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AUTOMATIC CRYSTALLISATION OF A FLOATING CHARGE

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Automatic crystallisation of a floating charge

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In an earlier article[1] which examined the many contradictions and problems that arise with respect to the theory of the floating charge and the cases concerned with crystallisation it was noted that Australian courts had not yet squarely tackled the effectiveness of automatic crystallisation clauses. It was concluded that when the question arose it would be necessary to determine whether a floating charge is a product of the "draftsman's skill, as tempered by negotiation",[2] or whether a floating charge should be seen as "a creature of the courts".[3] The latter conclusion introduces the need to answer a further question, namely whether the courts will regard the cessation of business, or some positive action by the debenture holders, as a pre-condition to crystallisation.

It appeared that Jenkinson J. in *Re Bismarck*[4] favoured the view that the courts should maintain control of automatic crystallisation clauses. In that case the debenture deed stated that:

"The right of the company to deal with the mortgage property shall forthwith cease on the happening of any one or more of the followng events . . ."[5]

A clearer indication that the parties proposed automatic crystallisation on the happening of the specified events could not be imagined. Yet His Honour held that on the basis of *Government Stocks and Other Securities Investment Company* v. *Manila Railways Co.*[6] such clauses postponed crystallisation until the debenture holder exercised his "option . . . to bring about that result".[7] The right of the company to deal with the mortgage property did not cease, but continued "by the sufferance of the debenture holders and at their mercy".[8]

Strong arguments for adopting his view are found in precedent, in theory and in policy considerations.

However, in a decision in April 1983, Mr. Justice Murphy, in *Deputy Commissioner of Taxation* v. *Horsburgh*,[9] held that the floating charge before him crystallised automatically on either of two events, default by the chargor or the creation of a prior fixed charge. Those events were specified in the charge as events upon which the charge "shall become fixed". The learned judge rejected submissions based on the view that regardless of the words used in the debenture, the charge would not crystallise until the intervention by the debenture holders. His Honour stated:

"I have read the authorities on this matter and it is my opinion that as a matter of law there is nothing to prevent an agreement being made where a floating charge crystallises on the happening of specified events . . . I am not able to accept that as a matter of legal theory that (such) a contract is ineffectual to achieve that purpose.[10]

"I find that the intention of the parties to the original floating charge as expressed in the deed, was that it would convert from a floating charge to a fixed charge on the happening of certain events."[11]

However, His Honour appears to contemplate the possibility that the debenture did not crystallise on default because he held that if it did not crystallise at that time, then it crystallised upon the creation of a subsequent prior ranking charge; and if not then, "even the defendant concedes that it crystallised on appointment of Receivers".[12]

The learned judge appears to take the view that the floating charge is purely and simply a contract, and that its character is to be interpreted largely, if not solely, by reference to contractual principles of construction. In so doing His Honour accepts the principle espoused by Speight J. in the case of *In re Manurewa Transport*[13] which, it is submitted, is the only strong authority for such a proposition. Speight J. said:

"A floating charge is not a work of art; it is a description for a type of security contained in a document which may provide a variety of circumstances whereupon crystallisation takes place."[14]

To adopt this view is to ignore the view that a floating charge is a creation of the court. A debenture does more than create an action *in personum*, it creates a proprietary interest affecting the rights of third parties. As with other proprietary interests created by the courts, such as the "use" or the "restrictive convenant", the courts have in the past controlled the effect of their creation, particularly with respect to priorities and innocent third parties who played no part in the negotiations of the rights created. This was the view of Fletcher Moulton L.J. in *Evans* v. *Rival Granite Quarries Ltd.*,[15] a case which has consistently been reaffirmed. Fletcher Moulton L.J. stated:

"I do not deny that in the earlier cases the actual words of the particular documents may have influenced the courts and enabled them to come to the conclusions which they did. But at an early period it became clear to judges that this conclusion did not depend upon the special language used in particular documents but upon the essence and nature of the security of this kind."[16]

In the same case Lord Mcnaghten included as part of the "essence" of a floating charge, that it would not crystallise until the undertaking ceased to be a going concern or until the debenture holders intervened.

The question which was clearly raised in the *Horsburgh case* was, would the courts take a further step and allow the debenture holder on the one hand, to encourage the chargee to carry on business, thereby creating debts and using its assets as security in the ordinary course of business, and on the other allow the debenture holder to maintain priority at all times by the use of automatic crystallisation. A further question linked to the first is, would the courts allow the intervention of the debenture holder to maintain their priority, and then allow a "de-fixing" of the charge without loss of priority and without forever freezing the business of the company. The answers to these questions were awaited by the profession with much interest.

In *Horsburgh's case* Mr. Justice Murphy answered "yes" to the first question, and by viewing the floating charges as a product of the draftsman's skill rather than a creature of the court, impliedly answered "yes" to the second. Given the copious and wide-ranging debate by legal commentators on these questions and the unsatisfactory nature of the authorities, it is disappointing that His Honour did little more than state his opinion, offering a cursory reference to the authority.[17] It is respectfully submitted that insofar as His Honour countenanced automatic crystallisation he may well be correct, but insofar as the decision paved the way for the courts releasing control over the floating charge he was not correct.

Inherent nature of a floating charge

(a) Development

A brief look at the history of the floating charge demonstrates that the courts did not feel obliged to abide by the terms decided upon by the parties. The floating charge is a relatively recent judicial creation born through commercial necessity and shaped to meet the pressing needs of joint stock companies to obtain finance. As late as 1850 the courts refused to recognise the floating charge because it was unfair to third parties.[18] However, progressively, the courts allowed the barriers to the creation of a floating charge at all, to be overcome. Firstly, equity overcame the need for an act confirming the transferee's prior intention to create an interest in future acquired goods. This was done by the courts' willingness to grant specific performance.[19] Secondly, the courts interpreted a mortgage of a company's "undertaking" as a charge with the characteristic which allowed the company the right to continue trading, and hence to deal with its stock unencumbered.[20]

(b) Theory

If the floating charge is more than a contractual agreement the question of its inherent characteristics must arise. Much depends on whether the theory underlying

the floating charge is seen to be the licence theory or the mortgage of future assets theory (the hovering charge theory). In the former case the charge fixes to the company's stock-in-trade as it arrives in the company's hands, and due to an implied licence the company may trade with these assets until the licence is removed. The licence can be removed on the basis that the chargee acts in breach of the licence. Until then the charge "defixes" as the stock is disposed of.[21] Under the latter theory the charge does not become fixed to the stock-in-trade until crystallisation. Prior to that time it is "ambulatory and shifting in its nature, hovering over and so to speak floating with the property".[22]

Both commentators and the judiciary exhibit a wide variation of views as to which is the correct theory, and these differences of opinion extend to which of the theories best supports automatic crystallisation.[23] Unfortunately:

"The difference of judicial opinion as to whether there is an implied licence given to the company is not a merely metaphysical one. It can result in different answers to problems concerning the rights of debenture holders.[24]

"These theories are not merely of academic interest; they can produce different practical consequences."[25]

The licence theory is the simplest theory. It was undoubtedly the original theory and it is submitted that it is the only one which can explain the puzzling group of cases known as the "Sheriff cases".[26] It is supported by Wickham J. in *Landall Holdings* v. *Caratti*,[27] who undertook an extensive review of the authorities and came to the conclusion that a debenture created "an immediate equitable charge upon the assets of the company", and surprisingly, this is supported also by Buckley L. J. in *Cretanor Maritime Company Ltd.* v. *Irish Marine Management Ltd.*[28] It was also the basis of the recent case of *Reynold Bros. Pty. Ltd.* v. *Esanda Ltd.*[28AA]

If the licence theory is the correct theory, it is submitted that following a breach of conditions by the chargor, equity would require some act by the chargee to remove the licence. This view supports those who argue against automatic crystallisation.[28A]

Irrespective of the language used in a debenture deed, certain characteristics in a floating charge can be isolated.

"It is plain that when you start with your floating security . . . the whole basis of that arrangement is that the business is going on and should go on until the debenture holders according to the terms of the deed intervene."[29]

All the descriptions of a floating charge take as the *ratio disidendi* the proposition that the charge remains floating, or otherwise ineffective only so long as the undertaking is a going concern.[30] In *Plyer* v. *Crompton*[31] efforts by the draftsman to prevent the charge crystallising on the reconstruction of the company failed because, as part of the reconstruction process, the "business ceas(ed) to be a going concern".

There is support for the proposition that action outside the ordinary course of business will create grounds for crystallisation.[31A]

Some of the terms used by Glass J. A. in *Reynolds Bros. (Motors)* to describe the company's right to carry on were "so long as the company is a going concern", "until the undertaking charged ceases to be a going concern" and until the company "has closed its doors".

Glass J. A. adopted the description of a floating charge found in *Wallace* v. *Eversted*[32] based on the right of the chargor to continue trading in the ordinary course of business. The learned judge stated:

"The Deed of Equitable Mortgage and floating charge does not itself define the nature of the licence vested in the mortgagor . . ."

In determining whether a company acts within the ordinary course of business all three judges undertook a subjective enquiry into whether the chargor's actions were the result of an intention to carry on business.

Mahoney J. A. emphasised that the breach of a "crystallising" term prohibiting the creation of prior interests did not crystallise the charge but rather, that priorities are determined by the nature of the floating charge together with the use of equitable principles (*supra*).

It is unclear whether the crystallisation that takes place on the appointment of a receiver or liquidator is due to the appointment or to the cessation of business. On a winding up the former must necessarily cause the latter (s. 368(1) *Companies Act* 1981). On the appointment of a receiver the business is effectively anaesthetised. From the few examples where the two have not coincided it would seem that the courts have treated them as separate crystallising events.[33]

Remedies available for enforcing a fixed charge are also available for enforcing a floating charge. Hence seizure, foreclosure[34] and grant of power of sale[35] are all available, and somewhere between the institution of the remedy and the enforcement of the rights the charge must have crystallised. The availability of these remedies is not dependent on such remedies being expressly mentioned in the deed.

There is support for the proposition that action outside the ordinary course of business will create grounds for crystallisation.[35]

Despite the decision in *Industrial Development Bank* v. *Valley Dairy Ltd. and McDonald*,[36] it is submitted that the charge will not crystallise on the issue of a writ in a debenture holder's action.

Automatic crystallisation?

Academics disagree over whether automatic crystallisation is a characteristic compatible with the nature of a floating charge. McLauchlan,[37] Sykes and Boyle[38] *Palmer's Company Law*[39] and Gough[40] all accept, with various conditions and riders, that automatic crystallisation is possible. Pennington,[41] Allan and Sher,[42] Farrar,[43] Gower[44] and Ford[45] refuse to commit themselves, Sykes[46] and *Halsbury's Laws of England*[47] are both against automatic crystallisation.

The difficulty with the cases relied on by those who reject automatic crystallisation is to determine to what extent particular decisions rely on the inherent nature of a floating charge, as distinct from the implied intentions of the contracting party.

In the *Manila Railway case*, Lord Halsbury L. C., in deciding that the charge would not automatically crystallise, was content to rely on the intention of the parties. Lord Nacnaghten agreed that a debenture holder's right to intervene might be suspended by agreement. But in relation to crystallisation, His Lordship felt it was in the nature of the agreement that it continue to float until a cessation of business or until the debenture holders intervened. Lord Shand said:

"I should have great difficulty in any case, even upon the construction of the instrument which has been presented, in holding that if the creditors in these debentures lay by and took no step whatever to arrest the business, or to put a receiver in charge of the business, they could affect anyone in the transaction of business with the company."[48]

The *Evans case* is not directly concerned with an automatic crystallisation clause. However, Their Lordships made certain statements concerning the nature of a floating charge. Vaughan Williams L. J. based his judgment on the licence theory. In the learned judge's opinion:

"Unless something has occurred entitling the debenture holders to make such an application and the application has in fact been made for the appointment of a receiver or an action brought by them or on their behalf to realise their security, or unless something has happened which entitles the debenture holders to determine their licence to the company to carry on their business and they *have actually done* so the company is entitled to do all the things which the licence entitles them to do."[49] (Emphasis added)

The learned judge refers to earlier authorities concerning the rights of debenture holders, which he said were given on the basis that the debenture holders had in some form to determine the licence to carry on business.[50] His Lordship adopted these principles to prevent "any further extension of the evil results from the admitted power of the debenture holders". Fletcher Moulton L. J. said:

"The effect of these floating securities has been frequently considered. Many years back the attention of the courts was drawn to their particular nature . . . In all the decisions the courts realised that in the case of a security of this nature it was impossible to come to any other conclusion than that it was intended to leave the company free to carry on its business until the time arrived when the debenture holders enforced their security . . . It is of the essence of such a charge that it remains dormant until the undertaking charged ceases . . . or until the

person in whose favour the charge is created *intervenes* . . . I call attention to the fact that Lord Macnaghten there lays down that that which changes the character of a floating security to that of a fixed security is either the cessation of business . . . or the actual intervention of the debenture holder, but not his mere right to intervene . . . the debenture holder must actually intervene . . ." [52] (Emphasis added)

". . . the freedom of the company to carry on its business is not based on special words creating that freedom but on the nature of the charge itself . . . It is impossible for a court of law to draw the inference that Parliament intended to confer upon companies complete freedom without commercial responsibilities."[52]

It is open to argue that these cases should be restricted to the proposition that mere default without more will not cause crystallisation. It is also true that under close analysis the language used is ambiguous; but these cases cannot, it is respectfully submitted, be cited, as they were in the *Horsburgh case*, as cases supporting the acceptability of automatic crystallisation clauses. In *Davey & Co.* v. *Williamson & Son Ltd.*[53] a case often cited as supporting automatic crystallisation, the crystallisation clause is in substance very similar to that in the case of *In re Bismarck*. The principal moneys were to become payable on the happening of the events specified in the deed, and the company's right to deal with the charge property was thereupon to cease. In a very short judgment the court held that the seizure in execution of a judgment was outside the ordinary course of business. Secondly the court agreed that crystallisation had *not* taken place. The court said: "The second ground on which the learned County Court Judge proceeded was that the rights of the debenture holders had not crystallised or, in other words, that the moneys secured by the debenture had not become payable. As to this, it is in the first place to be observed that although this is so, yet by reason of the clause . . . the security . . . had become enforceable."[54]

It is submitted that despite the constant reference to *Davey's case* as one relying on automatic crystallisation, the words of the judgment do not support that view. The learned judges went on to imply that there is an equity attached to the subject property prior to crystallisation. When referring to the circumstances of the case the court noted that the company as a going concern had come to an end. Hence *Davey's case* can be placed alongside the other Sheriff's cases where the Sheriff's rights were inferior to the equity in the goods under an uncrystallised charge. Alternatively, as Fletcher Moulton L. J. put it in *Evans' case*, it might be explained on the grounds of cessation of business — "otherwise it is wrongly decided".[54]

Ford[55] rightly points out that, given the nature in which this issue impliedly arose in *Stein* v. *Saywell*,[56] that case on its own is insufficient to dispose of the question.

Similarly, in *Federal Commissioner of Taxation* v. *Barnes*[57] the fact that the majority uses language which separates the crystallisation event from the appointment of a receiver and manager does not resolve the issue. The crystallisation clause in the report does not reveal the crystallisating event.

Policy

The floating charge is the invention of the courts and there are cogent reasons why they would wish to retain control of their creation. To allow the debenture holders complete freedom in determining the character of a charge and at the same time allow the company to continue to trade or mortgage its stock creates great injustice to innocent third parties, insurmountable problems for liquidators and receivers, and where the chargee is in a strong bargaining position, could potentially transfer the day to day control of the company from the directors to the debenture holders. The result of automatic crystallisation may well be the destruction of the company which the floating charge was originally designed to save.

(a) Execution creditors

The position of the execution creditors has been imaginatively described thus;

"An execution creditor is very much like a dog with a bone, and he may well begin to growl, metaphorically speaking, at being meddled with by debenture holders. The floating debenture permits the company to deal with the property charged in the ordinary course of the company's business. The company may sell it, or mortgage it, or charge it. Given a free hand, the company goes on and contracts debts, the unpaid creditor levies execution, and then the debenture holders, who have been lurking in ambush all the time start up like Roderick Dhu's "plaided warriors armed for strife" and remorselessly say to the execution creditor, "hand over to me the fruits of your execution, that property is mine". This is a genuine grievance. Practically it means that the creditors of a company which has issued debentures can never levy execution because when executions begin a company is waterlogged, if not sinking."[58]

If a business has ceased, or a receiver is appointed, innocent third parties will not be misled.[59] Given the multitude of daily transactions it cannot be expected that, whether or not registration of a registerable floating charge under the *Companies Act* 1981 (the Act) is regarded as constructive notice of the provisions of that charge, such registration would protect the unsecured creditor. An unsecured creditor who has been induced by the nature of the charge to believe a company has a healthy asset backing is left by an unexpected, or worse, an unnoticed, crystallisation, with no redress save action against a company which has become, in effect, an empty shell. This problem did not arise in the *Manurewa case* or the *Horsburgh case*. In both those cases

notice was not in issue. On more than one occasion Murphy J. drew attention to the fact that in the circumstance of the *Horsburgh case* the chargee second in time had actual notice of the automatic crystallisation clauses.[60]

If the courts hold that registration is constructive notice of the contents of the debenture, then the debenture holder's power grows even further. In that case it is possible that legal interests obtained by *bona fide* purchasers without actual notice of the terms of the debenture where they had knowledge that the event which caused crystallisation had occurred, would be postponed to the crystallised charge. Whether the notice of the crystallisation clause without actual knowledge of the event would be enough to constitute notice is arguable.

In *Reynolds (Bros.) (Motors)* the significance of notice of a floating charge and of its contents is discussed. Mahoney J.A. says at p. 427:

"It may be that, in this area of judge made law, whilst notice of the existence of a floating charge will not be sufficient to burden legal interests, notice that the aquisition of it involves contravention of such a restriction is."

His Honour suggests that the same outcome may occur as between competing equities.

The practical effect of such a situation in the normal environment of daily trading is intolerable. The legal complications of an unnoticed crystallisation which lies undetected for weeks, months or even years do not bear contemplation. Such a situation, though rare, highlights the conflict between the inherent characteristics that the business may continue unhindered and the power of the debenture draftsman.

(b) Secured creditors

Those dealing with the company who choose to use the subject property to secure their loans will, in the case of a prior unregisterable charge or charge created prior to the Act, find that automatic crystallisation triggered by the creation of prior ranking charges denies them the priority they expected. In the *Horsburgh case* it was only because the Commissioner of Taxation is in a particular position that he was able to collect the taxes on behalf of the community.

Where there is a failure to lodge a restrictive provision under s. 204 Schedule 5 of the Act, sub-section 204(3) postpones that charge to a later registered fixed charge (reversing the common law situation) unless the former charge first becomes fixed. Automatic crystallisation combined with a restrictive provision will achieve just that.

Section 204(2) of the Act impliedly postpones unregistered but registerable floating charges with no restrictive covenant provision to later fixed charges. However automatic crystallisation would be enough to end this implication. Hence the subsequent unregistered charge, or a subsequent registered charge with notice of the former charge, would not obtain priority.

(c) Receivers and managers

The problems created for a receiver and manager are even greater than problems facing third parties. Failure by debenture holders to recognise the triggering of an automatic crystallisation may mean the company will, either knowingly or unknowingly, continue to trade for years without the appointment of a receiver. When eventually a receiver is appointed his duty is to determine the point at which this crystallisation occurred. If the Act's provisions effectively provide notice to those acquiring a legal interest the tracing task would prove impossible. The position of secured creditors has already been described, and the receiver must determine the position with respect to all later secured interests.[60A]

The event causing crystallisation of the charge may well be obscure. For example, a minimum stock ratio may be used to trigger crystallisation.

The risks associated with an invalidly appointed receiver can prove disastrous. He may be liable as a trespasser,[61] he may not be able to rely on his indemnity arrangements or his right to remuneration.[62] The risk of improperly distributing assets also places the receiver in a very difficult position.

(d) The company

The company is in the worst position of all. A company requiring finance to continue operations is often at the mercy of the chargee. Their bargaining positions are not equal. With complete freedom to structure the nature of a floating charge the debenture holder has the power to redefine wholly his relationship with the company. Firstly, the events chosen to crystallise the charge may be trivial, and so structured as to force the company to undertake policies which the debenture holders wish the company to pursue. The nature of such events is limited only by the imagination of the draftsman. If we combine this with the ability to structure a floating charge to refloat without loss of priority[63] which, according to the principles enunciated by Murphy J., would be possible, the control of the debenture holders is further increased. Whether or not a charge can be refloated without loss of priority, it seems likely that partial crystallisation is possible.[64] This means that a charge structured to crystallise only in part on those assets the subject of a subsequent fixed charge will give the debenture holder the right to freeze parts of the business while maintaining priority and control. The court has expressly stated this to be unacceptable.[65]

One can foresee a situation where, because of an unexpected judgment in an action by a vexatious creditor, or an error of judgment by an employee, a company's operations are brought to a halt.

Undoubtedly the best way to resolve the problems associated with automatic crystallisation clauses is to introduce legislation specifically designed to set out the limits to debenture holder's powers. However, in the meantime both the legal considerations and policy considerations which the court must take into account when dealing with such clauses are considerable. To date these matters have not been squarely faced and as a consequence the matter has not yet been laid to rest. The legal issues are made more complex by the introduction of the hovering charge theory. There is no reason why the original theory, based on a licence to use the subject goods, should be discarded.

The prospect that the debenture holder can interfere with the running of the company is rejected, even by those judges who are said to support automatic crystallisation.

"It is inconsistent with the nature of a floating security that the holder should be able to pounce down on particular assets and to interfere with a company's business while still keeping his security a floating security; he cannot at once give freedom and insist on servitude."[66]

The possibility that a debenture holder who failed to take action at the time of the crystallisation event might thereby have waived his right to intervene may well be the correct analysis. It is just as circular to say that an acceptance of implied waiver is an acceptance of the invalidity of automatic crystallisation as to say the reverse. It is in the nature of a floating charge that intervention coupled with notice must take place before crystallisation, and failure of these pre-requisites to occur will result in the debenture holders having waived their rights to later rely on that crystallisation event. Where a debenture holder creates a situation where third parties are lulled into a position to their detriment, the courts have had no trouble in denying the debenture holder priority.[67] Is not the same principle applicable in relation to floating charges with automatic crystallisation clauses?

Mason says:

"The draftsman puts into shape, judges define and harmonise, Parliament gives its imprimatur, but it is mercantile custom and mercantile convenience which makes the law. This is the secret of a living law."[68]

However, in 1984 it is necessary to maintain a balance between financial strength and the requirements of the broader commercial community. Greater power for debenture holders does not *ipso facto* mean greater mercantile convenience.■

Footnotes

1. Dean, "Crystallisation of a Floating Charge," (1983) 1 *Companies and Securities L.J.* 185. **2.** *Ibid,; Re Manurewa Transport* (1971) N.Z.L.R. 909. **3.** Boyle, "The Validity of Automatic Crystallisation Clauses" [1979] *J. Bus. L.* 231, 235. **4.** *Re Bismarck Australia Pty. Ltd. (Receivers and Managers Appointed)* (1981) V.R. 527. **5.** *Ibid.*, 530. **6.** (1897) A.C. 81. **7.** *Re Bismarck Australia Pty. Ltd. (Receivers and Managers Appointed)* (1981) V.R. 527, 531. **8.** *Ibid.* **9.** (1983) 2 V.R. 591. **10.** *Ibid.*, 599, 600. **11.** *Ibid.*, 600. **12.** *Ibid.*, 601. **13.** (1971) N.Z.L.R. 909. **14.** *Ibid.*, 916. **15.** (1910) K.B. 979. **16.** *Ibid.*, 993. **17.** *Ibid.*, 599 and 602. **18.** *Russell* v. *The East Anglican Railway Co. & Ors* (1850) 3 Mac. & G. 104, 144, (42 E.R. 201, 216). **19.** *Holroyd & Ors* v. *Marshall & Ors* (1861-62) 10 H.L.C. 191. (11 E.R. 999). **20.** *In re Panama, New Zealand and Australian Royal Mail Co.* (1870) 5 Ch. App. 318; *In re Florence Land and Public Works Company, ex parte Moore* (1878) 10 Ch. D. 530; Pennington, "Genesis of the Floating Charge," 1960 23 *M.U.L.R.* 630, 646.