 J.C. Gray, *The Nature and Sources of the Law*, 2d ed., by R. Gray (Gloucester, Mass.: P. Smith, 1972) at 173.

59 This is not to suggest that there were two distinct charges requiring separate registration under the *Companies Act 1985* (U.K.), 1985, c. 6. It is suggested that there will be two distinct charges if the parties so intend, but that in *Spectrum* there was no evidence of that intention, and no obvious attraction in creating two separate charges so as to found an inference of that intention—particularly given the consequences of non-registration. *Agnew* gives some credence to the view that parties' intentions govern the question whether one or two charges are created (*Agnew*, *supra* note 6 at para. 29), although Lord Millett also said that the answer is "a matter of personal choice" (at para. 47).

the charge was only fixed if the account was "operated as [a blocked account] in fact".[60] But either form of assumption is inconsistent with the proposition that the hallmark of a floating charge is the right of a debtor to deal with secured property free of the creditor's proprietary interest in it during the ordinary course of business.[61] If the hallmark is genuine, the character of the charge does not turn on whether the debtor can draw on the account, but whether the debtor can draw on the account *free of the security*. The creditor's equitable interest in money drawn survives unless the creditor consents to the dealing, or is met with a defence of *bona fide* purchase.[62] Hence a charge can be fixed over an *un*blocked account and characterisation turned on the wrong question in *Spectrum*. It is not doubted that the character of a charge may turn on whether a secured account is blocked if the charge so provides, but the immediate point is that there was no such term in *Spectrum*.[63]

The third assumption made in *Spectrum* was that a charge-back—an arrangement whereby an obligor in debt purports to take security over his or her obligation—operates as an ordinary charge. The *Spectrum* charge was a charge-back. On the authority of *In re Bank of Credit and Commerce International S.A. (No. 8)*,[64] the assumption of charge-back validity is good in England and Wales, meaning that the following remarks have limited importance there.[65] However, the validity of this reasoning remains open, for example, at the ultimate appellate level in Australia. Should the matter arise there or anywhere else, two questions might become important. In Hohfeldian terms (statute aside), can an individual (*e.g.*, a bank) under a duty to pay a sum of money have rights, privileges, powers and immunities in respect of the duty? Can the paucital relation in debt simultaneously be multital?[66] The received understanding of debt yields negative answers to these questions. Speaking for the Full Court of the Supreme Court of New South Wales, Jordan C.J. explained:

> If one person for valuable consideration agrees to pay a sum of money to another, this invests the creditor with a right which, as against the debtor, is a right *in personam* and not a right *in rem*; but in every other sense than that as against the debtor the right is *in personam* only, the right is a right of property, and capable of being assigned. And as against others than the contracting party the creditor has a right *in rem* to the *res* constituted by the debt.[67]

This seems to preclude affirmative answers to the two questions posed. At least for jurisdictions where the validity of the charge-back remains an open question, the affirmative answers given to these questions in *BCCI (No. 8)* are therefore highly controversial. And the validity of the charge-back is vital to the issues in *Spectrum*. If (consistently with received principle) a charge-back operates only as a contractual

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60 *Spectrum*, *supra* note 1 at para. 160, following *Agnew*, *supra* note 6, at para. 48.

61 See *Spectrum*, *supra* note 1 at paras. 102, 104, 112 and 139.

62 Nolan, "Property", *supra* note 4 at 127; Goode, *Legal Problems*, *supra* note 29 at 117.

63 *Cf. Spectrum*, *supra* note 1 at para. 55, *per* Lord Hope.

64 [1998] A.C. 214 at 227 [*BCCI (No. 8)*].

65 See McCormack, *supra* note 44 at 505–507.

66 On the terms "multital" and "paucital", see W.N. Hohfeld, *Fundamental Legal Conceptions as Applied in Judicial Reasoning*, ed. by W.W. Cooke (New Haven, Connecticut: Yale University Press, 1964). at 72ff; Penner, "Hohfeldian Use-Rights", *supra* note 47.

67 See *In the Estate of McClure* (1947) 48 S.R. (N.S.W.) 93 at 96; R.M. Goode, "Charge-Backs and Legal Fictions" (1998) 114 Law Q. Rev. 178 at 179.

set-off, a release or a covenant not to sue on a debt, as existing authority in lower Australian courts suggests,[68] there is no charge to characterise for the purposes of section 175 or equivalent legislation. On the current law, this point is not decisive for England and Wales, but it might well be decisive in jurisdictions such as Australia. Should there be a retreat from the analysis in *BCCI (No. 8)* in England and Wales, the point might well be decisive there too.

VI. Conclusion

The two-stage approach to characterisation seems correct beyond question. However, it is suggested that the application of that approach in *Spectrum* exposes real difficulties that make it unlikely the law on company charge characterisation will be settled by the decision. Several avenues have been discussed where re-agitation of points the Law Lords intended to dispose of finally may be expected. In fairness, many of the arguments criticised above are found in cases and writings pre-dating *Spectrum*, making it unsurprising that debate in *Spectrum* took the shape it did. But the concern is that uncertainty remains.

Stepping back from its intricacies, the most notable feature of debate in this area is the attempt to use general law reasoning to thwart attempts by contracting parties to avoid section 175 through sophisticated drafting techniques. The arguably radical view taken in this note is that these attempts lack a convincing foundation in generally applicable principles concerning debt, equitable doctrines, and contractual and statutory interpretation. That matters because it is *general* principles that apply in this context: the principles referred to do not operate differently in insolvency cases. It is ironic that avoidance of section 175 was sought to be redressed by treating general principles this way because the charges in *Spectrum* and some of the other cases, if valid as charges (rather than contractual set-offs, for example), did not avoid section 175 in any event: as to proceeds, it is suggested, they were floating "as created".

[68] See *e.g.*, *Broad v. Commissioner of Stamp Duties* [1980] 2 N.S.W.L.R. 40 at 46.