KEY POINTS

- Floating charges are well known for causing complex issues particularly in the context of insolvency.
- However, there is controversy as to how floating charges address excluded assets and the proceeds of realisations of excluded assets.
- Transacting parties should be cognisant of the Excluded Asset Gap – the terms of the excluded asset class may not capture the proceeds from realising an excluded asset.

Feature

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The Excluded Asset Gap: why floating charges capture realisations of unsecured assets

Will the proceeds of the sale of an asset, excluded from the scope of a floating charge, be captured by that charge when sold by an insolvency practitioner? In this article the authors consider the default position under general law in relation to this issue and what parties should do to ensure their intentions are appropriately reflected when formulating security packages.

Will the proceeds of the sale of an asset, excluded from the scope of a floating charge, be captured by that charge when sold by an insolvency practitioner? The answer turns upon the "Excluded Asset" definition in the floating charge and poses a key normative question with practical consequences for lenders, insolvency officeholders and other creditors. If the proceeds from the realisation of an excluded asset are captured by the floating charge and distributed to the debenture-holder, the value of their security will be significantly enhanced, and the effect of the exclusion of assets from the charge will be reduced considerably in insolvency. By contrast, unsecured creditors will lose out.

We suggest that there exists a poorly understood lacuna which, in principle, could entitle debenture-holders to the proceeds of assets, even where excluded from the scope of a floating charge, when sold by insolvency practitioners (the "Excluded Asset Gap"). Professional advisers should consider the Excluded Asset Gap when designing and drafting security packages. To understand how the Excluded Asset Gap arises in many security agreements, a hypothetical scenario will be posed. Using this scenario as the backdrop, this article will consider the law of floating charges and the interaction between floating charges and company assets following: (i) crystallisation; and (ii) an insolvency process. Both factors will be crucial in understanding why a floating charge can capture the sale proceeds of an excluded asset.

THE SCENARIO

Suppose a company, "NewCo", has entered into a debt financing arrangement with its lender (the Lender). The Lender requires a security package as collateral, and the parties enter into an English law-governed debenture (the Debenture). The Debenture purports to create a floating charge over all or substantially all of NewCo's assets "both present and future (including assets expressed to be charged under the Debenture)" (the Floating Charge). The parties agree to exclude from the scope of the Floating Charge certain assets, such as shares held by NewCo in a joint venture company (the Shares). NewCo enters administration. NewCo's administrators implement a transaction resulting in the sale of the Shares to a third party (the Realisation). The Shares are not captured by the terms of the Floating Charge over NewCo's assets and are defined as Excluded Assets under the security agreement. Does the Floating Charge nevertheless catch the proceeds of the Realisation?

FLOATING CHARGES: POST-CRYSTALLISATION RECEIPTS

A floating charge captures assets within a *class* of assets[1] (both present and future)[2] and allows the security provider to use those assets in the ordinary course of business.[3] A floating charge will cover property within a specified class even if assets within the class are acquired after the appointment of an administrator or where the charge has crystallised. The charge "floats above" the class of assets, allowing individual assets within that class to come and go within the scope of the charge without encumbrances.[4] Unlike a fixed charge, which binds to the underlying asset itself, it is the *class* of assets that remains subject to the floating charge; in the ordinary course of business, the underlying assets can be disposed of free of the floating charge.

It is also tolerably clear that floating charges over all or substantially all of a company's assets will capture property acquired even after crystallisation of the floating charge (and the appointment of insolvency officeholders), provided that the property falls within the class of assets as defined by the charge.[5] Crystallisation affects who has control over the disposal of the assets free of the charges, and not whether the charge captures new, future assets.

THE EXCLUDED ASSET GAP

A clause in a debenture which appears to limit the assets over which a floating charge applies will not capture the proceeds of a realisation unless the terms of the debenture extends specifically to the proceeds of any realisation, regardless of whether the realisations were made before or after the administration. When charged assets are realised, they are not necessarily treated in the same way in the security package perimeter as was their progenitor. An asset not subject to a floating charge (because it falls outside the class of assets to which the charge applies) will, when converted or exchanged so that the new asset falls within the class of assets, fall within the scope of the floating charge.

By way of example, in a grain warehousing business subject to a floating charge, the floating charge will capture purchased grain delivered to the warehouse, even where the charge has crystallised. This would be the case even though the cash used to acquire the grain came from a bank account and was excluded from the floating charge's scope. The substantive effect would be that the effective value transfer – from cash into grain – has resulted in a net gain for the floating charge holder at that given time.

This proposition is supported by authority. In *N.W. Robbie & Co Ltd v Witney Warehouse Co Ltd*, after the appointment of a receiver and manager, a company sold £1,251 worth of goods on credit to the defendants (and £852 worth of goods from the defendant's subsidiary). It was held that the debt "belonging to the company became thus assigned in equity to the debenture-holders, at times when the defendants had no cross-claim of any kind against the company and consequently no right of set-off".[6] The High Court of Australia followed the decision in *Ferrier & Australian Factors (Qld) Pty v Bottomor* (1972) 126 CLR 597, Menzies J accepting the proposition "that a deed creating a floating charge upon present and future assets does operate to charge assets coming to the company after the debenture has crystallized".[7] Thus, any cash received in the administration by NewCo will be captured by the Floating Charge even if the Floating Charge crystallised on the appointment of the administrators.

So, then, does administration change the nature of the sale of the Shares (and the receipt of cash in exchange) such that the Floating Charge is precluded from capturing the cash? In *Mineral & Chemical Traders Pty Ltd v T Tymczyszym Pty Ltd*, the Supreme Court of New South Wales addressed this question head on.[8] The defendant company had given a floating charge over its assets and undertaking to the plaintiff. The defendant sold part of its business in return for shares, and the terms of the charge were then varied so that the charge would not extend to the shares. The defendant later entered liquidation, and the liquidator sold the shares. The plaintiff claimed that the proceeds of the sale came within the floating charge. Santow J agreed: the terms of the charge expressly included future property and it was well established that "such a charge may cover future assets which come into existence after crystallisation".[9]

Three propositions can be drawn from the above case law. First, a floating charge will capture future assets whose description falls within its defined scope. Second, where an excluded asset is sold in exchange for consideration within a floating charge's scope, the consideration will become subject to the floating charge. Finally, a floating charge will capture the proceeds of an asset within its scope even after administration has commenced.

In the scenario identified above, an Excluded Asset Gap is inherent in a floating charge. An excluded asset will necessarily be excluded from the security package, but the proceeds of the realisation of that asset will, in principle, fall within the scope of the security.

SHOULD INSOLVENCY CHANGE THE POSITION?

As a matter of law, the insolvency of NewCo does not change the scope of a floating charge. Criticisms that the Floating Charge should not capture the proceeds are related to the nature of floating charges; it is insufficient to suggest that cash mixed into a general bank account would remain an Excluded Asset simply because, at some time, its value was converted from an Excluded Asset. The temporally related argument that any proceeds of Excluded Assets sold in insolvency ought to remain excluded relies on the idea that the occurrence of the administration changes the treatment of Excluded Asset proceeds. This does not reflect the law of floating charges. The actions of the NewCo administrators have – on the surface – increased the return to secured creditors at the expense of the returns provided to unsecured creditors. The secured creditors may be regarded as having received a windfall, while the unsecured creditors are deprived of an asset they reasonably considered to be unencumbered. An administration does not affect the ability of a floating charge to capture new assets acquired or exchanged in the administration. What is it, then, about administration which might change the treatment of proceeds?

In our example, as the Shares are Excluded Assets, one argument is that they should not form part of the "bucket" used to pay secured creditors. This assumes that assets which will be used to fill those buckets have crystallised – ie if an asset is unsecured at the time of administration, it can only be used to satisfy unsecured creditors. No actions by the administrators can result in that asset being re-characterised and becoming subject to a floating charge. The proceeds of a secured asset realised by the administration should remain "ear-marked" for secured creditors so that any underlying Excluded Assets remain excluded from the security.

Yet this is doctrinally incorrect. The obligation to distribute proceeds of a secured asset to the debenture-holder depends on the proprietary rights a charge holder has in the assets. Fixed Charge assets do not form part of the estate.[10] Where a creditor has a proprietary interest in an asset, and the asset is sold by an insolvency practitioner with the express permission of the secured creditor, that creditor is entitled to an account of the realisations made in respect of the asset because of their proprietary rights.[11] By contrast, the unsecured creditors hold no proprietary interest in the Shares, and their disposal does not require consent nor do their proceeds demand ear-marking. If the parties had intended to exclude *proceeds* from a floating charge, they would need to maintain the cash in a separate bank account, segregated from the company's funds.[12]

Which assets will be used to "fill" the different "buckets" for creditor classes must be determined at the distribution stage, rather than at the administrator's appointment. The fact that a floating charge may continue to operate in administration suggests that the proper time for assessing the proverbial "shape" of the relevant buckets is a matter of contractual interpretation taking place at the end or after administration, ie the relevant time for determining the contents of the floating charge is tallied on declaring a final dividend to creditors since the floating charge's scope remains subject to the priority waterfall.[13]

For interim dividends, where the Shares are sold after the interim dividend, but before final distribution, their proceeds would be subject to the floating charge despite not being subject to the floating charge at the interim stage. The floating charge would, in theory,

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continue until the floating charge creditor's claim (or the prescribed part) was fully satisfied. In the same way, the practical effect will be that any realisations by an insolvency officeholder's actions of so-called "Excluded Assets" would be captured by a floating charge.

ADDRESSING THE EXCLUDED ASSET GAP

Many English law security agreement precedents do not account for the Excluded Asset Gap and result in proceeds of Excluded Assets becoming caught by the Floating Charge. Unless an Excluded Asset definition includes words indicating the contrary, the proceeds of an Excluded Asset can – and indeed should – form part of the security interests of a lender. For instance, some debentures are defined to include "related rights" of an Excluded Asset within the class of "excluded assets" but to exclude "related rights" only insofar as they require third-party consent. That is, for the reasons discussed above, insufficient.

Given this, what should parties do to ensure their intentions are appropriately reflected when formulating security packages? Crucially, parties need to ensure that they have fully considered the consequences of insolvency on the scope of Excluded Assets. Insolvency is, after all, when that security package will matter most. If parties truly intend for assets and their proceeds to be excluded from the security package, then it will be crucial to ensure that the Excluded Asset definition is defined correctly. A good draughtsman would specify that Excluded Assets include: (i) the Shares specifically and their proceeds *irrespective* of whether the Shares require third-party consent; and (ii) any Excluded Asset realisations are paid into a specific, designated bank account which is itself defined as an Excluded Asset. Invariably, the secured lender will want the proceeds of the sale of an Excluded Asset to be caught by a floating charge, and it should therefore be incumbent upon the lender's lawyers to ensure the definition of Excluded Assets is drafted with the default position under the general law firmly in mind.

Unsecured creditors will be anxious to give Excluded Assets a broad meaning, and an unclear definition will lead many to gauge credit risk incorrectly.[14] Unsecured creditors of NewCo may argue that the sale proceeds are "related rights" of an Excluded Asset, and therefore the proceeds of the Excluded Asset would *also* be excluded. It might also be said that the proceeds of Excluded Assets realised in insolvency should remain earmarked only for unsecured creditors. This is particularly so given that the publication of security packages on the Company's Register is "intended for the protection of the creditors of an insolvent company" by providing "persons dealing with a company the opportunity to discover […] whether its assets were burdened by […] charges which would reduce the amount available for unsecured creditors in a liquidation."[15]

Insolvency practitioners should seek to assess the scope of the Excluded Asset definition at the distribution stage. Given that the Excluded Asset Gap will affect the quantum earmarked for both secured and unsecured creditors, they should consider this in advance. Along with their legal advisors, insolvency practitioners will want to understand the impact of the definition on distributions to creditors, given that their actions may disproportionately benefit the unsecured creditors *pro-rata* at the direct expense of the secured creditors who benefit from the floating charge.

CONCLUSION

The "Excluded Assets" wording in English-law security agreements often suffers from an Excluded Asset Gap: they do not always capture the proceeds of Excluded Assets. An Excluded Asset definition that does not consider the location of the proceeds of the asset will likely result in the Excluded Asset Gap occurring, which will directly benefit the lenders. Parties to security agreements and insolvency practitioners alike should closely scrutinise the drafting of the Excluded Assets definition to ensure minimal disruption when distributions occur following an insolvency event.

Insolvency practitioners should make this assessment before the distribution of the estate. If an insolvency practitioner incorrectly assumes that the proceeds of an Excluded Asset remain excluded. their decision may give rise to a claim by secured creditors regarding the loss incurred by their actions. Lenders, too, should be wary of insolvency practitioners intuitively believing that proceeds of Excluded Assets remain excluded. This will likely result in material losses in recovery by the lenders. ■

1 *Re Yorkshire Woolcombers* [1903] 2 Ch 284.
2 See *Holroyd v Marshall* (1862) 10 H.L. Cas. 191 for floating charges over future property.
3 See *Ashborder BV v Green Gas Power Ltd* [2004] EWHC 1517 (Ch).
4 This remains the case post-crystallisation where a company is in administration: see Insolvency Act 1986, Sch B1, para 70.
5 See *Lightman & Moss on The Law of Administrators and Receivers of Companies* (6th ed), at para 3-100; and *Gough: Company Charges* (2nd ed), at para 6.22.
6 [1963] 1 WLR 1324 at 1338.
7 Ibid, para 17 at p 610.
8 (1994) 15 ACSR 398.
9 (1994) 15 ACSR 398, 412.
10 See *Buchler v Talbot* [2004] 2 AC 298, [51].
11 See *Re Berkeley Applegate (Investment Consultants) Ltd (No 2)* [1988] 4 BCC 279.
12 See *Re Global Trader Europe Ltd* [2009] 2 BCLC 18.
13 See *Re Lehman Brothers International (Europe) (in administration) and others* [2018] AC 465; also see Pt 14 Insolvency (England and Wales) Rules 2016 relating to distribution to creditors in administration, winding up and bankruptcy.
14 The debenture terms should be available to unsecured creditors as a consequence of the requirement to register the charge under Pt 25 of the Companies Act 2006.
15 *Smith v Bridgend County Borough Council* [2002] 1 AC 336, 347-348 per Lord Hoffmann.

Further Reading:

- All-asset security on leveraged financings: the scope of "excluded assets" (2016) 11 JIBFL 635.
- Making the most of what you've got: how secured creditors can overcome common obstacles to recourse (2018) 6 JIBFL 367.
- LexisPSL: Banking & Finance: Q&As: Does it matter if you carve some of the assets of a company security provider out of the scope of the security package it is creating?