

Case Note

SURVIVING *SPECTRUM PLUS*: FIXING CHARGES OVER DEBTS

In re Spectrum Plus Ltd
[2005] 3 WLR 58

This note predicts that banks will attempt to get around the ruling in *In re Spectrum Plus Ltd* [2005] 3 WLR 58 that a charge over a borrower's debts cannot be a fixed charge if the borrower is allowed the use of the proceeds of the debts without restriction. One alternative arrangement that may be used is to require the proceeds of the charged debts to be paid into a blocked account but to allow the bank to periodically apply such proceeds towards the reduction of the outstanding sums under the borrowing facility, so that the borrower is able to make fresh drawings under the facility for working capital. This note argues that such an arrangement is likely to be upheld as creating a fixed charge over the borrower's debts.

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1 If the Singapore courts follow the recent House of Lords' decision in *In re Spectrum Plus Plus Ltd*,¹ it will no longer be possible for a bank to take a fixed charge over a borrower's debts if the bank allows the proceeds of the debts to be paid into the borrower's account and used by the borrower without restriction. The bank's security will be regarded as only a floating charge over the borrower's debts and, in the liquidation of the borrower, the bank's claims secured by such a floating charge will lose priority to the statutory preferential claims against the borrower (ss 328(1) and 328(5) of the Companies Act²). In the humble view of this commentator, however, it is far too early to conclude that fixed charges over book debts will become commercially extinct as a form of security in the banking and financing industry.

2 In *Spectrum Plus*, a company (Spectrum) had executed a debenture in favour of its bank, granting what was described in the debenture as a "specific charge" over all its book debts and other debts.

1 [2005] 3 WLR 58 ("*Spectrum Plus*").

2 Cap 50, 1994 Rev Ed.

The debenture provided that all moneys which Spectrum might receive in respect of the specifically charged debts had to be paid into Spectrum's account with the bank, and that Spectrum was not to sell, factor, discount or otherwise charge or assign such debts without the prior consent of the bank. However, Spectrum was at liberty to deal with the debtors and to collect the debts in the normal course of business. Spectrum's account with the bank was a normal bank account with an overdraft facility and, as long as the overdraft limit was not exceeded, Spectrum could draw on the account for its business purposes. During the life of the facility, the overdraft limit was never exceeded but the account was also never in credit. Spectrum then went into liquidation, and the issue arose as to whether the bank held a fixed charge or a floating charge over Spectrum's uncollected book debts.

3 According to *Siebe Gorman & Co Ltd v Barclays Bank Ltd*,³ such an arrangement would give the bank a fixed charge over Spectrum's debts. The English Court of Appeal followed *Siebe Gorman* and held the security to be a fixed charge.⁴

4 However, the House of Lords overruled the Court of Appeal as well as *Siebe Gorman*, and held that only a floating charge had been created over Spectrum's debts. The law lords reaffirmed that, in principle, a fixed charge could be created over present and future book debts. However, if the borrower was entitled to deal with the book debts and utilise the proceeds of the book debts until the occurrence of a specified event, then the security was only a floating security, notwithstanding that it was described as a fixed charge in the debenture. As the bank did not place any restrictions on the use that Spectrum could make of the proceeds of the debts when paid into Spectrum's account, it had in law only a floating charge over the debts. On the other hand, if the proceeds of the debts had been paid into an account which was blocked so as to preserve the proceeds for the benefit of the security, there would have been the requisite amount of control to qualify the security as a fixed charge.

3 [1979] 2 Lloyd's Rep 142 ("*Siebe Gorman*").

4 [2004] Ch 337 at 359–384.

5 This type of analysis has been criticised as doctrinally erroneous and incomprehensible to serious financiers.⁵ This commentator has some sympathy with this view. However, this note simply aims to point out that, in any event, the practical effect of *Spectrum Plus* may be that banks will simply attempt other ways to take a fixed charge over a borrower's debts without unduly fettering the borrower's ability to use the proceeds of its debts to finance its business operations. This may not be as difficult as some may think, though there is of course no certainty that any alternative structures will have the desired effect until actually tested in the courts.

6 An alternative structure which a bank might wish to consider is as follows.⁶ A borrowing facility is granted to a borrower, and secured against a security over the borrower's debts which is described in the loan and security documentation as a fixed charge. The borrower is prohibited from dealing with its debts when uncollected and is bound to pay the proceeds of collected debts into a blocked account. The proceeds cannot be withdrawn at all by the borrower from the blocked account, in line with the rights of the bank as the holder of a fixed charge. In addition, the borrower might also be required to execute the bank's standard letter of charge and set-off over the blocked account, *ex abundante cautela*.

7 Commercially, of course, the money in the blocked account is as good as a repayment to the bank and a corresponding reduction in the borrowings of the borrower. The bank should therefore be able to agree that interest will not be charged on an amount of the borrowings that correspond to the credit balance in the blocked account, or that the interest charged on such amount of the borrowings will be exactly offset by interest earned on the credit balance in the blocked account. This is no different, in commercial logic, from the situation in *Spectrum Plus* where the bank allowed the borrower to immediately use the proceeds of the borrower's debts to reduce the overdraft and the interest being charged on the overdraft. Indeed, this commentator understands that there are currently similar facilities being offered by banks which involve the full offsetting of interest earned on a deposit account against the interest charged on the corresponding portion of a loan equivalent to the balance in the deposit account.

5 See Philip R Wood, "Is the English Law of Security Interests Sleepwalking?" (2005) 20 JIBFL 211.

6 For another possibility, see the last paragraph of David Capper, "Fixed Charges Over Book Debts" (2004) 67 Mod LR 1007 at 1011.

8 As the credit balance in the blocked account builds up from the continuing collection of the borrower's charged debts, the bank can exercise its security rights and apply the credit balance in the blocked account against the outstanding sums under the borrowing facility. This is the part that requires some additional administrative effort on the part of the bank. A system may be put in place to alert the bank of the credit balance in the blocked account reaching a certain threshold which is suitable for applying the set-off. In addition, the bank may be requested by the borrower at any time (but not obliged) to apply the credit balance. Upon the borrowings being reduced, the amount which the borrower will be able to draw on the facility will be increased by the amount of the reduction.

9 Apart from the minor inconvenience of the bank having to periodically apply the proceeds in the blocked account in reduction of the outstanding sums under the borrowing facility, such an arrangement achieves the same commercial purpose as the *Siebe Gorman* arrangement. Yet, on its face, the arrangement appears to satisfy the control test postulated in *Spectrum Plus*, as the borrower has no right to utilise the proceeds of the charged receivables.

10 Sceptics may point out that the suggested arrangement is so similar in substance to the arrangement considered by the House of Lords in *Spectrum Plus* as to be indistinguishable. This may appear to be a compelling objection, particularly if one recalls that, in *Spectrum Plus*, the borrower's account was overdrawn at all times and the proceeds of the charged receivables were immediately applied to reduce the outstanding sums. Surely the legal result cannot be dramatically different merely because the proceeds of the charged receivables are held in a blocked account and periodically used to reduce the outstanding sums?

11 Surprising as it may be, the answer to this question may well be yes. The proceeds of the charged receivables are at all times kept out of the control of the borrower, as prescribed by *Spectrum Plus* to be the necessary and sufficient element to constitute a fixed charge over debts. The periodic application of the proceeds of the charged debts in the blocked account in reduction of the outstanding sums does not negate or reduce such control. It is an exercise of the bank's security and set-off rights over moneys held in a blocked account without the consent of the borrower. The bank is also under no obligation to effect such reduction and may instead choose to hold the proceeds in the blocked account as security. Indeed, it is difficult to envisage a form of control over proceeds of charged receivables which is more dominant and absolute.

12 Practically, of course, there may be a good commercial reason for the bank to periodically exercise its security and set-off rights over the moneys in the blocked account, as long as the borrower does not default on its obligations under the borrowing facility. The result is that the borrower has the benefit of drawing more sums under the facility as the previously borrowed sums are repaid by the application by the bank of the proceeds of the charged receivables in the blocked account.

13 Can it then be argued that the entire arrangement is a sham in that the true intention of the parties is really to allow the borrower to utilise the proceeds of the charged debts as working capital without restriction? Such an argument is unlikely to succeed. The substance of the arrangement is that the bank has the absolute discretion whether to apply the moneys in the blocked account, and the borrower has no right to expect that the bank will always apply the moneys so as to reduce the outstanding sums under the facility and allow the borrower to draw more sums under the facility. The borrowing facility, being a revolving facility, will usually be repayable on demand, and there is no commercial or legal reason why the bank would agree to have less than full dictatorial powers as to whether to apply the moneys in the blocked account towards the reduction of the sums owed under the facility.

14 Further, the utilisation of the proceeds of charged debts to reduce or discharge the borrower's liabilities is wholly consistent with the intent and purpose of taking a fixed charge over receivables. The security is simply being used to reduce or discharge the secured debt. While *Spectrum Plus* talks of the proceeds of the charged debts being paid into a blocked account, it cannot be that such proceeds must be accumulated and kept in the blocked account indefinitely. The bank should retain its usual security rights over the proceeds, and can choose to exercise such security rights to such extent and at such times as it wishes.

15 It would be difficult, therefore, to contend that the real intention behind the suggested arrangement is to allow the borrower to utilise the proceeds of the charged debts as working capital without restriction. The *bona fide*, legitimate and true intention of the parties is exactly as is implemented by the suggested arrangement – that the bank be allowed to exercise its security rights over the proceeds of the charged debts to reduce the outstanding sums under the borrowing facility, so that the borrower may, if the bank so allows, make fresh drawings under the facility. The proceeds of the charged debts are used by the bank, in its discretion, for the sole purpose of discharging or reducing the secured debt, the very purpose for which the security is taken. In terms of legal characterisation, this should be quite far away from an arrangement

which allows the borrower to use the proceeds of its charged debts for its working capital without restriction.

16 At the most fundamental level, the reason why the suggested arrangement might survive *Spectrum Plus* to qualify as a fixed charge over debts is that the legal position is built around the narrow and technical concept of control over the proceeds of charged debts, but the commercial reality is that the borrower does not need the actual proceeds of the charged debts but, simply, money for working capital. The law draws a distinction between the proceeds of charged debts and money from other sources, such as fresh money lent by the bank, and requires the control to be exerted only over the former. It is not difficult to manoeuvre around this legal requirement to satisfy commercial needs; from the businessman's perspective, money is money.
