THE CHEQUERED HISTORY OF THE FLOATING CHARGE

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This article considers the history of secured creditors' rights in the United Kingdom through the lens of Michael Whincop's theory of the evolution of corporate law. The theory argues that, as a positive matter, nineteenth century (English) corporate law was largely a product of the judiciary in tandem with private parties, whereas twentieth century corporate law was a product of the legislature. Normatively, it suggests that nineteenth century judges were concerned with efficiency, whereas legislators in the twentieth century responded to populist calls for reform following scandals. The article argues that the history of the English law of secured credit is broadly consistent with Michael's claims. However, close scrutiny of the processes of development suggests that the positive limb of Michael's theory might be enriched by including an account of the significant contributions of transactional lawyers. Applying the normative limb, the general picture is also consistent with Michael's suggestions, but at the micro-level the superiority of judicial over statutory law-making turns out to be less than clear-cut, with each having — as might be expected — particular areas of comparative (dis)advantage.

Introduction

One of Michael's most pathbreaking contributions was his analysis of the evolution of corporate law.[1] His arguments are multi-faceted, but a central focus was on the nature of the *institutions* that drove the development of corporate law. Adopting a standard maxim of economic analysis, Michael began from the premise that the utility functions of the legislators would dictate the form of the resulting laws. This is clearly the case in the United States, where corporate law is left largely to the states and legislative incentives are driven by 'regulatory competition'. That is, state law-makers, responding to the possibility that corporations may change their jurisdiction of domicile if the relevant laws do not meet their needs, 'compete' to offer the most business-friendly packages. In Australia and the United Kingdom, no such competitive forces have historically prevailed, and so a micro-level

* Faculty of Law and Centre for Business Research, Cambridge University. This article is dedicated to the memory of Michael Whincop, whom I was privileged to know as a co-author and friend. I am grateful to Riz Mokal and to an anonymous referee for helpful comments on an earlier draft. The usual disclaimers apply.

1 Whincop (2001), esp Chs 1, 3 and 6. See also Armour (2002) (review of Michael's book).

inquiry into the processes of corporate law-making and the incentives of its constructors was called for.

Michael's analyses of *processes* suggested that, broadly speaking, nineteenth century (English) corporate law was largely a product of the judiciary in tandem with private parties, whereas twentieth century corporate law was a product of the legislature. Moreover, he argued that the *incentives* of these respective groups differed widely. Judges in the nineteenth century were concerned with efficiency, whereas legislators in the twentieth century (unconstrained by regulatory competition) were not; rather, they responded to populist calls for reform following scandals. Michael applied this thesis to most of the substantive corpus of corporate law — the corporate entity, directors' duties, shareholders' rights and remedies, and the maintenance of capital. One substantive area on which Michael's account was a little thin, however, was the regulation of debt finance — in particular, the law of secured transactions and corporate insolvency.[2] This article seeks to apply the thesis to the area of secured creditors' rights. It takes as a case study the development of the English law of secured credit and corporate insolvency.[3]

The rest of this article is organised as follows. Consideration is first given to the *positive* limb of the thesis, as applied to the development of the floating charge and its impact on corporate insolvency. That is, it considers the *processes* by which the law developed, and the *constraints* and *incentives* faced by those making the law. The history of the development of this area of law is broadly consistent with Michael's claims, dividing readily into periods of 'judicial' and 'legislative' law-making. However, close scrutiny of the processes of development suggests that Michael's theory might be enriched by including an account of the significant contributions of transactional lawyers. Subsequently, consideration shifts to the *normative* part of Michael's claim — namely, that judicial law-making tends to produce more efficient results than the legislature. Once again, the general picture appears consistent with Michael's suggestions, but at the micro-level the superiority of judicial over statutory law-making turns out to be less than clear-cut, with each having — as might be expected — particular areas of comparative (dis)advantage. The final section offers a brief conclusion.

The Evolution of Secured Creditors' Rights

The Nineteenth Century

The advent of the corporate form saw business creditors faced with new hazards. Shareholders, shielded by limited liability, were able to carry on business with reduced risk consequent on corporate failure. In response, the activities to which they were able to put the corporate assets were always

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2 More generally, as an Australian, Michael may not have appreciated the significance of the shift, in recent years, of legislative power from Westminster to Brussels. The European dimension is arguably a 'third phase' of English corporate law, not accounted for in Michael's study.

3 Unlike Michael, the author is unable to demonstrate familiarity with both English and Australian law.

subject to regulation designed to ensure that moral hazard did not worsen the creditors' position. On the one hand, the doctrine of *ultra vires* limited the activities in which corporate assets could be employed to those set out in the company's objects clause.[4] On the other, the doctrine of maintenance of capital banned shareholders from transferring their long-term investments back to themselves during the ongoing life of the company.[5] However, neither was an effective means of protecting creditors. Both were rules of the 'one-size-fits-all' variety, and thus unsuitable to providing meaningful protection across the wide spectrum of businesses that utilised the corporate form.[6]

At the same time, creditors were creating protection for themselves. They sought to take security interests over ever-increasing parcels of corporate assets, so as to maximise their insulation against the possibility of default. The first step was the recognition by courts that an equitable charge might validly be granted over future assets.[7] It became common by the mid-1860s for limited companies to grant debenture holders a charge over the 'entire undertaking and sums arising therefrom' of the company.[8] The potential drawback of such a security was that it was an implied term of most charging agreements that the chargor should not be free to dispose of the charged assets without the chargee's consent. This would have the effect of paralysing the business of a company granting an all-encompassing security.

The judiciary, when first called upon to interpret the meaning of such charges, construed them so as to avoid such an impractical result. The first case in which the question was discussed was *Re Panama, New Zealand and Australian Royal Mail Co*,[9] in which Sir George Giffard LJ put the matter as follows:[10]

> I take the object and meaning of the debenture to be this, that the word 'undertaking' necessarily infers that the company will go on, and that

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4 *Ashbury Railway Carriage and Iron Co Ltd v Riche* (1875) LR 7 HL 653.

5 *Re Exchange Banking Co (Flitcroft's Case)* (1882) 21 Ch D 518; *Trevor v Whitworth* (1887) 12 App Cas 409.

6 See generally Cheffins (1997), pp 526–37; Armour (2000); Armour (2003), pp 285–86. The doctrine of *ultra vires* has now, for most practical purposes, been abolished: First Company Law Directive (68/151/EEC); *Companies Act 1989*, inserting new ss 35–35B into the *Companies Act 1985*. If reform pronouncements are followed through into legislation, it would appear that the doctrine of capital maintenance will go the same way: see, for example, EC Commission Communication 'Modernising Company Law and Enhancing Corporate Governance in the EU — A Plan to Move Forward' COM (2003) 284 Final (21 May 2003) (reform of capital maintenance rules in Second Company Law Directive 'a priority').

7 *Holroyd v Marshall* (1862) 10 HLC 191; *Tailby v Official Receiver* (1888) 13 App Cas 523.

8 On the development of the floating charge, see Curtis (1941); Pennington (1960); Nolan (2004) pp 120–23.

9 (1870) LR 5 Ch App 318.

10 (1870) LR 5 Ch App 318 at 322.

> the debenture holder could not interfere until either the interest which was due was unpaid, or until the period had arrived for the payment of his principal, and that principal was unpaid. I think the meaning and object of the security was this, that the company might go on during that interval, and, furthermore, that during the interval the debenture holder would not be entitled to any account of mesne profits, or of any dealing with the property of the company in the ordinary course of carrying on their business. I do not refer to such things as sales or mortgages of property, but to the ordinary application of funds which came into the hands of the company in the usual course of business. I see no difficulty or inconvenience in giving that effect to this instrument ...

In a recent article, Richard Nolan has carefully charted the early development of the floating charge from an iterative relationship between transactional lawyers drafting loan agreements and judges called upon to enforce them.[11] At first, it was common for parties to insert an express clause stipulating that the company should be free to deal with the charged assets until some future event, such as default on the debt secured, winding-up or cessation of business. Over time, the courts became more familiar — and comfortable — with the notion of a charge coupled with the reservation of such a power, so that the existence of a power of this sort could readily be implied from the grant of a security over 'all the property' of the company.[12] Within 20 years, the term 'floating charge' had come to be used as shorthand for a security comprising this package of rights and powers, and express 'powers to deal' ceased to be used in charging agreements.[13]

Michael argued that the nineteenth century judiciary, called upon to interpret the then-new law of companies, applied older legal concepts such as trust and fiduciary duties by analogy, refashioning them in the process to suit the different circumstances of business.[14] A similar process can be seen at work in the law of debt finance, with the old 'forms' of property law — the charge and mortgage — being applied to the new context of corporate finance, adapted so as to flesh out the features of the 'floating charge' over the next 30 or so years. Thus it was established that the chargor was free to deal with the charged assets in the ordinary course of business, until something happened that would cause the charge to 'crystallise' — that is, to convert to a specific or fixed charge. It was determined that cessation of the chargee's business, the

11 Nolan (2004), pp 120–23.

12 *Re Florence Land Co* (1878) 10 Ch D 530; *Re Colonial Trusts* (1879) 15 Ch D 465. Related landmarks were (a) the finding that the (personal) bankruptcy doctrine of 'reputed ownership' did not apply in company liquidations (*Re Crumlin Viaduct Works Co* (1879) 11 Ch D 755), for a floating charge would surely have been liable to challenge thereunder had it done so; and (b) the decision that company charges were not registrable under the *Bills of Sale Act 1878*, the requirements of which would have made floating security impossible: *Re Standard Manufacturing Co Ltd* [1891] 1 Ch 627.

13 Nolan (2004), pp 123–24.

14 Whincop (2001), pp 26–35, 71–73, 200–201.

making of a winding-up resolution or order, or the appointment of a receiver, would all amount to crystallising events. Until cessation, the chargee's rights were subject to sales,[15] executions[16] and grants of specific security in the ordinary course of business[17] — although not to a sale of the entirety of the company's assets.[18]

A subsequent and closely related development was the institution of contractual receivership. Again, this can be seen — consistently with Michael's thesis — as the application and refashioning of an older legal concept to a new context. Traditionally, a receiver was a party appointed on a petition to the court of Chancery to oversee the income arising from mortgaged property. However, it became common for parties — as had long been the case with mortgages of land — to stipulate in the debenture that the chargee should, on default by the chargor, be entitled to appoint a receiver out of court. Thus the chargee would be entitled to appoint a receiver very rapidly on default, and since the events constituting 'default' were a matter for the loan agreement, this gave the chargee considerable leverage over the debtor company. It also became common for parties to stipulate that a receiver appointed under such a contract would be the agent of the company.[19] In a crucial development, the Court of Appeal in *Re Henry Pound* held that a debenture-holder was entitled to exercise a contractual power to appoint a receiver, notwithstanding that the company had already gone into winding-up.[20] Where, as had become common by the end of the nineteenth century, the debenture holder's security covered the entirety of the company's undertaking, then the receiver, as agent of the company, was able to continue to trade and effect sales of the business assets as a going concern where possible.[21]

The floating charge and contractual receivership were two linked institutions that both developed through the recognition by the judges of the day of the value of allowing parties freedom to modify their allocations of proprietary rights. These developments are consistent with the positive aspect of Michael's thesis as to the judiciary's role in the development of company

15 *Re Florence Land Co* (1878) 10 Ch D 530 at 541.

16 *Evans v Rival Granite Quarries Ltd* [1910] 2 KB 979.

17 *Re Automatic Bottlemakers Ltd* [1926] 1 Ch 412. The chargee does not, however, have power to grant equal-ranking general *floating* charges: *Re Benjamin Cope Ltd* [1914] 1 Ch 800.

18 *Taylor v M'Keand* (1880) 5 CPD 358 at 360; *Hubbuck v Helms* (1887) 56 LJ Ch 536; *cf. Re Borax Co* [1901] 1 Ch 326.

19 It is commonly said that making the receiver the company's agent was a device used to avoid the chargee being deemed to have gone into possession (which would be the case were the receiver the chargee's agent) and thereby facing liability on the basis of 'wilful default' if the assets are not managed so as to maximise the income: *Gaskell v Gosling* [1896] 1 QB 669 at 692–95. However, it appears that another motivation was the mortgagee's desire to avoid being made liable to third-party creditors as principal for the debts of the business: see *Gosling v Gaskell* [1897] AC 575.

20 (1889) 42 Ch D 402.

21 See *Gaskell v Gosling* [1896] 1 QB 669 at 700.

law. However, the story of their development over time reveals the significance of transactional lawyers, whose innovation in drafting was a crucial part of the process. Michael's analysis of the development of 'judge-made' law seems to assume that judges take the lead in 'adapting' existing bodies of law so as to facilitate private contracting, whilst at the same time private parties optimise their contractual terms immediately. Thus he suggests:[22]

> Judges have used analogy as a device to balance formal conservatism with instrumental justifications in the development of new bodies of doctrine.

However, a close look at a case study such as secured credit suggests that the development of the law was driven, at least in part, by innovation on the part of transactional lawyers that was 'encoded' and 'replicated' through precedents by the judiciary.[23] Thus the process of development is more *reflexive*, involving repeated iterations between judges and drafters acting as 'transaction cost engineers'.[24] This oversight is surprising, for Michael's own empirical work had revealed the considerable importance of precedent manuals in determining the content of standard form corporate contracts.[25] His theory can be enriched by linking these two themes together.

Another aspect of Michael's analysis was his claim that the judiciary possessed a keen awareness of the informational limitations faced by the court, and the comparative advantage of business people when it came to business decisions.[26] This, he suggested, led naturally to the courts favouring 'passive' enforcement strategies — those whereby the court simply allocates the *power to make a decision* to one of the parties, rather than actually *prescribing the mode of acting*.[27] The same explanation can be applied *mutatis mutandis* to transactional lawyers drafting contracts. It appears that the floating charge is precisely such a device, in reality giving decisional rights to the secured lender as to how the company will deal with its assets and how future projects will be financed. This control is exercised every time the company wishes to make a sale of assets otherwise than consistently with the terms of the charge, or to borrow otherwise than subordinated to the secured creditor. Needless to say, contractual receivership fits this pattern as well.[28]

Appreciating the significance of transactional lawyers in the development of commercial law does not, however, imply that the judiciary's role was non-existent. In particular, another idea found in Michael's work — one which can usefully be developed in this context — was the importance of the judicial role

22 Whincop (2001), p 200.

23 Franks and Sussman (1999); Deakin (2003).

24 Gilson (1984).

25 Whincop (2002, 2003).

26 Whincop (2001), pp 35–37, 198–99.

27 Schwartz (1992); Schwartz and Scott (2003).

28 A point that is, in fact, made by Michael himself: Whincop (2001), p 190.

in *allowing* proprietary rights to be made contractible by private parties. The contractual form of the agreements between companies and debenture-holders should not be allowed to obscure the fact that these agreements involved allocations or modifications of *proprietary rights* as between the parties, and thereby affected third parties as well — in particular, the unsecured creditors of the corporate debtor. There was no necessary or inexorable logic that led the judiciary to conclude that these arrangements should be upheld — indeed, in many other jurisdictions, arrangements similar to the floating charge would either be ineffective to create proprietary rights, or be struck down as fraudulent conveyances.[29] By giving proprietary effect to these agreements, the judiciary of the day allowed parties to achieve outcomes — in terms of the patterns of entitlements created in relation to the corporate assets — that would not have been possible for them to create by simple contract.[30]

The Twentieth Century

Michael argued that, in the twentieth century, the pattern of law-making changed. By then, enough precedents had accumulated on corporate law for the doctrine of *stare decisis* to impose real constraints on judicial freedom of action. The growth of this 'legal coding' of earlier knowledge meant that those specialising in corporate law had at once more law to learn, yet less time to think about its implications for commerce. As a result, the time for judicial innovation had come to an end.[31] The baton for the development of corporate law was passed on to the legislature. Michael suggested that, in jurisdictions not characterised by regulatory competition, this shift tended to result in the enactment of inefficient rules of corporate law, driven by populist concerns or interest-group lobbying.[32]

The 'twentieth century' described in this section is slightly elongated, starting in 1897 and running through to 2002. This, however, is the period within which the significant statutory reforms relating to secured creditors' rights took place. They were bunched in two sets of enactments, one on and around the turn of the nineteenth to twentieth centuries, and the other 100 years later.

The nineteenth century judiciary were at first sanguine in their consideration of the position of unsecured creditors when a floating charge was in place. The treatment of the floating charge as conferring proprietary rights necessarily resulted in the chargee taking precedence over the claims of

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29 See *Zartman v First National Bank of Waterloo* 189 NY 267, 82 NE 127 (1907); *Benedict v Ratner* 268 US 353 (1925) at 359–61. All-encompassing security interests, in the form of the 'floating lien', were introduced to the United States in the 1940s under the Uniform Commercial Code: UCC §§ 9-204, 9-205, 9-306. Scotland is another example of a jurisdiction where floating charges were introduced by statute (*Companies (Floating Charges) (Scotland) Act 1961*) after an initial rejection at common law.

30 Hansmann and Kraakman (2000); Armour and Whincop (2002).

31 Whincop (2001), pp 199–200.

32 Whincop (2001), pp 15–16, 93–96.

unsecured creditors in winding-up. The judicial response was that it was the unsecured creditor's responsibility to take steps to check whether or not security had been granted. As Malins V-C put the matter in 1876, in *Re General South America Co*:[33]

> a person dealing with a company knows also its powers of borrowing, and that the company has power to pledge every part of the property of the company ... Now if the creditors had been told that every particle of the property of this company was pledged to secure £72,000, could they have complained? And were they not told all this by the fact of its being a limited company? Were they not bound to make all these inquiries? The very policy of the *Winding-up Act* was that all persons dealing with a company should have notice of the extent to which the company could create liabilities, and of everything connected with them, and therefore these creditors were precisely in the same situation as if they had been told so in so many words.

However, less than 25 years later, Lord Macnaghten issued the first judicial call for legislative intervention to 'redress the balance' in favour of the unsecured creditors. Considering the position of the unsecured creditors in *Salomon v A Salomon & Co Ltd*:[34]

> For such a catastrophe as has occurred in this case some would blame the law that allows the creation of a floating charge. But a floating charge is too convenient a form of security to be lightly abolished. I have long thought, and I believe some of your Lordships also think, that the ordinary trade creditors of a trading company ought to have a preferential claim on the assets in liquidation in respect of debts incurred within a certain limited time before the winding-up. But that is not the law at present. Everybody knows that when there is a winding-up debenture-holders generally step in and sweep off everything; and a great scandal it is.

Here, then, is the first overt recognition that the judiciary were starting to feel that their hands were tied by precedent and practice. If change were to be made, it would be for the legislature to ordain it.

Change was not long in coming. The *Preferential Payments in Bankruptcy Amendment Act 1897* provided that the statutory scheme of preferential debts, already payable in priority to the claims of unsecured creditors, should now be payable in priority to any property comprised in or subject to a floating charge.[35] The preferential debts consisted of a congeries of claims that had been in various enactments granted statutory priority, including

33 (1876) 2 Ch D 337 at 341–43.

34 [1897] AC 22 at 53. This was a particularly egregious case from the unsecured creditors' point of view, as Salomon not only incorporated his business but also took a debenture over its assets, ensuring that on the company's insolvency his assigns scooped the pool of what little it contained.

35 *Preferential Payments in Bankruptcy Amendment Act 1897*, s 2.

obligations to pay employees' wages, pension contributions and holiday pay, certain rates and various claims of the Crown in respect of unpaid tax.[36] Shortly afterwards, the *Companies Act 1900* introduced a requirement for floating (and other) charges granted by a company to be registered, or be set aside at the instance of a liquidator.[37] The intention of Parliament was to ameliorate the position of both unsecured *and* secured creditors by providing a mechanism whereby those dealing with the company would be better informed.[38] Finally, the *Companies Act 1907* introduced a provision whereby a floating charge granted within a 'twilight period' shortly prior to the commencement of winding-up proceedings, otherwise than for new money, might be set aside by a liquidator.[39]

There was then a lengthy period during which little change was made to the law relating to floating charges. Towards the end of the twentieth century, the structure of English insolvency law was reviewed by the Cork Committee, prior to a major overhaul of the legislation in 1985. The Cork Report gave a generally positive review of the role played by the floating charge, noting that it was a well-established feature of corporate finance, and that the institution of receivership was very quick and effective as a mechanism for achieving a going-concern sale of business assets.[40] Indeed, so valuable did the Committee consider the institution of receivership that it recommended the creation of a new procedure, 'administration', to fulfil a similar function in relation to companies which did not have a floating charge.[41]

A controversial further recommendation, which was not implemented at that time, was that Lord Macnaghten's suggestion should be taken up, and that a proportion — 10 per cent — of the floating charge recoveries should be set aside for the benefit of the unsecured creditors.[42]

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36 See generally, Insolvency Law Review Committee (1982), Ch 32; Keay and Walton (1999). The legislature had long provided for statutory priority for certain payments to employees over unsecured creditors. This was first introduced by the *Bankruptcy Act 1825*, s 48, for personal bankruptcies, which protection had been extended to corporate insolvencies by the *Companies Act 1883, s 1*. However, the decision in *Richards v Overseer of Kidderminster* [1896] 2 Ch 212 made clear that an all-encompassing floating charge might prevent any payment being made even to preferential creditors, let alone ordinary unsecureds. The 1897 Act was a direct response to this decision.

37 *Companies Act 1900*, s 14. See generally Bennett (2003a), pp 218–19.

38 *Hansard*, HC Deb (4th Series), vol 84 (1900) at 1141. See also *Re Jackson & Bassford Ltd* [1906] 2 Ch 467 at 476; *Re Yolland, Husson & Birkett Ltd* [1908] 1 Ch 152 at 156; *Smith v Bridgend County Council* [2001] 3 WLR 1347 at 1354.

39 *Companies Act 1907*, s 13. The 'twilight period' was initially three months, but in subsequent legislation was extended to a year: see now *Insolvency Act 1986*, s 245(3). See generally Bennett (2003b), pp 183–84.

40 Insolvency Law Review Committee (1982), Chs 8 and 36.

41 Insolvency Law Review Committee (1982), Ch 9.

42 Insolvency Law Review Committee (1982), paras 1538–49.

Now fast forward 15 years. In 1999, a review of business rescue mechanisms was jointly commissioned by the DTI and the Treasury.[43] This diagnosed that the lack of accountability of floating charge holders was a significant obstacle to successful corporate rescues, and the subsequent White Paper prescribed a program of reforms.[44] The *Enterprise Act 2002* made two pertinent sets of changes.[45] First, it prospectively abolished the right of a floating charge holder to appoint an administrative receiver.[46] Instead, the holder of a 'qualifying' (all-encompassing, or nearly all-encompassing) floating charge is entitled to appoint an administrator out of court almost immediately.[47] The administrator does, however, owe duties to act in the interests of all creditors, and must pursue a statutorily prescribed hierarchy of objectives.[48] Second, it abolished the Crown's entitlement to preferential status, and instead created a version of the '10 per cent' fund envisaged by Cork. A 'prescribed part' of the floating charge recoveries (net of preferential payments) must be set aside for the unsecured creditors.[49]

Were these statutory reforms driven, as Michael argued, by interest-group politics and populist legislative agendas? Evidence as to the early reforms is impressionistic, but the pattern of the late twentieth century insolvency policy-making is certainly not inconsistent with his claim. Consider first the gestation of the 1985–86 legislation. It appears that, whilst the possibility of reform of the floating charge was considered by policy-makers, banks (who primarily benefited from the institution) were able to coordinate very effectively in lobbying the government of the day, and thereby see off any further retrenchment of these facilities.[50] However, over the course of the next 15 years, the political discourse changed. A recession in the early 1990s left many with the impression that banks were 'trigger happy' with the appointment of receivers,[51] closing good businesses too readily. Moreover, in 1997 the government changed. The 'New Labour' government's policy agenda was targeted very carefully at the preferences of marginal voters. A theme running

43 Insolvency Service (1999, 2000).

44 Insolvency Service (2001).

45 See generally Mokal (2001), pp 616–19; Finch (2003); Frisby (2004); Armour and Mokal (2004).

46 *Insolvency Act 1986*, s 72A, inserted by Enterprise Act 2002.

47 *Insolvency Act 1986*, Sch B1, para 14.

48 *Insolvency Act 1986*, Sch B1, para 3.

49 *Insolvency Act 1986*, s 176A, inserted by *Enterprise Act 2002*. The prescribed part has initially been set at 50 per cent of the first £10 000 of floating charge assets, plus 20 per cent thereafter up to a total prescribed part of £600 000.

50 Carruthers and Halliday (1998).

51 See, for example, 'Act of Goodwill', *Financial Times* 8 October 1996; '"Greedy" Banks Come Under Fire', *Cambridge Evening News* 13 August 1999; 'How "Rip-off" Receivers Cash in on Carve-ups', *Evening Standard* 25 November 1999. See also *Hansard*, HC Debs vol 298, col 299 (15 July 1997) (Austin Mitchell MP); *Hansard*, HL Debs vol 596, cols 942–51 (26 January 1999); Grylls (1994); Milman and Mond (1999).

through much of the program was an emphasis on ensuring *accountability* — or at least the generation of highly visible mechanisms designed to ensure this. Hence the heavy emphasis on accountability in the *Enterprise Act 2002* can be understood as the product of these political forces.

This section has shown that the history of the development of the floating charge and its impact on corporate insolvency is largely consistent with Michael's positive and institutional claims. The only significant exception is the way in which Michael appears to have overlooked the role played by transactional lawyers. Nevertheless, as has been suggested in the text, it is possible to integrate this with his claims to produce a richer version of his thesis.

The Efficiency of Secured Creditors' Rights

We now address the *normative* limb of Michael's claim, namely that the commercial intuitions of the judiciary led them towards decisions that were on the whole efficient, whereas the legislature's tendency to 'promise everything' to voters consistently led statutory reforms to be unwieldy in their implementation. 'Efficiency' is used in a *comparative* sense — that is, it implies that a world with the legal rule in question has lower net social costs than a world without it; or, to reverse the proposition, that the addition of the legal rule generates net social benefits compared with the pre-existing position.[52] A normative concern with efficiency does not, of course, imply that this is the sole, or even the most significant, criterion for evaluating legal rules.[53] Yet it is nevertheless often a useful starting point for the assessment of commercial law rules. Inefficient rules will be likely to be *futile*, for well-advised commercial parties will simply attempt to structure their affairs so as to avoid their impact. Moreover, whatever goals are thought to be ultimately socially desirable, efficient legal rules will permit them to be achieved to a greater extent than inefficient rules.

Was the late nineteenth century position, after the judicial recognition of the floating charge and the associated institution of contractual receivership, efficient? What was the impact of the legislative changes implemented during the 'twentieth century'? In answering these questions, we are fortunate to be able to draw upon a considerable literature on the putative efficiency of security. Several aspects of it are relevant to the question in hand. This section will consider benefits and costs respectively, in each case differentiating between the judicially facilitated system of the nineteenth century and the statutorily regulated system that followed it.

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52 That is, a form of so-called 'Kaldor–Hicks' efficiency.

53 Nor was Michael's work so narrowly concerned: his scholarship sought to extend the frame of reference of the 'law and economics' literature by considering too the distributional impact of legal rules. See, for example, Whincop (1999).

The Nineteenth Century Position

As we have seen, the position attained by the end of the nineteenth century permitted a company to grant a security interest to a single creditor covering the entirety of its assets, which creditor might then be entitled, upon default by the company, to appoint a receiver over the assets to the exclusion of a liquidator. This arrangement brought both benefits and costs.

Efficiencies in Enforcement. The appointment of a receiver over the entirety of the assets of a company might be a useful means of resolving the costs of collective action as between corporate creditors. The collective action problem facing creditors of a financially distressed debtor was famously analysed by Jackson.[54] A rational creditor whose debtor is in default has the option to commence execution proceedings against the debtor's assets. Alternatively, they might delay and attempt to renegotiate. If the creditor does not execute, then other creditors might. It may only take collection by a single creditor to force the debtor to sell assets needed for carrying on the business and hence to cease trading. Thus, if any other creditor is likely to collect, then each individual creditor is privately best off by collecting too, as there will necessarily be fewer assets available to satisfy the creditor's claim if they try to negotiate. Hence, unless all creditors can credibly agree not to exercise individual collection remedies, then each creditor's best strategy will be to collect immediately. 'Races to collect' provoked in this way can lead to the dismemberment of businesses that may be viable prospects for rescue. Moreover, it leads to the imposition of costs on the creditors as a group.[55]

The holder of the floating charge had, through their right to appoint a receiver, the ability to *control* the entirety of the company's assets in the event of a default. Where the bringing of execution or insolvency proceedings by any other creditor is defined as an event of default, then the secured creditor's right to take possession and to orchestrate the deployment of the assets in question can function as a solution to a prisoner's dilemma problem which would otherwise exist.[56] Where the security interest covers the entirety of the debtor's assets, as with a floating charge, then any going concern value of the debtor's business can be preserved from dismemberment through individual creditor enforcement. Hence receivership, usually thought of as a private enforcement

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54 Jackson (1982).

55 First, the game is costly to play: each creditor will want to monitor the debtor, and/or the behaviour of the other creditors, so as not to be last in the 'race to collect' when precipitated. This monitoring will be costly. Second, the overall returns available to the creditors may be reduced. Any going-concern surplus will be destroyed by the dismemberment of the debtor firm's business as assets are seized by many different creditors. The debtor's business may also be forced to cease trading prematurely as a result of such a race. Third, there will be an unnecessary duplication of administrative costs. The pursuit of individual collection proceedings will involve separate legal proceedings being brought by each creditor.

56 Picker (1992); Buckley (1994).

mechanism, might generate benefits for creditors in general by cutting down the costs of a 'race to collect' that might otherwise ensue.[57]

Policing Debtor Misbehaviour. A second alleged benefit is that the standard debenture 'package' is a useful means of minimising the risk that a corporate borrower will engage in excessively risky behaviour. Corporate shareholders, enjoying limited liability, can benefit where a firm borrows at a fixed interest rate and then alters its investment or financing policies so as to increase the riskiness of its returns.[58] This could be effected by liquidating assets either to pay extraordinary dividends ('liquidating dividends') or to purchase assets for use in high-risk projects ('asset substitution').[59] A similar effect can be achieved by increasing the firm's gearing by increasing borrowing levels ('debt dilution'). Such transfers are inefficient where the transaction has a negative impact on the firm's total value, and is chosen simply because the creditors are expropriated to a sufficient degree to make the process attractive to shareholders.[60]

Lenders exert influence over management at two points in time: first, when they make a credit decision and set the terms of a loan; and second, when they decide whether or not a default has occurred. The concept of 'default' can be extended beyond the mere non-payment of sums due by using 'loan covenants'. These can specify that any of a host of activities which might harm lenders' interests shall constitute a default. The use of loan covenants allows creditors to apportion the control and scrutiny functions amongst themselves in an efficient way.[61] Consider, for example, a 'negative pledge' — one of the most common covenants — by which a borrower promises not to issue any subsequent debt with a priority rating equal or superior to that of the initial lender. If a firm with such a covenant raises external finance for a new project, the new financier (be they debt or equity) will thereby bear all the additional risk which the project generates.[62] If they are rational, they will insist on credible evidence from management about the effects of the project on the firm's value, and price the terms of their investment accordingly.

57 Buckley (1994); Armour and Frisby (2001).

58 Jensen and Meckling (1976); Smith and Warner (1979a); Barnea et al (1985).

59 An empirically plausible context in which this might take place is a troubled firm liquidating tangible assets of stable value to fund risky assets such as employee hours.

60 Where it causes the firm to invest in a project with a negative net present value, this effect is known as 'over-investment' (see, for example, Berkovitch and Kim, 1990) An allied problem is the so-called 'under-investment' effect (Myers, 1977). This occurs where a firm with growth options (which are firm-specific and only open for a short period of time) has 'debt overhang' — that is, it is balance sheet insolvent. Under these circumstances, if new equity investment is required to ensure that the growth potential is exploited, then it will not be forthcoming since the returns to fresh investment from equity will be negative.

61 Schwartz (1989, 1997).

62 The new financier's expected return cannot be greater than the firm's value (after incorporating the effect of the new project) minus the promised return to the prior lender.

Alternatively, management might seek to renegotiate the terms of the original loan.[63]

Given that firms can write loan covenants, the efficiency of secured credit as a means of reducing agency costs is a function of its advantages over and above loan covenants.[64] To understand this in relation to the floating charge, it is necessary to include the institution of contractual receivership in the picture.[65] As enforcement is non-judicial, the use of security removes the need to *verify* a breach of covenant to the court.[66] Coupled with the control given to the creditor on enforcement, this means that the debenture holder is able *credibly* to *threaten* to enforce against the debtor — and thereby remove the board from office with certainty — if misbehaviour occurs.[67] Provided the creditor monitors the debtor's activities effectively, then the standard debenture package will give its holder considerable leverage over the debtor's decision-making. By threatening the debtor's management with dire consequences, an appropriately informed creditor can minimise financial agency costs — which will in turn create positive externalities for other creditors.

Economies of Specialisation. A third possible efficiency associated with the use of secured credit concerns economies of specialisation. Where the cost of acquiring information about the debtor's behaviour varies between creditors, then savings may be generated by the appropriate allocation of rights of priority and control enjoyed by secured creditors. Similar efficiencies from relative creditor enforcement ability may also be captured through the use of secured credit.[68]

Early theories focused on the use of rights of *priority* to capture comparative advantages in monitoring ability. Jackson and Kronman[69] claimed

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63 See Hart (1995), pp 126–51. An alternative technique for financing subsequent projects is through the sale of assets associated with existing projects. Once again, this can be prohibited through the use of loan covenants restricting dispositions of the firm's assets.

64 Schwartz (1989, 1997); Mann (1997).

65 The ordinary explanation for the superiority of secured credit over contractual loan covenants is that taking security is like a 'self-enforcing' loan covenant (Schwartz, 1997). Thus, should the borrower attempt to finance a second project by liquidating existing assets, a security interest will ensure that the original lender retains its priority to the assets in the hands of a purchaser (Smith and Warner, 1979b). This explanation does, however, seem less than complete in relation to the floating charge. As we have seen, the essence of this security is that prior to crystallisation the chargee is *free* to sell the charged assets. Of course, these sales may only be made in the ordinary course of business, and so unusual, or 'bet-the-company' transactions that dramatically increase the riskiness of creditors' loans might be restricted.

66 Schwartz (1997), p 1413; Scott (1997).

67 For judicial recognition of this dynamic, see *Oakdale v National Westminster Bank plc* [1997] 1 BCLC 63.

68 Triantis (1992), pp 245–47.

69 Jackson and Kronman (1979)

that, by reducing — *ceteris paribus* — the risk borne by the secured creditor, priority reduces the amount the secured creditor need spend on monitoring the debtor's actions in order to achieve a given level of return. This, they argued, could reduce the total expenditure by creditors on monitoring the debtor, where some creditors have a comparative advantage in monitoring the debtor's business generally. Consequently, if some creditors have a comparative disadvantage in acquiring general information about the debtor's actions, then it is efficient for those creditors to be generally secured — that is, through the use of a wraparound security interest such as a floating charge.

If the focus of attention is returned to the *control* aspects of security, discussed in the previous section, then the way in which 'general economies of specialisation' might be captured appears to cut in precisely the opposite direction — that is, *good* general monitors and enforcers might be expected to take a floating charge. Recall that such a general wraparound interest gives the chargee significant rights of control — in particular the ability, through using the threat of enforcement, to influence the debtor's decision-making and thereby to control financial agency costs. Such powers would be most valuable to a creditor who was able to make best use of them — an arrangement which would also produce positive externalities for other creditors.[70] This seems to explain much better the empirical regularity with which banks (who are good monitors) take all-encompassing security in the form of floating charges.

Thus a focus on priority rights suggests that floating charges would be taken by poor monitors, whereas a focus on control rights suggests that good monitors would take this type of security. In fact, floating charges are typically taken by banks,[71] who are generally good monitors.[72] It therefore appears that, at least with respect to floating charges, control rights are in practice more significant than priority rights, and that the pattern of banks taking floating charges thus grants control rights to the party best able to make use of them to police debtor misbehaviour.

To summarise the position so far: it is arguable that the judicially developed institutions of the floating charge and receivership generated benefits in terms of enforcement costs and, provided that they were allocated to a creditor with superior monitoring ability, could result in a lowering of *overall* monitoring costs. However, the leverage accorded the debenture holder derived more from the threat of enforcement than from the priority status accorded to their security.[73]

Rent-seeking and Priority. Whilst it may be argued that the introduction of the floating charge brought a number of efficiencies, it is strongly arguable that Lord Macnaghten's intuitions were at least partially correct — that is, it created externalities for unsecured creditors. Because the judiciary interpreted the floating charge as a property right, it necessarily implied that the chargee had priority to the unsecured creditors in the chargor's insolvency. Where the

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70 Armour and Frisby (2001), pp 87–88.

71 Armour and Frisby (2001).

72 Franks and Sussman (2000).

73 Mokal (2003).

unsecured creditors had extended credit prior to the grant of the charge, or were not aware that a charge had been granted, then they would not have been able to adjust the terms of their extensions of credit to reflect the increased risk they were bearing.

This would give debtors a perverse incentive to grant excessive security in order to be able to redistribute wealth (in an expected-value sense) away from unsecured creditors to themselves. The most acute version of this problem would be 'over-investment' — with the debtor being able to obtain (secured) finance to invest in projects, where unsecured creditors would consider such a loan too risky, simply on the basis that the secured creditor's downside payoffs are cushioned by assets that have already been pledged to unsecured creditors. This need not be a high-risk 'bet the firm' transaction, but might encompass something as prosaic as simply continuing to invest money in paying employees after the point has come when the business has ceased to be viable, in all save the most desperately optimistic of (managerial) eyes.

A number of arguments have been put to the effect that the priority of security interests (and therefore floating charges) is not redistributive. None is especially convincing. Jackson and Kronman[74] famously argued that redistribution effected by security *ex post* could be negated *ex ante* by the unsecured creditors charging an increased risk premium in order to compensate them for their lower expected returns. For this result to obtain, the following conditions must be satisfied: all creditors (a) have equal and costless access to all relevant information about the firm; (b) are able to adjust their contracts costlessly to reflect the current level of secured debt carried by the firm; and (c) are risk-neutral.[75]

Clearly, however, these conditions do not hold in the real world, and therefore redistribution may be feasible. Most obviously, so-called 'involuntary' creditors — tort victims, environmental agencies, taxing authorities, government agencies, and so on — are unable to adjust the 'terms' upon which they extend credit.[76] On the firm's insolvency, they may be prejudiced by the existence of secured credit, since they are unable to alter the 'terms' on which they extend credit so as to reflect their reduced expected returns.[77] Another circumstance in which redistribution might take place is where other creditors do not have complete information about the extent to which a debtor has taken secured credit. Lenders who have advanced only small amounts of credit to a corporate debtor may remain 'rationally ignorant' as to the amount of secured credit which it has granted. For parties such as customers, employees and small trade creditors, the costs of identifying the amount of secured credit, and more importantly adjusting the terms of their contractual relationship accordingly, may be greater than the expected benefit from doing so.

74 Jackson and Kronman (1979).

75 Smith and Warner (1979b); Schwartz (1981).

76 Leebron (1991); LoPucki (1994).

77 Scott (1979); Bebchuck and Fried (1996).

A second argument that is traditionally made is that no redistribution is effected provided secured credit is only given for 'new value'.[78] Although unsecured creditors are worse off *ex post* by the grant of security, a secured lender will introduce new money of a commensurate amount at the time of the loan. Because the transaction is 'balance sheet neutral', then interest aside, there is no redistribution.[79] The problem with this explanation is that an increase in the borrower's indebtedness will always increase the riskiness of other lenders' loans, because it will make the borrower more 'fragile' to changes in conditions and thereby increase the risk of default. If the money is used to fund a lucrative project, then this effect may be offset. However, if it is put into a poor-quality investment which generates negative returns, then the loan will reduce the expected value of unsecured creditors' loans. In short, the principal determinant of the impact of a loan on other creditors will be the use to which the money is put by the debtor.[80] Therefore, the appropriate question to ask is, for any given investment strategy adopted by the firm, what difference is made by secured as opposed to unsecured financing? Securing the loan makes it more likely that unsecured creditors will be worse off afterwards.

Rent-seeking and Control. Where a single party controls the debtor's actions, but does not reap the residual returns, then agency costs are likely to ensue. The comprehensive power exercised by the debenture-holder under the floating charge–receivership system, whilst useful in controlling debtor misbehaviour, does give rise to the possibility of rent-seeking on the part of the lender. Such difficulties are well documented in other jurisdictions where banks play a significant role in corporate governance generally. In the UK SME market, Franks and Sussman[81] revealed that when companies fell into financial distress, banks would orchestrate 'intensive care' operations whilst simultaneously minimising their own exposure. This means that, where the operations fail, the trade creditors have a commensurately larger portion of the exposure. Again, it is difficult to determine whether this is really redistributive, as the trade creditors undoubtedly free-ride on the bank's monitoring activity in the majority of cases where the rescue operation succeeds.

Negative Synergies of Control and Priority. The combination of *ex post* control and priority to returns may in theory lead to particularly severe costs. This is because the party appointing the receiver — and to whom the receiver is primarily accountable — is likely to have their incentives to pursue value-maximising asset-realisation strategies dulled by the fact that they have priority to the returns. The chargee may get paid in a range of outcomes, and will be concerned simply to do so as quickly as possible, regardless of the impact on junior claimants.[82] Some empirical evidence certainly appears to be consistent with this view, suggesting that the costs of receivership (as a

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78 Goode (1984); Kripke (1985).

79 Schwartz (1989), pp 228–34.

80 Triantis (1994), p 2162.

81 Franks and Sussman (2000).

82 Benveniste (1986); Aghion et al (1993).

proportion of assets realised) are proportionately higher than insolvency proceedings in other jurisdictions.[83] However, studies comparing administrative receivership with other UK corporate rescue procedures — that is, administration proceedings — do not find significant cost disparities.[84]

Summary of the 'Nineteenth Century' Position. It is likely that the priority status of the floating charge also permitted debtors to effect some redistribution from unsecured creditors to themselves, in expected-value terms. These would be incurred regardless of whether the debtor ended up in insolvency. Moreover, in cases where insolvency did supervene, the principal costs of the judicially sanctioned system were those arising from the debenture holder's use of control to engage in 'self-protection' exercises in the period immediately before insolvency, and the negative synergy between control and priority.

Table 1: The costs and benefits of the floating charge at the end of the nineteenth century

	Costs	**Benefits**
Ex ante (loan extended)	*Priority*: redistribution from prior unsecured creditors through borrowing on a secured basis (debt dilution, over-investment, etc).	*Priority and control:* Once secured loan advanced, lender can use priority/control to reduce subsequent financial agency costs.
Ex post (security enforced)	*Control*: redistribution by 'loss-shifting' *Priority*: perverse incentives of receiver — failure to maximise value of assets	*Control:* de facto stay solves collective action problem

Conversely, the greatest benefit of the system was the degree of control it gave to a particular lender. This package would be most attractive to a creditor with a comparative advantage at monitoring and enforcement functions, and so it could allow for efficient specialisation in these activities as between creditors. Where an activist creditor is given that degree of control, we would expect a financial structure to follow in which the 'floating charge holder' supplies a significant proportion of the debtor firm's external capital. This is indeed consistent with empirical evidence.[85] Under such circumstances, it is plausible that the degree of *absolute* exposure of the 'main lender' would greatly mitigate the adverse synergy of control and priority. Ultimately, the efficiency of the system as a whole depends on the relative size of the *positive*

83 Mokal (2004), p 11.

84 Franks and Sussman (2000); Katz and Mumford (2003).

85 Armour and Frisby (2001).

externalities conferred upon unsecured creditors in cases where 'secured creditor governance' averts a failure with the *negative* externalities imposed in situations where failure occurs.

The Twentieth Century

Have the legislative modifications to the rights of floating charge-holders been efficient? We shall focus the discussion on three aspects: registration; the setting aside of some floating charge monies to pay unsecured debts (be they preferential or otherwise); and the replacement of receivership with administration.[86]

Registration. The rationale for the requirement that company charges be registered was to facilitate the transmission of information about the company's financial structure to creditors who might otherwise be prejudiced.[87] In economic terms, the idea would be that registering performs a 'signalling' function, conveying information to uninformed creditors so that they may adjust their terms of business accordingly.

Whether the registration provisions are efficient depends on the size of the market failure they are purporting to correct, the degree to which they ameliorate it, and the compliance costs they generate. Starting with the last-mentioned of these, it is clear that registration involves compliance costs. Registration is mandatory, and failure to do so will result in the invalidation of the charge on insolvency.[88] Thus chargees will incur costs (which will, of course, be transferred to chargors) every time a charge is granted.

It is arguable that the relevant 'market failure' which results from lack of *information as to whether or not the debtor has borrowed on a secured basis* on the part of third-party creditors is negligible. Early case law shows the judiciary grappling with the concept of the ostensible scope of a company's freedom to deal with its assets when a floating charge had been granted, and developing the features that describe when dealings are in the 'ordinary course of business'.[89] If it was clear that certain things were *usually* permitted, and others *not*, then it must also have been clear that companies usually granted floating charges. Hence the value to trade creditors from being able to consult the register to determine that this was the case was likely to have been

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86 This discussion omits the introduction in 1907 of a cause of action allowing the liquidator to set aside floating charges given for 'late value' (see above, text to note 39, now IA 1986 s 245. A floating charge granted to secure past indebtedness is unambiguously redistributive, and the introduction of this cause of action is therefore an easy case to consider — it is clearly efficient that such transactions should be avoided.

87 *Smith v Bridgend County Borough Council* [2001] UKHL 58 at [19], [2002] 1 AC 336 at 347-48; Law Commission (2002), para 2.21.

88 *Companies Act 1985*, s 395.

89 See above, note 20 (discussing company's power to subsequent security interests after grant of floating charge).

negligible.[90] Indeed, short-term trade creditors do not look to the company's assets for payment, but rather to its cash flow. Their protection against insolvency is not priority, but the ability not to extend credit when the company is in difficulty. Empirical evidence suggests that trade creditors are adept at reading signals from the relevant marketplace about the debtor's financial performance, and adjust their extensions of credit according to the debtor's standing.[91]

It is, perhaps paradoxically, likely that the principal beneficiaries of the register are other (would-be) *secured* creditors, who can thereby establish which parties they need to negotiate with over priorities.[92] Moreover, by establishing a clear *standard* for the disclosure of this information, the registration system could allow parties to reduce the transaction costs associated with discovering this information.

To the extent that disclosure of information about a company's secured borrowing might assist creditors in making lending decisions, the way in which the [illegible] implemented in the *Companies Act* registration provisions is seriously [illegible].[93] First, although internet access has greatly reduced the time and co[illegible]olved in consulting the register,[94] the list of charges which must be registered is incomplete.[95] Second, because there is a 21-day 'grace period' after the creation of a charge before non-registration attracts the consequence of voidness, even consulting the register does not guarantee that one will not be subordinated.[96] Third, the register merely states who is the chargee, but does not make clear the current state of indebtedness.[97] It seems plausible to conclude, therefore, that the registration regime, as implemented, does not enhance efficiency. This first example is therefore consistent with Michael's claim.

Preferential Creditors. In the *Preferential Payments in Bankruptcy (Amendment) Act 1897*, Parliament introduced a provision whereby preferential creditors were to be paid ahead of floating charge recoveries. This was designed to respond to the (perceived) distributional inequities pointed out amongst others by Lord Macnaghten in *Salomon's Case*.[98] The categories of

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90 The registration system does, of course, enable creditors to determine the *identity* of the party entitled to exercise such control rights through holding a floating charge: Law Commission (2002); Mokal (2003). Given that we might expect all rational lenders to maximise the private benefits they receive from control, it is unlikely that this information would make any difference to an unsecured creditor's lending decision. Moreover, it is information that could also readily be obtained simply by asking the company.

91 Petersen and Rajan (1996).

92 Baird (1983).

93 Law Commission (2002).

94 See www.companieshouse.gov.uk/toolsToHelp/chdDirectInfo.shtml

95 See *Companies Act 1985*, s 396(1).

96 *Companies Act 1985*, s 395(1).

97 Law Commission (2002), para 3.17.

98 Above, text to note 48.

preferential creditors have changed over the years, but a central theme has been that certain types of creditor may be unable to negotiate effective protection in the terms on which they extend credit, and therefore might be open to suffering redistribution where the company makes use of secured credit. We shall focus on three such groups: employees; tax claims; and unsecured creditors generally (in whose favour a 'prescribed part' of floating charge assets must now be set aside).

Let us first consider the costs of such rules. The administration of a scheme whereby a certain part of floating charge assets is set aside for a particular category of creditor deemed 'preferential' involves direct costs.[99] Indeed, the newly inserted section 176A of the *Insolvency Act 1986* provides that an office-holder may be discharged of their obligation to set aside a proportion of floating charge recoveries for unsecured creditors where 'the cost of making a distribution to unsecured creditors would be disproportionate to the benefit'.[100] The 'benefit' that the office-holder must consider, of course, is solely the private *ex post* benefit to the unsecured creditors of receiving the payment. If the legislation expressly contemplates that in some cases the costs of administering the scheme will be greater than the private benefits to any group, then it is clear that in many cases the administration costs will be greater than the total social benefits.[101]

Moreover, legislative interference *ex post* with priorities agreed *ex ante* by contract tends simply to generate avoidance action, the professional fees spent upon which are simply deadweight losses. The history of the 'floating charge' is instructive. After the introduction of the preferential payments regime, secured creditors naturally became eager to ensure that *fixed* security was taken over as much of the assets of the insolvent company as was possible. A further impetus was given by the Court of Appeal's decision in 1970 in *Re Barleycorn Enterprises* that not only did preferential payments, but also the expenses of liquidation, rank ahead of floating charge recoveries.[102] Thus, by the mid-1970s, it had become commonplace for banks to require corporate borrowers to grant 'fixed charges' over book debts,[103] that very paradigm of a circulating asset class.[104] Moreover, resort was made to 'automatic crystallisation clauses' so as to ensure that a charge would cease to be a *floating* charge before the commencement of winding-up, thereby avoiding the

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99 That is, the costs of administering the payment of the claims in question.

100 *Insolvency Act 1986*, ss 176A(3)(b), 176A(5)(a).

101 Mokal (2001), pp 616–19.

102 [1970] Ch 465. The decision was recently overruled by the House of Lords in *Buchler v Talbot* [2004] 2 WLR 582.

103 *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd's Rep 142.

104 The classical account of a floating charge given by Romer LJ in *Re Yorkshire Woolcombers Association Ltd* [1903] 2 Ch 284 at 295 was delivered in the context of a charge over book debts.

subordination to other claims.[105] This led the legislature to introduce, in 1985, a statutory definition of a floating charge as 'a charge which, *as created*, was a floating charge.[106] It also led the Inland Revenue (the principal preferential creditor at the time) to expend substantial sums on litigation challenging the validity of 'fixed charges'. Twenty-five years after *Siebe Gorman*, the position has finally been reached where it is almost impossible to take a charge over book debts and permit the company to continue business without the charge being characterised as 'floating'.[107] Although the resources spent on transaction planning and litigation have been substantial, the net change in the priority position over this time has been close to nil.

Other, less obvious, forms of avoidance activity take place. Some of these, such as the receivers' practice of apportioning the consideration from sale of assets 'generously' towards their appointor's fixed, rather than floating, charges,[108] do not seem in themselves to create significant costs. Others, however, are more malignant. Consider the evidence cited by Franks and Sussman[109] of substantial 'credit flows' during informal restructurings. The evidence is consistent with the possibility that, where banks put companies into insolvency proceedings, they time the 'trigger' so as to minimise their exposure. Where there are substantial preferential claims, the bank's incentive would be to delay closing a failing firm until such point as the bank's exposure could be reduced below that which might expect to be realised from the fixed charge assets. This may be wasteful, as the ultimate resale value of the assets may be decreased by 'trading on' too long before sale.

Turning to benefits, the strongest *prima facie* claim perhaps may be made in relation to employees. Statutory priority for employee claims forces the company (and, through it, the other creditors) to insure them to a certain extent against the risk of failure. This may generate benefits where employees are risk-averse,[110] and particularly where they are asked to make investments in firm-specific human capital (which will be a risky investment).[111] Yet the extent to which these theoretically feasible benefits are captured by the statutory regime is negligible. Employees obtain priority for unpaid wage claims only up to a maximum of £800 per person. Whilst this in itself is unlikely to provide adequate insurance, it only tells part of the story. Employees also have entitlements under the *Employment Rights Act 1996* to

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105 See, for example, *Re Brightlife Ltd* [1987] Ch 200 (recognising validity of automatic crystallisation clauses); *Re Christonette International Ltd* [1982] 1 WLR 1245 (charge no longer a 'floating charge' once crystallised).

106 *Insolvency Act 1986*, s 251.

107 *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710; *Re Spectrum Plus Ltd* [2004] 1 All ER 981; rev'd [2004] EWCA Civ 670. For examples of the prior litigation, see: *Re Brightlife Ltd* [1987] Ch 200; *Re a Company, ex parte Copp* [1989] BCLC 13; *Re New Bullas Trading Ltd* [1994] 1 BCLC 485.

108 Franks and Sussman (2000).

109 Franks and Sussman (2000), pp 16–19.

110 Jackson and Scott (1989).

111 Armour and Deakin (2002).

payments out of the National Insurance Fund in respect of unpaid wages where their employer has entered insolvency proceedings.[112] More than twice as much may be claimed under this Act, and the payments are usually made far more quickly than by a liquidator.[113] However, the National Insurance Fund is subrogated to employees' preferential claims in their employers' insolvency where they have been paid under the 1996 Act.[114] Thus, in most cases, the employees' preferential claims are in fact another claim by the state.[115] However, trade union representatives are active and well-organised lobbyists in favour of maintaining — or even improving — employees' position in respect of preferential claims.[116]

The inclusion of Crown claims for tax amongst those preferentially entitled was said to be justified on the basis that the Crown is an involuntary creditor, for it cannot adjust the terms on which 'credit' for unpaid tax is extended. This, however, is manifestly not true, as the Crown has control over how much resources are dedicated to enforcement of unpaid taxes, and can thereby very much affect the 'terms' debtors can expect to experience. Moreover, it seems that Crown preference created unanticipated costs in corporate rescue proceedings. The Inland Revenue was reported to take an unduly negative approach to reorganisation proposals.[117] The reason for this is not hard to see. The Revenue would stand in most cases to be paid in full in liquidation, ahead of the holder of a floating charge, whereas in a CVA they would need to wait before receiving payment. What incentive was there to delay? This pattern too supported Michael's argument. Initially, efficient institutions were subjected to mandatory rules driven by interest group lobbying rather than efficiency. This seems likely to be linked to pressure from the Treasury, and to have led to inefficient results.

Will the replacement of Crown preference with a 'prescribed part' going to unsecured creditors represent a more efficient outcome? The very abolition of Crown preference is itself a significant advance. Whether the introduction of the 'carve out' for unsecured creditors is preferable to simple abolition is, however, worthy of further consideration. The most commonly advanced claim that a 'carve out' may generate benefits is that many unsecured creditors fail to 'adjust' the terms on which they lend, thereby creating incentives for firms to engage in inefficient rent-seeking through granting priority to secured creditors.[118] The floating charge's weak priority status means that the potential benefits obtainable in this way through the use of the floating charge are limited in the United Kingdom. Now, recall that the floating charge package

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112 Part XII, ss 182–90.

113 The amount is £210 per week, up to a maximum of eight weeks — that is, £1680 per employee.

114 *Employment Rights Act 1986*, s 189.

115 Keay and Walton (1999), p 100.

116 Insolvency Law Review Committee (1982).

117 This was reported in two separate questionnaire studies of insolvency practitioners: Keay and Walton (1999), p 102; Milman and Chittenden (1995).

118 See above, text to notes 101–106.

also gives banks considerable power, through their exercise of *control*, to minimise their exposure prior to procuring the company to go into insolvency proceedings. Could it be that a *general* 'carve out' for unsecured creditors will dampen chargees' incentives for this sort of activity? It is certainly possible, although it seems more likely that the response will simply be to expend further resources on transaction planning to design alternative forms of priority device, such as factoring and structural subordination techniques.[119]

Given the substantial costs generated by the preferential debts regime — both direct costs of administration and indirect avoidance costs — it seems most unlikely that the legislative intervention enhanced efficiency. This, too, is consistent with Michael's normative claim.

The Abolition of Receivership. The costs (and benefits) of receivership have been discussed in the previous section.[120] The principal change implemented by the corporate insolvency provisions of the *Enterprise Act 2002* has been the abolition of administrative receivership and its replacement with a 'streamlined' administration procedure. The principal policy objective has been to ensure that the office-holder in corporate rescues is accountable to a wider range of parties than simply their appointing debenture-holder. This accountability is generated, first, by a duty to take into account the interests of all creditors, and second, by a requirement that the administrator refer their proposals for approval to a meeting of the company's (unsecured) creditors.

If these accountability mechanisms are effective, then the new procedure may be expected to reduce the direct costs associated with corporate rescue procedures — in terms of the professional fees charged by the office-holders — and also to reduce the costs resulting from insufficient incentives to maximise the value of the assets *ex post*. It is not, however, clear whether the proposed remedy for these market failures will indeed result in a net improvement. Key features of the regime still favour the banks: they control entry and the appointment of the administrator; they control the tap by which funds are (not) poured into the company during the administration. Moreover, significant parts of the duties are couched in subjective terms. Thus it may be difficult for a disgruntled creditor to establish that an administrator has breached their duties. The new process may, in essence, generate litigation costs in return for little amelioration of incentives.[121]

If on the other hand, the new regime does amount to a significant change *ex post*, then bank strategy is likely to change *ex ante* in a way that may negate

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119 Factoring involves the outright sale of circulating assets (eg book debts) to a third party in return for a discounted cash payment. Where debt factoring is on a 'recourse' basis—that is, the third party assignee (the factor) has recourse against the assignor company if the debtor fails to pay—then it is functionally very similar to a grant of security. See *Re George Inglefield Ltd* [1933] Ch 1. Structural subordination involves selling assets to a subsidiary and procuring that entity to borrow from the creditor to whom it is desired to give priority.

120 See above, text to notes 39–45

121 Frisby (2004).

any benefits the legal change brings.[122] Recall also that one of the most significant costs under the pre-2003 regime was that of rent-seeking by debenture-holders during the period *before* a company entered formal insolvency proceedings.[123] A company whose account is being handled by the 'intensive care' section of a bank's operation may be propped up long enough simply for the bank to minimise its exposure, at the expense of trade creditors. If banks expect to find their recoveries in formal proceedings curtailed, they may be expected to intensify their self-protection efforts *beforehand*. If this happens, then we might expect to see the change in the law being followed by a tendency for firms to enter insolvency proceedings with a smaller proportion of bank debt than under the old regime.

If these reforms do not unambiguously advance the public interest, then how may they be explained? Michael argued that populism and interest group lobbying were behind many legislative reforms. It is certainly possible to identify such elements in the precursors to the *Enterprise Act*. By the late 1990s, there was political capital to be had by the abolition of receivership. The Labour government, concerned with ensuring accountability, transparency and measurable targets, considered that the institution of receivership, whereby the Insolvency Practitioner acted as agent of the company, yet owed duties to none but their appointor, was singularly lacking in these regards. It was decided to replace it with a 'streamlined' administration procedure, that would aim to capture the benefits of receivership — speed, appointment by a party with the best information (namely, the bank) — whilst simultaneously imposing greater accountability, through creditor voting and imposing duties on the administrator to act in the interests of all creditors, rather than just their appointor. Yet, at the same time, it appears that bank lobbying nevertheless had a powerful influence on the government.[124] The result was a procedure that appears superficially to generate a great deal of accountability, yet on a careful second look is revealed to be rather more equivocal in its effects.[125] In conclusion, it seems that Michael's thesis appears not to be obviously inconsistent with the history of the development of the floating charge.

Summary of the 'Twentieth Century' Position

The system of registration of company charges comes closest to conferring a small net social benefit. Whilst the system is costly to operate and confers little benefit on unsecured creditors, it is probably useful for those considering lending on a *secured* basis to be able to discover the identities of the parties with whom they may wish to bargain over priorities, and to do so in a standardised fashion.[126] In contrast, it seems likely that the preferential debts

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122 Prentice (2004).

123 See above, text to notes 107–112.

124 See, for example, British Bankers' Association (2001).

125 Frisby (2004); cf Mokal (2004).

126 When the function registration is seen in this light, there seems little to be gained from requiring floating charges to be added to the record, for these will rank behind fixed security regardless. Yet, for a world in which a registration system is

regime generates social costs that far outweigh the benefits it brings. In particular, it tends to exacerbate debenture holders' incentives to engage in avoidance activities, whilst delivering few benefits to the parties given preferential status. The replacement of administrative receivership with 'streamlined' administration seems likely to be neutral in terms of its efficiency, with costs and benefits balanced in the abstract — although only time will tell whether this is indeed the case.

Table 2: How twentieth century legislation modified costs and benefits of the floating charge

	Costs	Benefits
Ex ante (loan extended)	*Priority*: redistribution from prior unsecured creditors through borrowing on a secured basis (debt dilution, over-investment, etc). ***Registration:*** **Little net impact.** *Preferential debts regime:* Creates deadweight loss in transaction planning.	*Priority and control:* Once secured loan advanced lender can use priority/control to reduce subsequent financial agency costs.
Ex post (security enforced)	*Control*: redistribution by 'loss-shifting' ***Preferential debts regime:*** **exacerbates loss-shifting** *Priority:* Perverse incentives of receiver — failure to maximise value of assets ***Administrator's duties:*** **Ameliorate perverse incentives but create litigation costs**	*Control:* de facto stay solves collective action problem

Conclusions

The foregoing survey of the chequered 'economic history' of the floating charge has necessarily been brief. At a high level of generality, it has tended to bear out Michael's claims. The basic structure of the system of control and priorities in relation to smaller corporate borrowers was arrived upon in the nineteenth century without the intervention of the legislature. During that period, existing forms of security were adapted for the new context of corporate borrowing. By the twentieth century, the contours of the judicially

already in existence for fixed security, the marginal cost of including floating security within the system is itself relatively small.

sanctioned system had become relatively settled. Parliamentary intervention was a significant source of legal innovation from that point forward. However, few of the parliamentary innovations generated net social benefits, and some — most egregiously, the preferential debts regime — arguably generated significant losses. What is more, it seems hard to refute the claim that these twentieth century reforms were motivated in large part by interest-group lobbying or populism. As a first cut, therefore, the economic history of the floating charge seems to bear out Michael's claims.

A closer look, however, reveals that the 'bimodal' account of law-making favoured by Michael only captures part of the history of the floating charge. His descriptive account underplays the significance of transactional lawyers in planning the structures to which first the judiciary and then the legislature responded — in the recognition and redefinition respectively of the floating charge. This is surprising, for his own empirical work had revealed the considerable importance of precedent manuals in determining the content of standard form corporate contracts.[127] These 'transaction cost engineers' are, of course, merely responding to the system within which they perceive their clients to be operating, and so the process of legal evolution in a system not subject to regulatory competition is *reflexive*, rather than simply flowing from the imposition of the preferences of the legislator.

The evolution of the floating charge shows that the simple slogan that the early judicial development of corporate law was efficient, whereas subsequent legislation was not, needs to be tempered by reference to a number of exceptions. In particular, the judicially created priority of the floating charge clearly led to considerable costs, and some aspects of the twentieth century legislation (in particular, the registration requirement) probably created net benefits. Nevertheless, overall, there is much of value in Michael's claim. Simply analysing the development of the law according to the manner in which change was effected is a very revealing exercise.

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[127] Whincop (2002, 2003).

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