

# Fixed and floating charges:

This article aims to give Credit Managers an introduction to when it is possible and commercial to obtain an effective fixed and floating charge over the assets and undertaking of a company debtor. This article does not address any of the issues relating to the registration of personal property security interests when the new register that is planned to take effect in May of 2011.



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**SCENARIO:** You are the Credit Manager of a key supplier of ABC Manufacturing Pty Ltd (ABC). It has been a close relationship over a number of years and your companies' production lines are now integrated through a just-in-time manufacturing model. Over the past 12 months ABC has been in financial difficulties and has let your company's trading terms deteriorate. This means that a debt of over \$500,000 has been built up. Your General Manager now wants to know how your company can get a security interest over ABC because she wants to make sure your company is not just an unsecured creditor if ABC goes into administration or liquidation. You have heard from your contacts in ABC that insolvency accountants have been attending its head office this week to look at its books in preparation for appointment as voluntary administrator. You were also told that this may be months away, but at this point in time your company is an unsecured creditor without any security.

## A. What is a fixed and floating charge?

It is a form of security, akin to a mortgage over the assets and undertaking of a company. It is fixed to the extent that it is a security covering all non-trading assets of the company such as real property, plant and equipment and intellectual property. It is also a floating security over the other assets of the company that circulate during the ordinary course of business until such time as it crystallises and becomes a fixed charge over these assets as well. Examples of circulating assets include inventory and cash- assets that the business buys and sells in the ordinary course of business.

The fixed and floating charge is distinguished from other forms of security

because it also covers future property of the debtor company.

Without exploring the meaning of "crystallise" or "circulating assets" or "asset" in summary the fixed and floating charge is the best form of security you can have against your company debtors because it covers all the corporate debtor's assets and undertaking as the business develops as a going concern.

## B. What does a fixed and floating charge do for a creditor?

Credit Managers who attend a lot of creditor's meetings of companies under insolvent administration will note that the banks generally have priority over the other creditors through fixed and floating charges. It is often a frustrating experience for Credit Managers to go to a creditor's meeting and be informed that any assets of the insolvent company will be distributed to a bank as a priority, and in other situations, the banks appoint their own receivers who take over the assets and undertakings of the company. This often leaves only a corporate shell to unsecured creditors and no prospects of recovery.

A valid fixed and floating charge may be a royal flush if you imagine creditor priorities to be a game of poker. It tends to be the best "hand" to have when a company debtor goes into insolvent administration.

The most important right of a fixed and floating charge holder is priority against other creditors. The fixed and floating charge holder is a secured creditor of an insolvent company and through the fixed element of the charge it has an actual proprietary interest in the company's property. For example, in the scenario the Credit Manager may wish to obtain a fixed charge over certain equipment that is part of the just-in-time

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# The royal flush

production process. This equipment might be useful to the credit manager's company in the event that ABC closes down upon liquidation.

The fixed and floating charge holder has the right under the *Corporations Act* to appoint a voluntary administrator over the debtor company if it has a charge over all the assets of the debtor company. Further, there is a right to privately appoint a receiver to protect the assets under the charge and take action to collect the debt owed. In the scenario a voluntary administrator or privately appointed receiver may be necessary to ensure that operations at ABC continue if it is insolvent. In this scenario the credit manager's company is able to ensure that the production process continues because the receiver is able to take over

ABC's production line and keep it in operation at least temporarily.

## C. A fixed and floating charge needs to be registered

A new charge over a company is required by the *Corporations Act* to be registered with the ASIC within 45 days of its creation. The ASIC form 309 together with the charge instrument and an ASIC form 350 to certify that mortgage duty has been paid must be lodged with the ASIC within this deadline.

Assuming that a charge is validly registered with the ASIC within 45 days of its creation the next issue is whether there are other charge holders with a priority that are entitled to all of the assets of the debtor company in the event of liquidation. For example, is there a bank ►

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with a prior registered charge in the scenario that would “clean up”? It would not be commercial to take a charge over a debtor company if there is a prior charge holder whose debt will swallow up all of the assets of the debtor company. There is also likely to be a requirement in standard bank charges for bank consent to be provided before any further charges may be granted. The benefit of registration of charges, however, is that you will be able to obtain information about another charge holder’s security interest through ASIC company searches.

#### **D. Should the credit manager obtain security in the scenario?**

In the scenario there is a risk that if a charge were obtained it would be void should a liquidator or administrator be appointed within 6 months of lodgement. This would mean the security may be ineffective as the Corporations Act provides that a floating charge created within 6 months of the appointment of administrators is void, should the company subsequently be placed in liquidation.

This means that in the scenario if the credit manager believed that ABC was likely to go into administration within the next 6 months it may be fruitless to explore taking a charge, at the death of ABC.

Further, if the credit manager is aware that ABC is insolvent then this also puts any fixed charge obtained at risk of being voided by a liquidator. Insolvency means that a company is unable to pay its debts as and when they fall due and payable. One basis for a liquidator setting aside a fixed charge may be if they are able to prove that ABC was insolvent at the time the charge was obtained. Under the *Corporations Act* this may be voidable under the two categories of insolvent transactions, either as unfair preferences or uncommercial transactions.

The first step would be to discuss with ABC’s management its intentions.

If ABC is preparing for the imminent appointment of an administrator this is not the end of the story. There has been a development of “Pre-pack Administrations” in Australia recently and this comes out of insolvency practice in the United States. The Credit Manager’s company may be able to position itself move favourably under a “Pre-pack Administration”.

The Chapter 11 procedure in the United States is Court-focused bankruptcy process and it provides a litigation moratorium of 120 days when an insolvent corporation is placed under bankruptcy protection. This is Court sanctioned “breathing space” for an insolvent company to help it develop a restructuring solution. In Australia under the voluntary administration regime the insolvent company is placed under a moratorium from creditor action for a period of one month. The United States “Pre-Pack” is where the debtor company, its creditors and stakeholders come to an arrangement regarding the post-bankruptcy status of all parties before entering into Chapter 11. This means that by the time the debtor corporation approaches the Courts to enter into bankruptcy it is a mere formality because the key parties have already agreed upon the corporation’s restructure.

If ABC successfully organises a “Pre-Pack Administration” it would mean that all the restructuring of the company through a deed of company arrangement would be accepted by key stakeholders in advance. The benefit is that it may allow the credit manager’s company to protect its real interests in the scenario, business continuity and the minimisation of the debt write off.

#### **Alternatives in this scenario**

Other than exploring what restructuring proposals ABC may make under a “Pre-Pack Administration” the Credit Manager may look into all forms of security that may be obtained, including:

- Director’s guarantees
- Bank guarantees
- Security over property of the debtor’s
- Mortgages of real property owned by directors of the debtor
- Increased margin on sales

For example, in the scenario there may be a concern that the production process, including registered designs owned by ABC may be sold by a liquidator to a competitor. This may be addressed by licencing or assignment of these registered designs from ABC in consideration for reduction in the value of the debt owed. Other commercial negotiation may involve changing production contracts so that they are more favourable to the Credit Manager’s company by increasing margins on future orders. ■

#### **CHECKLIST:**

- **Conduct an ASIC search of your debtor to identify if there are any winding up applications that have been commenced and identify any other charge holders**
- **Obtain further information from your debtor regarding its balance sheet and liabilities to creditors including other charge holders**
- **Look at the risks and benefits all the forms of security could provide, such as a director’s guarantees, mortgages over property, security over inventory, etc**
- **Obtain legal advice regarding whether it is feasible to obtain a fixed and floating charge and consider commercial alternatives to protect your company’s real interests**

A new charge over a company is required by the Corporations Act to be registered with ASIC within 45 days of its creation.

This article is not intended to be comprehensive but rather to offer credit managers a starting point to considering real life problems.

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