ARTICLE

Book Debts – Banks May Need to Think Again as *Siebe Gorman* is Put under Microscope

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Any lingering hope that banks could rely on the wording of fixed charging clauses to provide a route to priority over either book debts or their proceeds, while at the same time allowing their customers flexibility over the use of their money, seems to have been extinguished by the decision of the Companies Court in *Re Spectrum Plus Ltd. [2004] EWHC 9 (Ch)).*

This was one of a number of cases where liquidators were holding up the process of final determination of priority over assets due to the judicial uncertainty created over the position of banks and others holding what purports to be fixed charge security over book debts and/or their proceeds. For banks financing trade or retail business, the availability of a convenient form of security which assures the bank that the net value of the company which it is financing will be realized in the bank's favour on an insolvency is a major consideration in its lending decision.

Where the monitoring of individual receivables (often involving the taking of absolute assignments on specific invoices) is impracticable due to the sheer weight of invoice traffic, the only viable security – assuming that the customer is happy to have a registration against its name – is to take a charge and if possible a fixed charge which will defeat other creditors in an insolvency. The court's endorsement in 1979 of the form used by the bank in *Siebe Gorman & Co Ltd v Barclays Bank Ltd [1979] 2 Lloyd's Rep 142* appeared to cement the banks' position. The appearance of a charge on the company's register containing that format of charging clause told both liquidator and other potential creditors that there would be little available on an insolvency of a company which had the bulk of its assets tied up in book debts.

The *Spectrum* charge

The aim of the charging clause is to ring-fence book debts from every angle, and the clause in National Westminster Bank's standard debenture executed by Spectrum Plus Ltd on 7 October 1997 sought to do exactly that. It provided:

(1) that all book debts and other debts now and from time to time owing to the company would be the subject of a specific fixed charge;

(2) that the company would pay all moneys received in respect of such debts into the company's account with Nat West;

(3) that the company could not sell, factor or otherwise deal with the debts (though crucially not the proceeds in the account) without the consent of the bank; and

(4) that if required to do so the company would execute legal assignments of the debts to the bank.

What the clause (intentionally) does not seek to do, as highlighted above and pointed out by a number of commentators over the 25 years that *Siebe Gorman* has stood as good law, is to place any real practical restriction on the customer's access to the funds in the account. In practical terms such a restriction would stifle the business which the bank was attempting to assist through its finance, because the day to day monitoring of an account which was host to the incoming funds which need to be recycled as working capital would make the entire basis of the financing unsustainable economically. Banks would have to post members of staff on full-time duty assigned to a particular customer's account and would have to pass on the associated cost to the customer. The customer in turn would not accept the level of intrusion into its day-to-day affairs.

NatWest's lending

On 6 October 1997 NatWest advanced GBP200,000 to the company and debited the new account into which the proceeds of the book debts were to be paid. The account was never in credit throughout its period of operation. As funds came into the account to reduce the overdraft, the company drew on the account to increase the overdraft again as was intended. On 15 October 2001 the company resolved to go into creditors' voluntary liquidation. On that date GBP165,407 was due to Nat West and GBP156,554 was estimated to be realisable from book debts with a face value of just over GBP290,000. Preferential creditors were due around GBP16,000 but there was a shortfall to

creditors generally of around GBP650,000. Nat West applied to the Companies Court under s.112 Insolvency Act 1986 for a declaration that its debenture created a fixed charge over Spectrum's book debts and the proceeds thereof. The Inland Revenue and Customs and Excise together with the Secretary of State for Trade and Industry representing the preferred creditor interests were joined as defendants to the action.

Challenging *Siebe Gorman*

Nat West sought priority over the book debts recovered by the liquidator of some GBP113,000 but which the liquidator had failed to pay into the NatWest account as required by the debenture. It was entitled to the money, it said, on the basis of the authority laid down in the decision in *Siebe Gorman* and many subsequent cases which followed it. The priority creditors made it clear that they were asking the court to reject *Siebe Gorman* – something that a number of previous courts had been reluctant to do. On this occasion, however, Sir Andrew Morrit Vice-Chancellor felt the time had come to look critically at the *Siebe Gorman* legacy. The first crack in this structure had appeared as a result of the decision of the Privy Council in *Re Brumark: Agnew v Inland Revenue Commissioners [2001] 2 AC 710* where the court heard an appeal from the New Zealand Court of Appeal and had to determine whether a charge over uncollected book debts which nevertheless left the company free to use the proceeds in the ordinary course of business was a fixed or floating charge.

The *Brumark* approach

The court in *Brumark* adopted a two-stage approach to weighing the security. The first stage was to construe the instrument and examine what rights and obligations the parties actually intended to create at the time of execution, rather than whether they intended those rights and obligations to manifest themselves in a fixed charge. The second stage was then to categorize the instrument created, which process is a matter of law rather than party intention. The labelling given to the instrument by the parties is not a significant consideration in this stage of the process. The real question, as Lord Millett pointed out in *Brumark,* was whether the charged assets were intended to be under the control of the company or alternatively the bank as charge holder. If they were intended to be under the control of the company then the instrument could only constitute a floating charge. In explaining the court's approach, Lord Millett pointed to what was generally thought to be the reasoning behind the contrary decision in *Siebe Gorman.* In that case, he said, the proceeds of debt collected by the company were required to be paid into a blocked account. However an examination of the background facts in *Siebe Gorman* reveals that no such restriction existed. The rules for operation of the account were in fact no different than those in the present case.

The *Spectrum* account was an ordinary current account with a clearing bank. There was no express restriction on its operation and, on the face of it, its purpose was to provide working capital. The restrictions that were apparent in the facility and debenture were aimed at preventing the company from dealing with the debts by factoring or otherwise charging them to third parties, but not so as to restrict how they spent the proceeds once they had passed into or through the NatWest account.

The *Spectrum* decision

The court in *Spectrum* followed the two stages outlined in *Brumark* with a third stage which involved looking critically at the label applied to the instrument by the parties and seeing whether that accurately reflected the rights and obligations which the parties actually intended to bestow on each other. The result of that analysis was that in the *Spectrum* case what the parties had really intended to create was a form of floating charge and not a fixed charge. The key failing in previous decisions had been to regard the labelling of the instrument, rather than the practical rights which the instrument was intended to provide, as the decisive factor in determining whether the charge would take effect as a fixed charge or a floating charge. The nomenclature itself did not cause the account to be blocked for the purposes of assessing the security. Only an express provision will achieve that result.

Financing working capital after *Spectrum*

Where does that leave the banks? If one rewinds the tape to a date before *Siebe Gorman,* banks always recognized the inherent difficulty in effecting a worthwhile security in respect of lending where the realisable assets of the company were bound up in an ever-moving stream of receivables which had to provide in turn the continuing working capital needs of the company. When invoicing volume defied any attempt to monitor closely what was happening on a day-to-day basis, the banks had to achieve a real understanding of the company's business so that balance sheet fluctuations meant something. Much of today's commodity finance business has to operate in this way. This is because customers are often not prepared to advertise their lending liabilities to the trade at large. Those banks that do lend frequently do so against balance sheet unless there are obvious transactional security opportunities, but they develop and retain the in-house expertise to follow the plot and recognize danger signs before they find themselves irretrievably compromised.

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The reduction over the past twenty years in similar specialized high street banking expertise (my bank, like yours, is now a trendy wine bar) has been part of a pattern of centralization and standardization in high street lending which is now virtually irreversible. Bank shareholders lapping up the latest profit announcements will not be easily persuaded that the banks have got this decision wrong. The decision in *Spectrum*, while hardly surprising following the *Brumark* judgement, may cause some banks to reassess their approach to the market or find an acceptable arrangement by which the customer and its debtors will recognize the bank's priority right to the proceeds of debt. It depends how much of an appetite they have for this sector. Do not expect to see an overnight reaction. In the right economic cycle it may not affect their approach even if they are extremely risk averse. In the long term, however, this decision must be good news for the commercial finance arms of some of the high street banks and other trade finance outfits who have already positioned themselves in the market and established schemes which repay and re-lend funds in a way which does not offend the market or the principle, now firmly established in *Spectrum* and *Brumark,* that control of the asset rather than the label on the charging instrument determines the nature of the priority afforded by the charge.

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