

OPTIMIZING ENGLISH AND AMERICAN SECURITY INTERESTS

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INTRODUCTION

Security is a relationship between collateral and monetary obligations. The essence of the relationship is that if the obligations are not paid, the collateral may be sold and the sale proceeds applied to pay the obligations. The security concept is embodied in mortgages, security interests, and liens.

Security enjoys a highly privileged position in American law. A simple-sentence grant of a security interest,¹ combined with the filing of notice in an obscure set of public records, will give the secured creditor's claim priority over employees' wage claims,² child support

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1 4 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE, § 31-2 (6th ed. 2010) (“[I]t is enough for the debtor to write on the back of an envelope, ‘I hereby grant bank a security interest in my cattle, John Jones.’”).

2 *E.g.*, *First Nat’l Bank of Ind. v. Gabonay*, 545 N.E.2d 1130, 1133 (Ind. Ct. App. 1989) (“The Bank’s security interest in the corporation’s personal property was perfected long before the three months preceding the corporation’s demise when the employees’ claim for unpaid wages accrued.”).

obligations,³ tax claims,⁴ civil damage judgments,⁵ criminal fines and forfeitures,⁶ claims for unjust enrichment,⁷ and just about any other kind of debt imaginable.⁸

Scholars have attempted to justify security on both contract and property theories. On the American side, Dean David Leebron best articulated the contract argument:

The priority claim of a secured creditor rests almost entirely on principles of contract and notice. A persuasive theory of secured credit financing has been elusive, but the priority of a secured creditor over other financial creditors can be justified on the grounds that non-secured creditors grant a loan knowing that some assets are subject to security interests or could be subjected to security interests without their permission. If particular creditors will not tolerate other creditors having security interests in the borrower's assets, they can refuse to make a loan or make it only if the borrower agrees not to subject its assets to any security interests.⁹

3 *E.g.*, *Les Realty Corp. v. Hogan*, 714 A.2d 366, 370 (N.J. Super. Ct. Ch. Div. 1998) (“[C]hild support judgments are not given any special treatment in so far as priority of liens and are therefore subject to the general rule of ‘first in time, first in right.’”).

4 *E.g.*, *United States v. McDermott*, 507 U.S. 447, 449 (1993) (“Federal tax liens do not automatically have priority over all other liens. Absent provision to the contrary, priority for purposes of federal law is governed by the common-law principle that ‘the first in time is the first in right.’” (citation omitted)).

5 *E.g.*, *Bank Leumi Trust Co. of N.Y. v. Liggett*, 496 N.Y.S.2d 14, 16 (App. Div. 1985) (stating that “[i]t has long been established that first in time priority obtains as between mortgages and judgments,” and awarding priority to mortgage over judgment for fraudulent transfer).

6 *E.g.*, *People v. Green*, 22 Cal. Rptr. 3d 736, 738 (Ct. App. 2004) (holding that a criminal defendant's attorney's security interest for attorneys' fees had priority over the state's claim pursuant to California's “Freeze-and-Seize Law”).

7 *E.g.*, *Ninth Dist. Prod. Credit Ass'n v. Ed Duggan, Inc.*, 821 P.2d 788, 797 (Colo. 1991) (“The UCC priority system thus reflects the legislative judgment that the value of a predictable system of priorities ordinarily outweighs the disadvantage of the system's occasional inequities.”).

8 The principal exception is that property tax liens have priority over earlier-perfected security interests and mortgages. *E.g.*, ALASKA STAT. § 29.45.300(b) (2012) (“Property taxes, together with penalty and interest, are a lien upon the property assessed, and the lien is prior and paramount to all other liens or encumbrances against the property.”).

9 David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1646 (1991). On the English side, Gerard McCormack stated:

The question arises why the law should permit the taking of security. Three justifications are usually offered.

The first reason is based on freedom of contract: security is seen as resenting a fair exchange for the loan. In other words, the secured creditor has bar-

Contract cannot, however, justify security because security agreements “[are] effective according to [their] terms . . . against purchasers of the collateral, and against creditors.”¹⁰ That includes purchasers and creditors who did not consent to the security agreement, had no way of knowing of its existence, or never chose to become creditors at all.¹¹ Agreement is the essence of contract, but the affected purchasers and creditors have not agreed. As Professors Lynn LoPucki and Elizabeth Warren put it, “[s]ecurity is an agreement between A and B that C take nothing.”¹²

Other scholars attempt to justify security on property theories. For example, Professors Stephen Harris and Charles Mooney argued:

It seems clear enough that security interests, under Article 9 and real estate law alike, are interests in property. The legal regime for security interests reflects property law functionally as well as doctrinally. We believe it follows that the law should honor the transfer or retention of security interests on the same normative grounds on which it respects the alienation of property generally.¹³

The property theory begins from the generally accepted premise that a building owner can, by conveying the building in an otherwise unobjectionable transaction, cut off the rights of the debtor’s creditors to the building. By analogy, the property theory holds that by conveying the first \$100,000 of the value of the building in return for a \$100,000 loan, the owner should be able to cut off the rights of the debtor’s other creditors to the first \$100,000 of the value of the building. Frequent American literature references to security interests as

gained for rights of a proprietary nature over the debtor’s property whereas the general creditors have not.

GERARD McCORMACK, SECURED CREDIT UNDER ENGLISH AND AMERICAN LAW 12 (2004).
 10 U.C.C. § 9-201(a) (2012).

11 See, e.g., Elizabeth Warren, Essay, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 354 (1993) (“Because involuntary creditors, such as tort victims and environmental cleanup funds, were unable to negotiate in advance for the kind of superior treatment at state law that secured creditors demanded, they would likely come into the claims process only after others had taken the most valuable assets.”).

12 LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT, at xxxi (7th ed.2012).

13 Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors’ Choices Seriously*, 80 VA. L. REV. 2021, 2051 (1994) (footnotes omitted).

“property”¹⁴ and English literature references to charges as “proprietary”¹⁵ are invocations of this theory.

A necessary implication of the property conveyance theory is that encumbered property has multiple owners. The secured creditor owns the value of the collateral up to the full amount of the debt. The debtor owns the value of the collateral in excess of the amount of the debt, the right to redeem the property by paying the debt,¹⁶ and the right to use the property in the interim.

The principal policy objections to security are that it is deceptive¹⁷ (the “Deception Problem”) and that it distorts incentives for the management of property (the “Incentives Problem”). The essence of the Deception Problem is that debtors who have granted security interests appear to have wealth, but do not. The effect is to deceive third parties who extend credit without knowledge of the pre-existing security. The problem is generally referred to as “ostensible ownership” in the United States¹⁸ and as “false wealth” in England.¹⁹

14 See, e.g., Lawrence Ponoroff & F. Stephen Knippenberg, *Having One's Property and Eating It Too: When the Article 9 Security Interest Becomes a Nuisance*, 82 NOTRE DAME L. REV. 373, 374–75 (2006) (arguing that, under reigning conceptualization of security interest as property, “secured parties are figures of privilege among all creditors, enjoying a pervasive ‘property priority’ under state law and even in bankruptcy.”).

15 See, e.g., Louise Gullifer & Jennifer Payne, *The Characterization of Fixed and Floating Charges*, in COMPANY CHARGES: SPECTRUM AND BEYOND 51, 56 (Joshua Getzler & Jennifer Payne eds., 2006) (discussing three different theories that have been put forward regarding whether a floating lien is “proprietary”).

16 See U.C.C. § 9-623 (2012) (granting to debtors the right to redeem collateral by paying the debt at any time prior to the secured party's disposition of the collateral).

17 See Jonathan C. Lipson, *Secrets and Liens: The End of Notice in Commercial Finance Law*, 21 EMORY BANKR. DEV. J. 421, 426 (2005) (“Article 9 of the UCC . . . appears increasingly tolerant of secret liens.” (footnote omitted)); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1891 (1994) (“[T]he deceptive nature of security enables secured creditors and debtors to extract a . . . subsidy from relatively uninformed unsecured creditors who predictably miscalculate their likelihoods of recovery.”); Xuan-Thao Nguyen, *Collateralizing Intellectual Property*, 42 GA. L. REV. 1, 29 (2007) (“The concept of secured financing with intellectual property assets is deceptively simple . . .”).

18 See *Transp. Equip. Co. v. Guar. State Bank*, 518 F.2d 377, 381 (10th Cir. 1975) (“The ostensible ownership exercised through possession is demonstrated through simple physical control. One who controls the collateral possesses it, and leads others to believe it is his.” (emphasis omitted) (quoting *In re Automated Bookbinding Servs., Inc.*, 471 F.2d 546, 552 (4th Cir. 1972) (“Exercise of . . . ostensible ownership could perpetrate fraud on potential creditors who, not being able to know of the creditor's security interest, would think the collateral belonged to the debtor.”))).

19 See, e.g., LAW COMMISSION, REGISTRATION OF SECURITY INTERESTS, CONSULTATION PAPER NO. 164 ¶ 1.9 (2002), available at http://www.justice.gov.uk/lawcommission/docs/cp164_Company_Security_Interests_Consultation.pdf (“The risk of the impres-

The Incentives Problem is most egregious and easiest to see when the amount of the secured debt equals or exceeds the value of the collateral. Consider, for example, a business that operates with one billion dollars in assets encumbered by one billion dollars in secured debt. As the property's owner, the debtor has the right to control its use. The debtor can engage in business activities that risk inflicting billions of dollars in damages on third parties.²⁰ Those third parties have no remedy against the debtor, because the debtor owns no part of the value of its own assets.²¹ They have no remedy against the secured party because the secured party—switching its metaphorical role from “owner” to “creditor”—has priority over them.²² By shielding the debtor's property from the valid claims of third parties, security renders both “owners” judgment-proof²³ and encourages the irresponsible management of wealth.²⁴

Through a functional comparison of English and American security interests, this Article identifies potential practical solutions to

sion of ‘false wealth’ and the lack of a means whereby the existence of non-possessory secured lending could be discovered resulted in the introduction of the requirement to register the existence of many non-possessory securities, whether created by companies or by individuals.”).

20 Prominent recent examples of such liability-producing activities were the BP-Deepwater Horizon oil spill and the securitization of mortgage debt that precipitated the financial panic of 2008.

21 See Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 14–19 (1996) (explaining the strategy of judgment proofing through secured debt).

22 The UCC provides that “[t]he existence of a security interest, agricultural lien, or authority given to a debtor to dispose of or use collateral, without more, does not subject a secured party to liability in contract or tort for the debtor's acts or omissions.” U.C.C. § 9-402 (2012).

23 See generally Lynn M. LoPucki, *The Essential Structure of Judgment Proofing*, 51 STAN. L. REV. 147 (1998) (arguing that current law allows businesses, especially large businesses, to successfully judgment-proof); S. Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45 (1986) (using a theoretical model of accidents to explore the problem of judgment proofing).

24 See Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 843–52 (2004) (explaining the secured creditor's disincentive to maximize value for the benefit of other claimants).

This inefficiency can be mitigated in a variety of ways. The government can require the purchase of insurance. LoPucki, *supra* note 21, at 71–88. The government can impose criminal liability on individuals for the irresponsible managers and imprison them. The irresponsible management may happen to affect the value of the collateral, giving the secured party some incentive to prevent it. The secured debt may be less than the full value of the collateral, leaving the debtor with an equity to be concerned about. These potential mitigants are, however, rarely capable of overcoming the fundamental inefficiency of secured credit. The judgment-proofing tendency of secured credit virtually always distorts incentives to some degree.

the Deception and Incentives Problems. The proof that these solutions can potentially work in one country is that they appear already to be working, in similar circumstances, in the other.

The challenge was to distinguish these potential solutions from the hundreds of differences that exist in legal doctrines and concepts between English and American security interests. We accomplished that by conducting our comparison at the functional rather than the doctrinal level. Put simply, we focused on the resolutions of particular problems in the two systems. We treated the systems as the same if they reach the same resolutions—what LoPucki and Weyrauch have referred to as “delivered law”—regardless of the paths by which they arrived at them.²⁵ To the extent that terminology differed between the two systems, we posed the problems and resolutions in a neutral language, which we constructed as needed. This method is well-recognized in the field of comparative law.²⁶

Functional comparison dramatically reduces the apparent level of difference between two legal systems.²⁷ The explanation for this previously recognized phenomenon is beyond the scope of this Article.

25 Lynn M. LoPucki & Walter O. Weyrauch, *A Theory of Legal Strategy*, 49 DUKE L.J. 1405, 1430 (2000) (“Delivered law is the pattern of outcomes the legal system delivers.”).

26 Zweigert and Kötz explain the starting point for our approach:

The basic methodological principle of all comparative law is that of *functionality*. . . . Incomparables cannot usefully be compared, and in law the only things which are comparable are those which fulfill the same function. . . . The proposition rests on what every comparatist learns, namely that the legal system of every society faces essentially the same problems, and solves these problems by quite different means though very often with similar results. The question to which any comparative study is devoted must be posed in purely functional terms; the problem must be stated without any reference to the concepts of one’s own legal system.

KONRAD ZWIGERT & HEIN KÖTZ, *INTRODUCTION TO COMPARATIVE LAW* 34 (3d ed. 1998). See generally Lynn M. LoPucki, *The Systems Approach to Law*, 82 CORNELL L. REV. 479, 514-16 (1997) (describing the application of this approach to a comparison of U.S. and Canadian reorganization).

27 See Lynn M. LoPucki & George G. Triantis, *A Systems Approach to Comparing U.S. and Canadian Reorganization of Financially Distressed Companies*, 35 HARV. INT’L L.J. 267, 269 (1994) (reporting “striking similarities in function” between the U.S. and Canadian reorganization regimes). Zweigert and Kötz state:

[T]he comparatist can rest content if his researches through all the relevant material lead to the conclusion that the systems he has compared reach the same or similar practical results, but if he finds that there are great differences or indeed diametrically opposite results, he should be warned and go back to check again whether the terms in which he posed his original question were indeed purely functional

ZWIGERT & KÖTZ, *supra* note 26, at 40.

In our comparison of English and American security interests, the effect was to demonstrate that the systems are operating almost identically.

The few functional differences that remain are each true policy alternatives. We know that each is likely capable of transplant to the other system, because each is already operating in an otherwise almost-identical system.

Of the seven functional differences we identify, the most important addresses the Incentives Problem. In the American system, security interests have priority over virtually all competitors. In the English system, a “carve-out” gives administrative expenses, preferential creditors, and an unsecured creditor “prescribed share” priority over security interests.

Three other differences address the Deception Problem. Both the English and American systems generate secret liens, but they do so in different ways and with respect to different collateral. The English system is company-based while the American system is name-based. The English system supplies more information, and to a wider audience. The three remaining differences are of only minor importance.

We do not claim to have shown that the devices identified solve the underlying problems, even in the countries in which they are currently in use. Our claim is that they are potential solutions because they are purported to have mitigated those problems.

We also make two other claims. First, our comparison is the most extensive point-by-point comparison of the English and American law governing secured transactions to date.²⁸ Second, the extraordinary level of similarity we observed at the functional level suggests that law-making is in most instances better described as a search for the only solution that will work, than as a process of choosing among alternative policy solutions.

Both the English and American security systems recognize a wide variety of security devices.²⁹ To render our subject manageable, we

28 McCORMACK, *supra* note 9, discusses both English and American secured transactions law, but does so in largely separate essays. There is little point-by-point comparison. The same is true of Nick Segal, *The Effect of Reorganization Proceedings on Security Interest: The Position Under English and U.S. Law*, 32 BROOK. J. INT’L L. 927 (2007). Both describe the English and American legal regimes, but neither attempts to explain what is the same or different about them.

29 English law recognizes mortgages, pledges, contractual liens, and equitable charges (fixed or floating). See ROYSTON MILES GOODE, *LEGAL PROBLEMS OF CREDIT AND SECURITY* 5 (3rd ed. 2003). American law recognizes a variety of security interests that have been excluded from Article 9 coverage, including security interests in insurance, noncommercial tort claims, and compensation of employees. U.C.C. § 9-109(d)(3), (8), (12) (2012).

confine consideration in this Article to the principal forms of security granted by companies. In the American system, that is the Uniform Commercial Code Article 9 security interest with respect to personal property and the mortgage with respect to real property. In the English system, that is the fixed and floating charge, either of which can—in theory at least—extend to both real and personal property.

This Article proceeds in four parts. Part I compares the English and American systems with respect to attachment, perfection, and enforcement of security interests. Part II explains the distinction between fixed and floating charges under English law. Part III compares American security interests with English fixed charges by comparing the outcomes in prototypical cases. Part IV compares American floating liens with English floating charges in the same manner. The final Part concludes that the Americans should consider adopting the English Carve-out, the English should consider adopting the American cramdown, and both should consider improvements to their security interest registration systems.

I. SYSTEMS COMPARED GENERALLY

English fixed and floating charges are created, perfected, prioritized, and enforced in essentially the same manner as American security interests.

A. *Attachment*

In both the English and American systems, debtors and creditors create security interests by contract. In both, the creation is referred to as “attachment.” The conditions necessary for security interests to attach in the two systems are almost identical. To illustrate:

Goode describes four conditions which are necessary in order for an interest to attach: (1) there must be an agreement between debtor and creditor that the interest shall attach; (2) the asset must be identifiable as falling within the scope of the agreement; (3) the debtor must have a present interest in the asset, or power to give the asset as security; and (4) there must be some current obligation of debtor to creditor which the asset is designed to secure.³⁰

Each of these four conditions for attachment is clearly visible in the provisions of the Uniform Commercial Code that define attachment:

§ 9-203(a). A security interest attaches to collateral when it becomes enforceable against the debtor with respect to the collateral

30 LAW COMMISSION, *supra* note 19, ¶ 2.5 n.10.

- (b) . . . [A] security interest is enforceable against the debtor and third parties with respect to the collateral only if:
- (1) value has been given;
 - (2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and
 - (3) one of the following conditions is met:
 - (A) the debtor has authenticated a security agreement that provides a description of the collateral³¹

The English requirement of an agreement is matched in the UCC § 9-203(b)(3) requirement of an authenticated security agreement. If the collateral is land, both systems require that the agreement be the equivalent of a writing.³² For other collateral, the American system requires a writing or tangible equivalent,³³ while the English system does not.³⁴ But in both countries, security agreements are nearly always in writing to meet registration requirements or for evidentiary reasons, making the difference of little commercial importance.

The English requirement that “the asset must be identifiable as falling within the scope of the agreement”³⁵ is matched by the American requirement that the security agreement “provides a description of the collateral”³⁶ that “reasonably identifies what is described.”³⁷ The English requirement that the debtor “have a present interest in the asset, or power to give the asset as security”³⁸ is matched by the American requirement that “the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party.”³⁹ Lastly, the English requirement that there be “some current obligation of debtor to creditor which the asset is designed to secure”⁴⁰ is

31 U.C.C. § 9-203(a)–(b)(3)(A) (2012).

32 Law of Property (Miscellaneous Provisions) Act, 1989, c. 34, § 2(1) (“A contract for the sale or other disposition of an interest in land can only be made in writing”); *id.* § 2(6) (“In this section . . . ‘interest in land’ means any estate, interest or charge in or over land”).

33 U.C.C. § 9-102(a)(7) (2012) (defining “authenticate”).

34 ROY GOODE, GOODE ON COMMERCIAL LAW 671 (Ewan McKendrick ed., 4th ed. 2010) (“[I]f the intended security interest is an interest in land, it must be made in writing and signed by or on behalf of both parties”); LAW COMMISSION, COMPANY SECURITY INTERESTS, CONSULTATION PAPER NO. 176, ¶ 3.76 (“Present law does not require writing for every kind of non-possessory security agreement.”).

35 LAW COMMISSION, *supra* note 19, ¶ 2.5 n.10.

36 U.C.C. § 9-203(b)(3)(A) (2012).

37 *Id.* § 9-108(a).

38 LAW COMMISSION, *supra* note 19, ¶ 2.5 n.10.

39 U.C.C. § 9-203(b)(2) (2012).

40 LAW COMMISSION, *supra* note 19, ¶ 2.5 n.10.

matched by the American requirement that “value has been given.”⁴¹ Although the American statute does not say who must give value “the assumption seems to be that it is the creditor.”⁴² Typically, that value will be the loan.

One apparent difference between the English and American systems is that the English system permits the taking of floating charges against “the undertaking,” that is, the business of the debtor.⁴³ The American system permits only the taking of security interests in specific property, or specific categories of property.⁴⁴ A description of the collateral as “all of the debtor’s assets” or words of similar import, is insufficient.⁴⁵ The difference may, however, merely be cosmetic. American lawyers combine all possible categories of property to create descriptions that cover all property of the debtor that can serve as collateral. Such descriptions are upheld.⁴⁶

B. Perfection

The legitimacy of secured creditor priority ultimately rests on the assumption that “all creditors have [had the] opportunity to discover

41 U.C.C. § 9-203(b)(1) (2012).

42 LOPUCKI & WARREN, *supra* note 12, at 143 (“Although [§ 9-203(b)(1)] does not say who must give value, the assumption seems to be that it is the creditor.”).

43 *In re Pan., N.Z., and Austl. Royal Mail Co.* (1870) 5 Ch. App. 318 (holding that where a company had charged its “undertaking, and all sums of money arising therefrom,” the word “undertaking” signified not merely the income from the business but also present and future property of the company); ROBERT PENNINGTON, *COMPANY LAW* 163 (2009) (“The floating charge enabled companies effectively to create a security over their business undertakings as a going concern . . .”).

44 U.C.C. § 9-108 (2012).

45 *See, e.g., Nat’l Ropes, Inc. v. Nat’l Diving Serv., Inc.*, 513 F.2d 53, 57 (5th Cir. 1975) (describing collateral in security agreement as “all property of the undersigned of every name and nature whatsoever” not sufficient); *ProGrowth Bank, Inc. v. Wells Fargo Bank, N.A.*, 2009 WL 2982939, *3 (D. Minn. Sept. 14, 2009) (“[U]se of such an all-encompassing (or ‘supergeneric’) provision is not permitted to ‘describe’ the collateral when granting a security interest as it ‘does not reasonably identify the collateral.’” (citation omitted)).

46 *See, e.g., Donald v. Madison Indus., Inc.*, 483 F.2d 837, 840 (10th Cir. 1973) (upholding a description that began “[a]ll items of personal property,” listed categories, and ended “[t]his is intended to cover everything owned by this business”); *Rosenberg v. Rudnick*, 262 F. Supp. 635, 636 (D. Mass. 1967) (finding a valid grant of security over inventory where the security agreement described the collateral as “all the equipment, machinery, fixtures, inventory and accounts receivable of the debtor, together with all additions thereto and all property now or hereafter substituted therefor or otherwise acquired in the ordinary course of business”).

the existence of the secured creditor.”⁴⁷ In recognition of this dependence, both the English and American systems impose “perfection” requirements designed to provide notice. Perfection requirements include taking possession or control of collateral and public lien registration.

The English and American registration systems differ in four relevant respects. First, American registrations are generally effective when made, while English registrations relate back to charge creation. Second, the English system is company-based, while the American system is name-based. Third, although both systems grant exceptions from registration that result in secret liens, the exceptions are different. Lastly, the English system seeks to provide public notice, while the American system seeks to provide notice only for the benefit of prospective secured lenders.

1. Security Interest Priority Dates

In the United States, the approach taken by the Uniform Commercial Code is that the first creditor to file or perfect has priority over creditors who file or perfect subsequently,⁴⁸ regardless of when the security agreements were made or the loan proceeds disbursed. This has been referred to in the American literature as a “pure race” approach, because “a filing secured creditor prevails even over those unrecorded security interests of which he was aware.”⁴⁹

The English rule is that competing company charges “rank in order of their creation.”⁵⁰ (That is also the basic rule for competing real estate mortgages in the United States.)⁵¹ A charge is created upon the execution of “a contract for valuable consideration to . . .

47 Harris & Mooney, *supra* note 13, at 2064 (“[W]e see nothing unfair or untoward about permitting a secured creditor to go to the head of the line when earlier-in-time creditors have not chosen to obtain security themselves and all creditors have an opportunity to discover the existence of the secured creditor.”).

48 U.C.C. § 9-322(a)(1) (2012) (“Conflicting perfected security interests . . . rank according to priority in time of filing or perfection. Priority dates from the earlier of the time a filing covering the collateral is first made or the security interest . . . is first perfected, if there is no period thereafter when there is neither filing nor perfection.”).

49 *Langley v. FDIC*, 484 U.S. 86, 95 (1987).

50 *Macmillan Inc. v. Bishopsgate Inv. Trust Place (No. 3)*, [1995] W.L.R. 978 (Ch. D) at 1000. This rule was first articulated in *Rice v. Rice*, 2 Drew 73, 78 (1853) (“[A]s between persons having only equitable interests, if their equities are in all other respects equal, priority of time gives the better equity . . .” (emphasis omitted)).

51 See *LOPUCKI & WARREN*, *supra* note 12, at 537 (noting that rule ranking mortgages in the order of grant “has a much wider effect, because the priority thus gained is not so easily upset by the recording of one of the mortgages”).

charge [an item of collateral, which] passes a beneficial interest by way of property in that [collateral].”⁵² The order in which the competing creditors register their interests does not matter. However, the Companies Act requires a charge created by a company to be perfected by registration within twenty-one days after the date of its creation.⁵³ Failure to comply with this provision renders the charge void against other creditors and against the liquidator or administrator of the company.⁵⁴

The deceptive nature of the English rule is well recognized. The rule creates an “invisibility period” of up to twenty-one days:

The principal rule is that priority of competing charges is determined by the order of their creation. The combination of this and the 21-day period allowed for registration has given rise to what has been called the ‘21-day invisibility’ problem. A person who searches the Companies Register, finds no record of an earlier charge and takes and registers her own charge immediately, may nevertheless be postponed to an earlier chargee who registers after the taking, or even the registration, of the second charge but within the 21 days allowed.⁵⁵

The Law Commission has already recommended that priority be determined solely by comparing dates of registration.⁵⁶

52 *Palmer v. Carey*, [1926] A.C. 703 (HL) at 706–07 (appeal taken from Austl.).

53 The Act provides:

(1) The period allowed for registration of a charge created by a company is—

(a) 21 days beginning with the day after the day on which the charge is created, or

(b) if the charge is created outside the United Kingdom, 21 days beginning with the day after the day on which the instrument by which the charge is created or evidenced (or a copy of it) could, in due course of post (and if dispatched with due diligence) have been received in the United Kingdom.

Companies Act, 2006, c. 46, § 870.

54 The Act provides:

(1) If a company creates a charge to which section 860 applies, the charge is void (so far as any security on the company’s property or undertaking is conferred by it) against—

(a) a liquidator of the company,
 (b) an administrator of the company, and
 (c) a creditor of the company,

Id. § 874.

55 LAW COMMISSION, *supra* note 19, ¶ 2.37

56 LAW COMMISSION, COMPANY SECURITY INTERESTS, LAW COMMISSION REPORT NO. 296 ¶ 11 (2005).

2. Entity-based Versus Name-based Filing

The system for filing and searching is entity-based in England, but name-based in the United States. That the English system is entity-based means that a security interest registration is associated with a particular company at the time it is made. That is, the secured creditor selects the company against which to file or search by reference to the company records. The secured creditor can make the match by name, company number, or other information in the company records,⁵⁷ and the filing officer places the filing in the company records. The secured creditor can err only by choosing the wrong company.

In the American name-based system, the secured creditor must file in the exact, correct name of the debtor. Because the filing officer does not associate the security interest registration with the company registration, the filing officer does not know whether the security interest registration identifies an existing company. With difficulty, the filer can search the company records to discover the debtor's name, and computer search logic may or may not save filers or searchers from minor errors in punctuation and abbreviation. But the American system will not overcome the use of a trade name, or a misspelling. As a result, as many as fifteen to seventeen percent of registrations against corporate entities in the United States are ineffective.⁵⁸

In 2001, the Article 9 drafters laid the groundwork for a change to entity-based filing, by changing the place for filing and searching to the debtor's incorporation state and requiring inclusion of the company number on each filing. Those changes made it possible for the filing officers to associate filings with companies. But in the ensuing nine years, only one or two commercially unimportant states actually made the association.⁵⁹ In 2010, the American Uniform Law Commis-

57 See Companies House, Form MG07, CHFP000, 05/10 Version 4.0, available at http://www.companieshouse.gov.uk/forms/generalForms/MG07_particulars_for_the_registration_of_a_charge_to_secure_a_series_of_debentures.pdf (last visited Jan. 16, 2013). Item 1 on that form makes submission of both the Company number and the Company name mandatory. *Id.*

58 See generally Aneta Ferguson, *The Trademark Filing Trap*, 49 IDEA 197 (2009) (finding empirically that 15% of secured creditors filed notice in the wrong filing system and failed to file in the right system, making their security interests unenforceable against third parties); Rachele Soderstrom, *An Imperfect System of Perfection: Fixing the Debtor Name Error Problem* (unpublished paper 2010) (finding empirically that 17% of filings in the Vermont UCC filing system were ineffective).

59 For example, Maine combined UCC and incorporation records in a manner that allows users to file against a corporation the user selects from among those regis-

sion apparently abandoned this reform effort by dropping the requirement that company numbers be included on filings,⁶⁰ and declaring the exact, correct name of an entity not necessarily to be the name on the computerized records of the filing office.⁶¹ For the filing office to match filings to company records is no longer practical.

3. Secret Liens

Second, in both the English and American systems, some security interests are effective without registration or any substitute method of publicity. The effect is to validate secret liens, and deceive those who deal with the debtor on the basis of the public record.

In the English system, all floating charges must be registered,⁶² but fixed charges must be registered only if they are of particular types

tered in the state. The system is at <https://www10.informe.org/ucc/filing/begin.shtml>. Select “File a Financing Statement - Form UCC-1, then select “Standard UCC Lien,” then select “Registered Organization,” then enter “Pickles” to see the names of Maine corporations that contain “Pickles.”

60 See AMENDMENTS TO UNIFORM COMMERCIAL CODE ARTICLE 9, July 21, 2010, at 63–64 (specifying deletion of U.C.C. § 9-516(b)(5)(C)(iii) that had required, as a condition of filing, “an organizational identification number for the debtor or indicate that the debtor has none”).

61 See *id.* at 49 (declaring in U.C.C. § 9-503(a)(1) that financing statement names are “sufficient” only if the financing statements provide the names of debtors as indicated on the “public organic record[s] most recently filed”); *id.* at 14 (defining “public organic record” to mean “a record consisting of the record initially filed with or issued by a State . . . to form or organize an organization” in U.C.C. § 9-102(a)(68)). Most states charge a fee for a copy of the “public organic record” making the search cumbersome.

62 Companies Act, 2006, c. 46, § 860(7)(g) (“This section applies to . . . (g) a floating charge on the company’s property or undertaking . . .”). An exception to this rule arises under Regulation 4 of the Financial Collateral Arrangements (No. 2) Regulations 2003 (SI 2003/3226), which implements Directive 2002/47/EC of the European Parliament and of the Council of June 6, 2002 on financial collateral arrangements, as amended, into English law. The regulation exempts floating charges involving a “security financial collateral arrangement” (as defined in SI 2003/3226, Regulation 3) from the registration requirements of the Companies Act. However, the only English case to interpret this exception found that to constitute a “security financial collateral arrangement” control by the chargee was required. See, *Gray & Ors v G-T-P Group Ltd Re F2G Realisations Limited (in Liquidation)* [2010] EWHC 1772 (Ch). According to SI 2003/3226, Regulation 3, for a floating charge to constitute a “security financial collateral arrangement” the floating charge must be “registered or otherwise designated so as to be in the possession or under the control of the collateral-taker.” This has been interpreted by at least one English commentator as meaning that the “definition of ‘security financial collateral arrangement’ and of ‘security interest’ in the Regulations means that they do not apply to floating charges before the charge has crystallised and some control over the collateral has passed to the charge holder.” G McCORMACK, REGISTRATION OF COMPANY CHARGES

listed in the Companies Act.⁶³ The list does not, for example, include charges on insurance policies⁶⁴ and on shares.⁶⁵ The shortcomings caused the Law Commission to conclude:

[B]ecause the list of registrable charges is incomplete (in part because the list has been little changed since its introduction over a century ago), and because the priority aspect has developed only as an indirect effect of attempts to secure compliance, the current scheme does not seem to fulfil either its ‘public notice’ function or its ‘priority’ function efficiently.⁶⁶

The American system has the same shortcoming with respect to security interests in insurance policies or shares.⁶⁷ In addition, the American system authorizes secret liens in bank accounts, investment

(3d ed. 2009). We agree with the view expressed by Professor McCormack. Given the limited applicability of this exception (particularly given that it only applies to crystallized floating charges, which arguably are not floating charges at all), this Article treats all floating charges as needing to be registered.

63 The Act provides:

(1) A company that creates a charge to which this section applies must deliver the prescribed particulars of the charge, together with the instrument (if any) by which the charge is created or evidenced, to the registrar for registration before the end of the period allowed for registration. . . .

(7) This section applies to the following charges—

- (a) a charge on land or any interest in land . . . ,
- (b) a charge created or evidenced by an instrument which, if executed by an individual, would require registration as a bill of sale,
- (c) a charge for the purposes of securing any issue of debentures,
- (d) a charge on uncalled share capital of the company,
- (e) a charge on calls made but not paid,
- (f) a charge on book debts of the company,
- (g) a floating charge on the company’s property or undertaking,
- (h) a charge on a ship or aircraft, or any share in a ship,
- (i) a charge on goodwill or on any intellectual property.

Companies Act, 2006, c. 46, § 860.

64 See *Paul & Frank Ltd. v. Discount Bank (Overseas) Ltd.*, [1967] Ch. 348 (holding that a fixed charge over an insurance policy did not require registration and was valid against the liquidator of the company); LOUISE GULLIFER & JENNIFER PAYNE, *CORPORATE FINANCE LAW* 267 (2011).

65 See *Arthur D Little Ltd. (In administration) v. Ableco Finance LLC*, [2003] Ch. 217 (holding that a charge on shares was a fixed charge not requiring registration); EILIS FERRAN, *PRINCIPLES OF CORPORATE FINANCE LAW* 399 (2008).

66 LAW COMMISSION, *supra* note 19, ¶ 3.10.

67 See U.C.C. § 9-109(d)(8) (2012) (excluding security interests in insurance from Uniform Commercial Code coverage); *id.* § 9-310(b)(5), (6), (8) (excusing filing to perfect a security interest in securities).

property, and some other kinds of collateral.⁶⁸ The American system does so by requiring that the secured creditor take “control” over the collateral, but defining control in a manner that taking it is unlikely to alert third parties to the existence of the security interest.

The American requirement for perfecting a security interest in a bank account is illustrative. No public filing is required.⁶⁹ The secured creditor can perfect by taking control.⁷⁰ The secured creditor takes control by entering into an agreement with the debtor and the bank, in which the bank agrees to “comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor.”⁷¹ The secured creditor has control “even if the debtor retains the right to direct the disposition of funds from the deposit account.”⁷² Thus, the debtor can continue to use the secured-creditor-controlled account in the exact same manner as if it were unencumbered. The bank “is not required to confirm the existence of the [potential control] agreement to another person unless requested to do so by its customer.”⁷³ The result is a lien that is invisible to the public, including all but the most diligent who deal with the debtor. Similar potential for secret liens exists with respect to “control” of securities and commodity accounts.⁷⁴

68 See, e.g., Lipson, *supra* note 17, at 421 (“[R]ecent revisions to Article 9 of the UCC . . . tolerate secret liens that may arise on such increasingly important assets such as data, intellectual property, bank accounts, and securities.”).

69 U.C.C. § 9-310(b) (2012) (“The filing of a financing statement is not necessary to perfect a security interest . . . (8) in deposit accounts”); *id.* § 9-309(1) (“The following security interests are perfected when they attach: (1) a purchase-money security interest in consumer goods”).

70 *Id.* § 9-314(a) (“A security interest in . . . deposit accounts . . . may be perfected by control of the collateral under Section . . . 9-104”).

71 *Id.* § 9-104(a)(2).

72 *Id.* § 9-104(b).

73 *Id.* § 9-342.

74 *Id.* § 9-310(b)(8) (“The filing of a financing statement is not necessary to perfect a security interest . . . (8) in . . . investment property . . . which is perfected by control under section 9-314.”). Section 9-314(c) states that “[a] security interest in investment property is perfected by control under Section 9-106.” *Id.* § 9-314(c). Section 9-106 provides that a “person has control of a certificated security, uncertificated security, or security entitlement as provided in Section 8-106.” *Id.* § 9-106. Section 8-106(f) provides:

A purchaser who has satisfied the requirements of subsection (c) or (d) has control, even if the registered owner in the case of subsection (c) or the entitlement holder in the case of subsection (d) retains the right to make substitutions for the uncertificated security or security entitlement, to originate instructions or entitlement orders to the issuer or securities intermedi-

English law does not permit secret charges in bank accounts.⁷⁵ Ordinarily, a charge against a bank account would be a floating charge.⁷⁶ As was discussed above, with one minor exception floating charges must be registered.⁷⁷

English and American law differ with respect to the sale of accounts receivable. American law regards such sales as the equivalent of security interests and requires registration.⁷⁸ English law does not require registration of a sale of accounts:

In the case of a factoring agreement, the purchase rights of the factor, which are not charges, do not require registration. Consequently, there is no means in the nature of public notice by which a competing factor or secured creditor can discover the existence of a previous sale of the book debts.⁷⁹

4. Public Notice Versus Prospective-Lender Notice

The English registration system makes information about registrations more widely available than does the American system. The English broadly conceive the system's purposes to include the provision of information to the public,⁸⁰ credit rating agencies, insolvency administrators, and creditors who no longer have leverage over their debtor because they have already committed their funds:

Commentators now recognise that registration fulfills several purposes:

ary, or otherwise to deal with the uncertificated security or security entitlement.

Id. § 8-106.

⁷⁵ A fixed charge could be taken over an account that is segregated and blocked, that is, where control over the account rests with the creditor. Such fixed charges are, however, difficult to administer, and, as a consequence, are used in limited contexts.

⁷⁶ See *infra* Part II.B.

⁷⁷ Companies Act, 2006, c.46, § 860(7)(g) (requiring registration of “a floating charge on the company’s property or undertaking”). See *supra* note 62.

⁷⁸ U.C.C. § 1-201(b)(35) (2012) (“‘Security interest’ includes any interest of . . . a buyer of accounts”); *id.* § 9-109(a)(3) (“[T]his article applies to . . . a sale of accounts”); *id.* § 9-310(a) (“[A] financing statement must be filed to perfect all security interests”).

⁷⁹ Michael Bridge, *England and Wales, in CROSS-BORDER SECURITY OVER RECEIVABLES* 147, 166 (Harry C. Sigman & Eva-Maria Kieninger eds., 2009).

⁸⁰ LAW COMMISSION, *supra* note 19, ¶ 3.9 (“[R]egistration was originally introduced to provide information to the public about whether a company had charged its assets, in order to prevent it giving an impression of ‘false wealth’ by appearing to own assets that in fact were charged in favour of others.”). But see *id.* ¶ 4.73 (“We provisionally propose that there should not be a general requirement to provide further information or a copy of the security agreement to a member of the public upon request, but we would welcome consultees’ views.”).

- (1) it provides information on the state of the encumbrances on a company's property to those who may be interested (for example, creditors and those considering or advising on dealing with the company, including credit reference agencies, financial analysts and potential investors);
- (2) it assists companies in enabling them to give some form of assurance to potential lenders that their property is unencumbered;
- (3) it provides a degree of protection to a chargee, in relation to the validity and priority of its registered charge; and
- (4) it assists receivers and liquidators in deciding whether or not to acknowledge the validity of a mortgage or charge.⁸¹

The English system also provides relatively generous access to the terms of the security agreement. Each company is required to keep "available for inspection a copy of every instrument creating a charge requiring registration"⁸² and "a register of charges . . . , [into which the company is required to enter] (a) all charges specifically affecting property of the company, and (b) all floating charges on the whole or part of the company's property or undertaking,"⁸³ which "in each case [shall] give a short description of the property charged, the amount of the charge and, except in the cases of securities to bearer, the names of the persons entitled to it."⁸⁴ The documents and the register are required to be open to the inspection of any creditor or member of the company without payment of a fee.⁸⁵ Any person can inspect the documents and the company's register of charges (but not copies of the instruments) on payment of a nominal fee.⁸⁶

By contrast, the American system operates on the principle that existing liens are the business of no one but the debtor, and those to whom the debtor wishes to disclose them:

Because creditors of and prospective purchasers from a debtor may have legitimate needs for more detailed information, it is necessary to provide a procedure under which the secured party will be required to provide information. On the other hand, the secured party should not be under a duty to disclose any details of the debtor's financial affairs to any casual inquirer or competitor who may inquire. For this reason, this section gives the right to request information to the debtor only. The debtor may submit a request in connection with negotiations with subsequent creditors and purchasers, as well as for the purpose of determining the status of its

81 *Id.* ¶ 2.21 (footnote omitted).

82 Companies Act, 2006, § 875(1).

83 *Id.* § 876(1).

84 *Id.* § 876(2).

85 *Id.* § 877(4).

86 *Id.*

credit relationship or demonstrating which of its assets are free of a security interest.⁸⁷

Despite the acknowledgement that creditors and prospective purchasers from the debtor may need additional information from the secured creditor, Article 9 gives only the debtor a legal right to obtain it. “Section 9-210 provides a statutory procedure under which the secured party, at the debtor’s request, may be required to make disclosure. However, in many cases, information may be forthcoming without the need to resort to the formalities of that section.”⁸⁸ The information obtainable through U.C.C. § 9-210 does not include a copy of the security agreement. In most cases, however, the debtor will have a copy. No provision of Article 9 requires that either the debtor or the secured party furnish a copy of the security agreement to anyone.

The difference between the English and American systems in access to information is most visible in the example of an unsecured creditor who is considering whether to take legal action against its debtor. In the English system, this creditor would have the right to review copies of every instrument creating a charge against the company. In the American system, this creditor would have the right to only the names of persons who might have security interests and general categories of property those interests might encumber.⁸⁹

C. Enforcement

If an American debtor defaults on its obligations under the security agreement, the secured creditor has by law the right to repossess tangible personal property collateral by self-help if it can do so without breach of the peace.⁹⁰ An English debtor has the same right only if the security agreement so provides, but security agreements almost invariably so provide.⁹¹ Neither system permits self-help with respect

87 U.C.C. § 9-210 cmt. 3.

88 *Id.* § 9-502 cmt. 2.

89 Typically, an American “notice filing” will include only the name and address of the debtor, the name and address of the creditor, and an indication of the collateral. *See id.* § 9-521(a) (official form for notice filing).

90 *See id.* § 9-609(a) (“After default, a secured party . . . may take possession of the collateral . . .”); *id.* § 9-609(b) (“A secured party may proceed . . . without judicial process, if it proceeds without breach of the peace.”).

91 *See* GOODE, *supra* note 34, at 680 (“The right to take possession . . . invariably is[] expressly reserved in the security instrument, and is . . . equally available, whether the creditor is the holder of a legal mortgage, an equitable mortgage or a charge. . . . If the security comprises goods which can be seized without entry on to the premises

to real estate.⁹² In both systems the secured creditor can sell the collateral under its own power of sale⁹³ or through a court-supervised sale,⁹⁴ and apply the proceeds of sale to payment of the secured obligation.⁹⁵ In both, the debtor has the right to “redeem” the collateral

of the debtor, the creditor may use self-help, taking the goods without an order of the court” (footnote omitted)).

92 For the United States, see *Spinks v. Equity Residential Briarwood Apartments*, 90 Cal. Rptr. 3d 453, 480 (Ct. App. 2009) (“The statutes . . . reflect a policy, with deep roots in English law, barring the use of forceful self-help to enforce a right to possession of real property and requiring instead the use of judicial process to gain possession.” (quoting *Glass v. Najafi*, 92 Cal. Rptr. 2d 606, 608 (2000)) (internal quotation marks omitted). For England, see GOODE, *supra* note 34, at 680–81 (“[W]here the asset given as security is land, the creditor will . . . appoint a receiver to take possession for him or apply for a possession order so as to avoid the possibility of a breach of the peace, as well as liability to prosecution if he were to make a violent entry [A] court order is necessary to enforce a right to possession of land under a mortgage securing a regulated agreement within the Consumer Credit Act 1974” (footnotes omitted)).

93 For England, see Law of Property Act, 1925, 15 & 16 Geo. 5, c. 20, § 101, which provides:

(1) A mortgagee, where the mortgage is made by deed, shall, by virtue of this Act, have the following powers, to the like extent as if they had been in terms conferred by the mortgage deed . . . :

(i) A power, when the mortgage money has become due, to sell . . . the mortgaged property, or any part thereof, either subject to prior charges or not

94 For the United States, see U.C.C. § 9-601(a) (“A secured party [] may reduce a claim to judgment, foreclose, or otherwise enforce the claim [or] security interest . . . by any available judicial procedure”). For England, see Law of Property Act, 1925, § 91 (“(2) . . . [T]he court, on the request of the mortgagee . . . may direct a sale of the mortgaged property . . . (6) . . . ‘mortgaged property’ includes the . . . interest which a mortgagee would have had power to convey if the statutory power of sale were applicable.”). See also *id.* § 205(1)(xvi) (“‘Mortgage’ includes any charge . . . on any property for securing money or money’s worth”).

95 For the United States, see U.C.C. § 9-610(a) (stating that after default a secured party may sell or otherwise dispose of any or all of the collateral); *id.* § 9-615(a) (“A secured party shall apply . . . the cash proceeds of disposition under Section 9-610 in the following order to [expenses of sale and] the satisfaction of obligations secured by the security interest . . . under which the disposition is made”). For England, see Law of Property Act, 1925, §105 (“The money . . . received by the mortgagee, arising from the sale, after discharge of prior incumbrances to which the sale is not made subject, if any . . . shall be . . . applied by him, first, in payment of all costs . . . and expenses properly incurred by him as incident to the sale . . . and secondly, in discharge of the mortgage money, interest, and costs . . . due under the mortgage; and the residue . . . shall be paid to the person entitled to the mortgaged property”). See also *id.* § 205(1)(xvi) (“‘Mortgage’ includes any charge . . . on any property for securing money or money’s worth”).

after default by paying the full amount due under the contract prior to sale of the collateral.⁹⁶

In summary, the English and American systems are highly similar with respect to attachment and enforcement of security interests. Both function poorly with regard to perfection, although they do so in different ways.

II. THE FIXED CHARGE-FLOATING CHARGE DISTINCTION

The distinction between fixed and floating charges is important because floating charges are subject to the English Carve-out, while fixed charges are not. The distinction has been difficult to make because no statute defines “floating charge”⁹⁷ and the process of defining it by case law has proceeded slowly. As Professor Goode put it in an article advocating abolition of the floating charge:

Corporate floating charges have now been with us for some 135 years—plenty of time, one might think, for the courts to have worked out in detail their nature and priority. . . . It is astonishing that after all this time we still extol the virtues of a security device which continues to generate controversy and differences of opinion among the judiciary as to its essential nature.⁹⁸

The slow process of case-based definition began in 1903. In *In re Yorkshire Woolcombers Ass’n Ltd.*,⁹⁹ Lord Justice Romer set forth the fol-

96 *E.g.*, U.C.C. § 9-623(a) (“A debtor . . . may redeem collateral.”); *id.* § 9-623(b) (“To redeem collateral, a person shall tender . . . fulfillment of all obligations secured by the collateral”); *id.* § 9-623(c) (“A redemption may occur at any time before a secured party . . . has disposed of collateral or entered into a contract for its disposition”). On the English side, Ferran states:

Any provision in the terms of a mortgage which purports to remove the mortgagor’s right to redeem, or which would indirectly tend to have the effect of making the mortgage irredeemable, is regarded in equity as a ‘clog’ or ‘fetter’ on the equity of redemption and, as such, it is void. The principle that clogs on the equity of redemption are void applies to all types of mortgages and also to charges, including floating charges.

FERRAN, *supra* note 65, at 365–66 (footnotes omitted).

97 Insolvency Act, 1986, c. 45, § 251 (purporting to define a floating charge as “a charge which, as created, was a floating charge”); *id.* §§ 40(1), 176A(9). That is not a definition of floating charge, but merely a statement that crystallizations will be ignored for most purposes in insolvency cases. *See* Smith (Adm’r of Cosslett (Contractors) Ltd.) v. Bridgend Cnty. Borough Council, [2002] 1 A.C. 336 (HL) at 357 (Lord Scott of Foscote L.J.) (“[T]here has never been any statutory definition of ‘floating charge.’ The definitions are all judicial ones and, in most cases, expressed in order to distinguish floating charges from fixed charges.”).

98 Roy Goode, *The Case for Abolition of the Floating Charge*, in COMPANY CHARGES: SPECTRUM AND BEYOND, *supra* note 15, at 21.

99 [1903] 2 Ch. 284; *aff’d sub nom.* Illingworth v. Houldsworth, [1904] A.C. 355.

lowing three-part test for the existence of a floating charge. A charge is floating:

- (1.) [I]f it is a charge on a class of assets of a company present and future;
- (2.) [I]f that class is one which, in the ordinary course of the business of the company, would be changing from time to time; and
- (3.) [I]f you find that by the charge it is contemplated that, until some future step is taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way as far as concerns the particular class of assets [subject to the charge].¹⁰⁰

The first criterion makes clear that a floating charge can extend to assets the debtor does not yet own, or that do not yet even exist. The second indicates that a floating charge is typically taken over “revolving assets”¹⁰¹ such as inventory or accounts receivable. The third is interpreted to mean that the floating charge debtor remains “free to manage and deal with” the collateral in the ordinary course of business until some future event occurs which terminates that right.¹⁰²

Lord Justice Romer acknowledged that he was not giving a precise definition of the floating charge.

I certainly do not intend to attempt to give an exact definition of the term “floating charge,” nor am I prepared to say that there will not be a floating charge within the meaning of the [Companies] Act [1900], which does not contain all the three characteristics that I am about to mention, but I certainly think that if a charge has the three characteristics that I am about to mention it is a floating charge.¹⁰³

As he predicted, later cases chipped away at the relevance of the first two criteria.¹⁰⁴

The essence of the distinction remained unclear for the next one-hundred years. In 2001, through Lord Millett, the Privy Council in

100 *In re Yorkshire Woolcombers Ass'n. Ltd.*, [1903] 2 Ch. at 295.

101 GOODE, *supra* note 34, at 724. (“The concept underlying a floating charge is therefore one of a class of revolving assets . . .”).

102 *Id.*

103 *In re Yorkshire Woolcombers*, [1903] 2 Ch. at 295.

104 *See, e.g., In re Croftbell Ltd.*, [1990] BCLC 844 (holding that a charge on subsidiary shares was floating despite the absence of regular turnover); *In re ASRS Establishment Ltd.*, [2000] 2 BCLC 631 (holding that a charge over an escrow account was floating despite the account not being subject to fluctuation); *Smith v. Bridgend Cnty. Borough Council*, [2002] 1 A.C. 336 at 357 (holding that a charge on heavy duty coal-washing plants was floating despite the absence of turnover in the collateral).

*Agnew v. Commissioner of Inland Revenue*¹⁰⁵ held that “the first two [criteria] are typical of a floating charge but they are not distinctive of it, since they are not necessarily inconsistent with a fixed charge.”¹⁰⁶ Lord Millett went on to say that Lord Justice Romer’s third criterion “is the hallmark of a floating charge and serves to distinguish it from a fixed charge.”¹⁰⁷ This reduction of Lord Justice Romer’s criteria from three to one was corroborated in 2005 by Lord Scott. In *In re Spectrum Plus Ltd.*, Lord Scott stated that “if a security has Romer LJ’s third characteristic . . . it qualifies as a floating charge, and cannot be a fixed charge, whatever may be its other characteristics.”¹⁰⁸ In other words, Lord Justice Romer’s third criterion for characterizing a charge as floating—lack of secured creditor control over the collateral—is both necessary and sufficient; while Lord Justice Romer’s first and second criteria are merely indicative.

A. Control as the Distinction

Although his comment was not ultimately as influential as Lord Justice Romer’s, Lord Justice Williams also weighed in on the distinguishing factor in *Yorkshire Woolcombers*. He said:

[W]hat you do require to make a [fixed charge] is that the security whenever it has once come into existence, and been identified or appropriated as a security, shall never thereafter at the will of the [chargor] cease to be a security. If at the will of the [chargor] he can dispose of it and prevent its being any longer a security, although something else may be substituted more or less for it, that is not a ‘[fixed] security.’¹⁰⁹

In *Agnew*, Lord Millett quoted Lord Justice Williams’s comment as part of his rationale for declaring that the first two of Lord Justice Romer’s three criteria were not necessary components of a floating charge.¹¹⁰ In so doing, he stated that “[s]ince the existence of a fixed charge would make it impossible for the company to carry on business in the ordinary way without the consent of the charge holder, it follows that its ability to do so without such consent is inconsistent with

105 [2001] 2 A.C. 710.

106 *Id.* ¶ 13.(Lord Millett L.J.).

107 *Id.*

108 *In re Spectrum Plus Ltd.*, [2005] 2 A.C. 680, ¶ 107, (Lord Scott L.J.).

109 *In re Yorkshire Woolcombers Ass’n Ltd.*, [1903] 2 Ch. 284 at 294.

110 *Agnew v. Commissioner of Inland Revenue*, [2001] 2 A.C. 710 at 719–20.

the fixed nature of the charge.”¹¹¹ This viewpoint was clarified and expanded upon by the House of Lords¹¹² in the *Spectrum* case:

[T]he essential characteristic of a floating charge, the characteristic that distinguishes it from a fixed charge, is that the asset subject to the charge is not finally appropriated as a security for the payment of the debt until the occurrence of some future event. In the meantime the chargor is left free to use the charged asset and to remove it from the security. .¹¹³

After *Spectrum*, Professor Goode states that:

The acid test for distinguishing between a fixed and a floating charge is not whether the assets comprising the security are fixed or circulating but whether the creditor has or has not taken sufficient steps to exclude the debtor’s right to continue to manage the assets and dispose of them in the ordinary course of business free from the charge.¹¹⁴

In essence, the debtor has “control” if the debtor can dispose of the collateral free of the charge. The disposition intended is in the English ordinary course of business, not the American ordinary course of business.¹¹⁵

B. Collateral’s Nature as the Distinction

Agnew and *Spectrum* held the existence of creditor control to be legally determinative of whether a charge is fixed or floating. But it is the collateral’s nature that is actually determinative.

In theory a floating charge “is not confined to circulating assets but can be made to cover any description of property”¹¹⁶ and “a fixed charge may be taken over revolving assets.”¹¹⁷ But, as we previously noted, secured creditors gain greater advantage from fixed charges than from floating charges, principally because floating charges are

111 *Id.* ¶ 13. (Lord Millett L.J.).

112 On October 1, 2009, The Supreme Court replaced the Appellate Committee of the House of Lords as the highest court in the United Kingdom.

113 *In re Spectrum*, [2005] 2 A.C. 680, ¶ 111 (Lord Scott).

114 GOODE, *supra* note 34, at 726. *See also* FERRAN, *supra* note 65, at 378 (“The essence of the floating charge . . . is that the assets that are the subject-matter of the security remain under the management and control of the [debtor].”).

115 The distinction between the English ordinary course and the American ordinary course is discussed *infra* notes 158–161 and accompanying text.

116 GOODE, *supra* note 34, at 726.

117 *Id.* *See In re Spectrum*, [2005] 2 A.C. 680, ¶ 80 (“There is no doubt that . . . it is in law possible for a company to create a security consisting of a fixed charge over all its present and future book debts.”). “Revolving assets” is synonymous in meaning to “circulating assets.”

subject to the English Carve-out. “Hence, in England banking lawyers have had a powerful incentive to develop new types of security which will be classifiable as ‘fixed’ from the outset.”¹¹⁸ Secured lenders also have sufficient leverage in their dealings with borrowers to frame their charges against revolving assets as fixed.¹¹⁹

In doing so, however, secured creditors encounter a practical difficulty. To make their charges fixed, they must actually control their borrowers’ disposition of the revolving assets. Such control does not merely impede the borrowers’ businesses,¹²⁰ it is expensive for secured creditors to exercise.

In *Spectrum*, Lord Walker gave this succinct description of the operation of a typical business: “Trading stock is sold and becomes represented by book debts; these are collected and paid into the bank; the trader’s overdraft facility enables it to draw cheques in favour of its suppliers to pay for new stock; and so the trading cycle continues.”¹²¹ Translated from the English to American, Lord Walker is pointing out that businesses sell their inventory on credit. Their customers’ obligations to pay are accounts receivable. The businesses collect the accounts receivable and deposit the proceeds to their accounts at their secured creditor banks. The businesses then write checks on the bank accounts to purchase new inventory to replace what was sold. The “overdraft facility” to which Lord Walker refers is the business’ loan account with the bank, which is often combined with the bank account (a debt owing from the bank to the business) in a single, negative balance. These assets, inventory, accounts, and bank deposits are the typical revolving assets of a business. The remaining assets of a typical business, real estate, equipment, and intangibles such as intellectual property and licenses are “fixed” assets.

Under *Spectrum*, a charge against accounts receivable can be a fixed charge only if “the assets can be released from the charge only

118 George L. Gretton, *Reception Without Integration? Floating Charges and Mixed Systems*, 78 TUL. L. REV. 307, 315 (2003).

119 See *In re Spectrum*, [2005] 2 A.C. 680, ¶ 101 (Lord Scott LJ) (“[T]he lenders are usually in the stronger bargaining position and able to stipulate the terms to be included in the debenture which will constitute their security. So it is not in the least surprising to find attempts by lenders to obtain fixed charges as security rather than floating charges . . .”).

120 *In re Woodroffes (Musical Instruments) Ltd.*, [1986] Ch. 366 at 377–78 (“The thinking behind the creation of [floating] charges has always been a recognition that a fixed charge on the whole undertaking and assets of the company would paralyse it and prevent it from carrying on its business . . .” (citing *In re Florence Land and Public Works Co.*, Ex parte Moor [1878-79] 10 Ch. D. 530, at 541 (Sir George Jessel M.R.))).

121 *In re Spectrum*, [2005] 2 A.C. 680, ¶ 139.

with the active concurrence of the chargee.”¹²² Lord Walker gave this illustration of what arrangement might suffice:

[I]f the terms of the debenture were such as to require the trader to pay all its collected debts into the bank and to prohibit the trader from drawing on the account (so that the account is blocked), a charge on debts, described as a fixed or specific charge, would indeed take effect as such In those circumstances the chargee would be in control, prior to crystallisation, and the trader would be unable to trade in the ordinary way without the chargee’s positive concurrence. In *Agnew’s* case . . . Lord Millett pointed out that it was not enough to provide in the debenture for an account to be blocked, if it was not in fact operated as a blocked account.¹²³

What that illustration required of the bank was its “positive concurrence” in each disbursement of funds from the blocked account. The credit agreement in *Spectrum* provided for the bank’s positive concurrence in decisions dealing with the accounts while they remained outstanding,¹²⁴ but not in withdrawing funds from the bank account. The provision at issue was as follows:

With reference to the book debts and other debts hereby specifically charged [Spectrum] shall pay into [Spectrum’s] account with the bank all moneys which it may receive in respect of such debts and shall not without the prior consent in writing of the bank sell factor discount or otherwise charge or assign the same in favour of any other person or purport to do so and [Spectrum] shall if called upon to do so by the bank from time to time execute legal assignments of such book debts and other debts to the bank.¹²⁵

Thus, the Bank had an agreement entitling it to whatever control it chose to take—what we refer to in this Article as “potential control”—but it hadn’t actually taken that control. The insufficiency of potential control to create a fixed charge suggests that, for the English banks to succeed in their quest for fixed charges over the revolving assets, the banks will have to insist on approving each disbursement from the bank account. Neither we nor the English commentators can imagine bankers seeking to understand and meaningfully approve

122 *Id.* ¶ 138 (Lord Walker L.J.).

123 *Id.* ¶ 140 (citations omitted).

124 Addressing the credit agreement provisions regarding the accounts, Lord Hope stated “[t]here is no doubt that their effect was to prevent the company from entering into transactions with any third party in relation to the book debts prior to their collection. The uncollected book debts were to be held exclusively for the benefit of the bank.” *Id.* ¶ 55.

125 *Id.* ¶ 81 (Lord Scott L.J.) (quoting the provision).

each disbursement from their debtors' bank accounts.¹²⁶ We can imagine them setting up a system in which software evaluates each disbursement by some lax standard and claiming that the system meets the *Spectrum* test.

Such purported control seems unlikely to prove sufficient, however, because its obvious intent would be to defeat the policy favoring preferential creditors. As Lord Walker stated in *Spectrum*, "there is a public interest which overrides unrestrained freedom of contract. . . . On the fixed/floating issue, it is ensuring that preferential creditors obtain the measure of protection which Parliament intended them to have."¹²⁷

Thus, we agree with the English commentators that the banks' quest for fixed charges over revolving assets has almost certainly come to an end¹²⁸:

It is true that the banks still hanker after the ability to take a priority-preserving fixed charge over receivables by stipulating for control over accounts as dictated by *Spectrum*, but in practice this will not happen, as few companies will be willing to subject themselves to a regime requiring them to open a blocked account and obtain approval for every withdrawal from their account. For most practical purposes the fixed charge over book debts is dead.¹²⁹

The de facto dominance of the collateral's nature test over the control test is explained legally by way of a presumption. As Goode

126 One states:

[I]t would . . . be necessary that the consent to the transfer to the current account was, for every transfer, an independent act of will by the chargee, so that the chargee was not under any obligation to permit transfers. There are . . . practical problems with this. First, it is expensive and time-consuming for the chargee and secondly it has the effect that the chargor cannot be assured of having cash available to meet the expenses it incurs in the ordinary course of business.

GULLIFER & PAYNE, *supra* note 64, at 253–54 (footnotes omitted).

127 *In re Spectrum*, [2005] 2 A.C. 680, ¶ 141 (Lord Walker L.J.). The preferential creditors are employees and funds for the payment of employees, including pension and health benefit funds. The policy appears to be that employees should be paid before floating charge holders. Rationales probably include (1) that employees frequently lack the ability to compete with floating charge holders in contracting and (2) the government might otherwise have to reimburse the employees through welfare payments.

128 *E.g.* Michael Bridge, *England and Wales in CROSS-BORDER SECURITY OVER TANGIBLES* 125, 130 (Harry C. Sigman & Eva-Maria Kieninger eds., 2007) ("In recent times, the controls required for a fixed charge have been reemphasized, so that in practical terms it is impossible to take a fixed charge over a debtor's circulating capital." (footnotes omitted)).

129 Goode, *supra* note 98, at 22.

put it, “[a] charge over circulating assets is []thus presumptively intended as a floating charge, so that restrictions on the debtor[’s] . . . ordinary dealing powers need to be specifically agreed, whereas a charge over fixed assets is assumed to be intended as a fixed charge.”¹³⁰ Case law corroborates that view:

[If] the charged property is stock, or book debts—i.e. where the assets are naturally fluctuating—the court will readily conclude that a liberty for the [debtor] to deal with the charged assets is inconsistent with a fixed charge; where . . . the assets are specific and do not necessarily fluctuate, some liberty to release the charged assets may not be inconsistent with a fixed charge.¹³¹

The effect is to bring the analysis of *Yorkshire Woolcombers* full circle. Although the third part of Lord Justice Romer’s test—secured creditor control—has prevailed legally, the practical effect is much the same as if the second part—the revolving nature of the collateral—had. In the remainder of our analysis, we will assume that secured creditors typically “take a fixed charge over fixed assets and a floating charge merely over circulating assets.”¹³²

C. Crystallization

Crystallization is an event by which a floating charge becomes a fixed charge.¹³³ Once crystallized, the charge will have priority as a fixed charge against later competitors for the collateral. The effect is not, however, retroactive:

A crystallized floating charge ranks as a fixed charge for the purposes of determining its priority against other interests in the company’s property which are created or acquired after crystallization. Although there is one case that suggests otherwise, the better view is that crystallization does not affect the priority of a floating charge against other interests in the same property which pre[-]date crystallization.¹³⁴

130 GOODE, *supra* note 34, at 726. “Fixed assets” are assets like equipment or land, which a debtor expects to hold on a long-term basis. “Circulating assets” are assets such as inventory/stock-in-trade, accounts/receivables, and crops. The debtor is constantly acquiring and disposing of these short-term assets. They represent the asset side of the debtor’s working capital.

131 *In re Cimex Tissues, Ltd.*, [1994] BCLC 626 at 635.

132 GOODE, *supra* note 34, at 726.

133 See *In re Spectrum Plus Ltd.*, [2005] 2 A.C. 680, ¶ 108 (Lord Scott L.J.) (“[O]n the occurrence of a crystallization event, [e.g.,] liquidation, the [collateral] at that time would be subject to the fixed charge . . .”).

134 FERRAN, *supra* note 65, at 388 (footnotes omitted).

Although crystallization and default are independent concepts, crystallization often occurs at the time of default and many of the issues that arise, and the contract provisions addressing those issues, are similar.¹³⁵ Both crystallization and default are events that mark the beginning of the floating charge holder's right to enforce the charge against specific collateral. Crystallization implies a revocation of the debtor's right to deal freely with the collateral, but the revocation may not affect the rights of third parties until they learn of it.¹³⁶

Crystallization can occur by operation of law, automatically in accord with a provision of the security agreement, or pursuant to contractual notice from the secured creditor to the debtor. Crystallization occurs by operation of law upon the occurrence of any of four events¹³⁷: (1) cessation of the debtor company's business;¹³⁸ (2) the commencement of liquidation/winding-up;¹³⁹ (3) the creditor lawfully taking possession of the charged assets;¹⁴⁰ or (4) the appointment of a receiver¹⁴¹ or of an administrator by a qualifying charge holder.¹⁴² The commencement of administration proceedings does not, in and of itself, result in crystallization.¹⁴³

The debtor and the secured creditor can also, by agreement between them, provide "that any specified event" will cause the charge

135 "Default" is not defined in the U.C.C. Professors LoPucki and Warren define "default" as "the debtor's failure to pay the debt when due or otherwise perform the agreement between the debtor and creditor." LOPUCKI & WARREN, *supra* note 12, at 217. Early English cases used the term "default" to refer to what is now known as a "crystallization event." See, e.g., *Evans v. Rival Granite*, [1910] 2 K.B. 979, at 990 (Lord Williams L.J.) ("[The floating charge holder] may exercise his right[s] [over the collateral] whenever he pleases after default." (quoting *The Governments Stock and Other Securities Investment Co. v. Manila Ry. Co.*, [1897] A.C. 81, at 86) (internal quotation marks omitted)).

136 See *infra* Part IV (discussing the effect of crystallization on third parties).

137 See *Edward Nelson & Co. v. Faber & Co.*, [1903] 2 KB 367, at 376.

138 See *In re Woodroffes (Musical Instruments) Ltd.*, [1986] Ch. 366, at 377–78.

139 See *In re Panama New Zealand and Australian Royal Mail Co.*, [1869-70] 5 Ch. App. 318, at 322–23.

140 See *Mercantile Bank of India Ltd. v. Chartered Bank of India, Australia & China*, [1937] 1 All E.R. 231, at 240–41.

141 See *Evans v. Rival Granite*, [1910] 2 K.B. 979, at 986–88, 1000.

142 Insolvency Act, 1986, c. 45, sch. B1 ¶ 14.

143 FERRAN, *supra* note 65, at 390 ("The commencement of administration proceedings in respect of a company in accordance with the Insolvency Act 1986 does not constitute an implied crystallizing event."); GULLIFER & PAYNE, *supra* note 64, at 244 & n.204 (stating that the appointment of an administrator "by the directors or by the court" does not result in crystallization because this does not constitute an "intervention by the chargee").

to crystallize.¹⁴⁴ The agreement can provide that crystallization occurs automatically or upon notice from the secured creditor to the debtor. The purpose of an automatic crystallization provision is usually to crystallize the charge before a lien creditor establishes rights in the collateral or the debtor grants a fixed charge to a competing creditor.¹⁴⁵

If so provided in the security agreement, automatic crystallization can be reversed, a process referred to as de-crystallization.¹⁴⁶ De-crystallization would allow the debtor to continue to deal freely with the collateral despite the covenant breach.¹⁴⁷

Automatic crystallization can occur in situations where the creditor does not desire it.¹⁴⁸ Professor Ferran notes that if “the crystallization clause is so widely drafted that the [creditor] has frequently to agree to de-crystallization, this pattern of events may lead a court to conclude that the original agreement was later varied by the parties so as to exclude the automatic crystallization provision.”¹⁴⁹ De-crystallization may also force consideration of whether the “re-floated” charge constitutes the same floating charge as before or a new floating charge,¹⁵⁰ which would trigger a fresh registration requirement, establish a new and later priority date, and restart the statutory period for the avoidance of floating charges in insolvency proceedings.¹⁵¹

144 *In re Permanent Houses (Holdings) Ltd*, [1988] BCLC 563, 567 (stating that “there [is] no conceptual reason why the parties should not agree that any specified event should cause the charge to crystallize”). See also *In re Brightlife Ltd.*, [1987] Ch. 200 at 214–15 (“I do not think it is open to the courts to restrict the contractual freedom of parties to a floating charge on such grounds. . . . [A]rguments for and against the floating charge are matters for Parliament rather than the courts . . . [the] limited and pragmatic interventions by the legislature make it . . . wholly inappropriate for the courts to impose additional restrictive rules . . .”).

145 LAW COMMISSION, *supra* note 19, ¶ 2.44 (“Presumably the aim [of automatic crystallization clauses] is now . . . to preserve the priority of a floating charge as against subsequent fixed charges.”).

146 FERRAN, *supra* note 65, at 390 (“[A]n automatic crystallization clause may be coupled with an express clause entitling its holder to de-crystallize it again.”).

147 For an example of the use of a de-crystallization clause, see the decision of the High Court of New Zealand in *Covacich v. Riordan*, [1994] 2 NZLR 502.

148 FERRAN, *supra* note 65, at 390.

149 *Id.*

150 GOODE ON LEGAL PROBLEMS OF CREDIT AND SECURITY ¶ 4-57–59 (Louise Gullifer ed., 4th ed. 2008) [hereinafter GULLIFER, LEGAL PROBLEMS].

151 The statutory period ranges between twelve months and two years ending with the onset of insolvency (unless new value was given for the charge at the time of its creation or re-creation). See Insolvency Act, 1986, c. 45, § 245.

A notice-crystallization clause¹⁵² gives the creditor more flexibility over the timing of crystallization and largely removes the need for a de-crystallization clause. The security agreement identifies events that give the secured creditor the right to crystallize the floating lien by giving notice. The secured creditor then decides whether and when to do so.¹⁵³ The giving of notice is the crystallization event.

Notice crystallization clauses need not be conditioned upon the debtor's breach of a covenant. "Pure" notice crystallization is a procedure by which the creditor may "at any time by notice to the [debtor] convert the floating charge into a [fixed] charge as regards any asset specified in the notice."¹⁵⁴ Under English law, if the creditor and a debtor have agreed upon terms that allow the creditor to crystallize at will, the court will give effect to their agreement.

To give notice before competitors establish prior rights in the collateral, the secured creditor must know the competitors are about to do so. Even if the secured creditor engaged in extensive and expensive monitoring, some competitors would succeed in gaining priority.

As is discussed further in Part III, the ease with which secured creditors can crystallize their floating charges makes it difficult for third parties to rely on the floating nature of the charge. Because third parties are reluctant to rely, the debtor's right to deal freely with the collateral becomes largely theoretical. Floating charges have the effect of fixed charges because, as far as third parties know, they may already have become fixed charges.

III. FIXED CHARGES COMPARED WITH SECURITY INTERESTS

In this Part, we compare the function of English fixed charges with those of American security interests in the contexts of collateral sales, competitions among security interests, competitions of security interests with execution creditors, and in insolvency proceedings. We conclude that English fixed charges and American security interests function in highly similar manners.

152 For an example of the use of a notice-crystallization clause, see *In re Woodroffes (Musical Instruments) Ltd.*, [1986] Ch. 366, 377–78.

153 FERRAN, *supra* note 65, at 389–90.

154 *In re Brightlife Ltd.*, [1987] Ch. 200, 207–08 (holding that a clause with the quoted language was enforceable).

A. *Sale of Collateral*

1. Original Collateral

If an English debtor “sells property that is subject to a [fixed] charge, and the sale is not authorised by the chargee, the buyer will take subject to the charge.”¹⁵⁵ The secured party can then “follow his asset . . . into the hands of any third party [with certain exceptions].”¹⁵⁶

The American rule is the same. U.C.C. § 9-315(a)(1) provides that “a security interest continues in collateral notwithstanding sale, lease, license, exchange, or other disposition thereof unless the secured party authorized the disposition free of the security interest.”¹⁵⁷

In both countries, buyers in the ordinary course of business who buy from the sellers’ inventories take free of security interests in that inventory. In the English system this result is explained by saying that, because the charge is against revolving assets, the charge is a floating charge. By the nature of the charge, the debtor can deal freely with the collateral. In the American system, this result follows from a statutory rule that a buyer in ordinary course of business takes free of a security interest created by his seller.¹⁵⁸

The English concept of “sale in the ordinary course” is broader than the corresponding American concept. Under the American concept, only inventory can be sold in the ordinary course of business. Official Comment 3 to U.C.C. § 9-320 states that “subsection (a) applies primarily to inventory collateral” and the courts generally have interpreted the section as limited to sales of inventory.¹⁵⁹ Narrowing

155 LAW COMMISSION, *supra* note 56, ¶ 3.49.

If the company sells property that is subject to a charge, and the sale is not authorised by the [creditor], the buyer will take subject to the charge unless it [is] protected by one of the exceptions to the principle that a person cannot transfer a better title than he has. The [creditor]’s rights are not affected and it can enforce its rights against the buyer.

Id. (footnotes omitted)

156 GOODE, *supra* note 34, at 664.

157 U.C.C. § 9-315(a) (2012). (“(1) a security interest or agricultural lien continues in collateral notwithstanding sale, lease, license, exchange, or other disposition thereof unless the secured party authorized the disposition free of the security interest or agricultural lien; and (2) a security interest attaches to any identifiable proceeds of collateral.”)

158 *Id.* § 9-320(a).

159 *Id.* § 9-320 cmt. 3. See *United States v. Handy & Harman*, 750 F.2d 777, 782 n.4 (9th Cir. 1984) (“The official text of U.C.C. §§ 1-201(9) and 9-307(1) (1977) is worded so that only buyers of goods that are inventory in the hands of the seller can

the protected categories of buyers even further, the American definition of buyer in ordinary course specifically excludes buyers of bulk sales of inventory.¹⁶⁰

Under the English concept, “capital” or “fixed” assets such as business equipment or licenses can be sold in the ordinary course of business.¹⁶¹ English law is generally highly protective of buyers in the ordinary course.¹⁶² That buyers can buy fixed assets in the ordinary course of business has led to concern that they might be able to take free of fixed charges.¹⁶³ Thus, after noting that “a purchaser (as opposed to a subsequent chargee) of the company’s assets will not be put on notice of the charge merely because it has been registered . . . because a buyer of goods in the ordinary course of business cannot be expected to search against her seller,”¹⁶⁴ the Law Commission continued:

take the goods free of security interests.”). *But see In re Morristown Lincoln-Mercury, Inc.*, 25 B.R. 377, 388 (Bankr. E.D. Tenn. 1982) (“It is unnecessary for the court to classify the van as either inventory or non-inventory. The statutory definition of buyer in the ordinary course of business does not require a conclusion that the goods purchased were inventory. The fact is that Smith purchased a motor vehicle from a seller in the business of selling goods of that kind.”).

160 A “bulk sale” of inventory is a sale of all or large portion of the debtor’s inventory, at a reduced price, to a competitor or dealer in inventories, rather than to a customer.

161 *See Stevenson v. Rogers*, [1999] Q.B. 1028 at 1028 (holding that a sale by a fisherman of his old working boat was held to be made in course of business within section 14(2) of the Sale of Goods Act 1979); *Brown, Sales of Goods in the Course of a Business*, (1999) 115 L.Q.R. 384, 387 (“Undeniably, the position adopted in *Stevenson* is inflexible: a seller now sells goods in the course of a business where there is an isolated sale of goods which are not his principal stock-in-trade and other factors such as regularity of dealing or business proficiency are immaterial.”)

162 *Heath v. Crealock*, [1874] 10 Ch. App. 22 at 33 (stating that it “is a rule without exception, that from a purchaser for value without notice this Court takes away nothing which that purchaser has honestly acquired”); *Pilcher v. Rawlins*, [1872] 7 Ch. App. 259 at 268–69 (stating that “a purchaser for valuable consideration, without notice, obtaining, upon the occasion of his purchase, and by means of his purchase deed, some legal estate, some legal right, some legal advantage; and, according to my view of the established law of this Court, such a purchaser’s plea of a purchase for valuable consideration without notice is an absolute, unqualified, unanswerable defence”).

163 *See HUGH BEALE ET AL., THE LAW OF PERSONAL PROPERTY SECURITY* 435 (2007) (stating that “[i]t seems generally agreed that purchasers in the ordinary course of business should not have constructive notice”).

164 LAW COMMISSION, *supra* note 19, ¶ 2.60. GULLIFER, *LEGAL PROBLEMS, supra* note 150, ¶ 2-29 (“[R]egistration is notice only to those who could reasonably be expected to search. This would normally exclude a buyer in the ordinary course of business . . .”).

It may be that in this context a distinction should be drawn between the purchaser of an item of the company's normal stock (which is in any event unlikely to be the subject of a fixed charge) and the purchaser of a capital asset which is sold by the business. It might seem reasonable to expect the purchaser to check for charges against capital assets. However, it seems to be assumed that, in the context of floating charges, sales of capital assets are in the ordinary course of business as much as sales of inventory; and in the context of the Sale of Goods Act 1979, section 14, the sale of a capital asset has been held to be in the course of business. Thus it is not clear that this distinction between purchasers of capital assets and purchasers of inventory can be maintained.¹⁶⁵

If the distinction could not be maintained, buyers of capital assets in the ordinary course of business would be able to take free of fixed charges and a sharp functional difference would exist between the English and American systems.

We can find no direct authority, however, that buyers of capital assets in the ordinary course can take free of fixed charges. In *Ashborder BV v. Green Gas Power Ltd*,¹⁶⁶—the only case we can find holding that capital assets can be sold free of a charge in the ordinary course—the court held the charge over the capital assets to be floating.

There was a danger in the present case in laying too great an emphasis on the nature of the assets in question, namely the licences and the OGL shares. The fact that assets were not part of a company's circulating capital or stock in trade, which it needed to sell as part of its ordinary business, could understandably have an important influence in the categorisation of a charge as a fixed charge, rather than a floating charge, in an appropriate case. In the present case, however, the parties had agreed an express provision permitting each of the Octagon group companies to dispose of assets in the ordinary course of its business. The clause in the debenture assigning rights to the trustee effected an equitable assignment rather than a legal assignment and an equitable assignment was not inconsistent with a floating charge over the assets specified. The debentures did not create a fixed charge over the licences or the OGL shares.¹⁶⁷

165 LAW COMMISSION, *supra* note 19, ¶ 2.61 (footnotes omitted).

166 [2004] EWHC 1517 (Ch). The case contains a detailed discussion of the law defining "ordinary course of business" per Judge Etherton. *Id.* at ¶¶ 202, 216, and 227. *See also* *Stevenson v. Rogers*, [1999] Q.B. 1028 at 1028 (holding that a sale of a fishing boat by a fisherman was in the ordinary course of business).

167 *Ashborder*, [2004] EWHC 1517 (Ch) at 635.

In describing the current state of English law in its final report, the Law Commission sided more strongly with the fixed charge holder:

In the [Consultation Paper] we explained that a buyer will take subject to a registered fixed charge, unless the doctrine of a bona fide purchaser of a legal estate without notice applies. There is some doubt as to when a purchaser who does not have actual knowledge of the charge will be put on notice of it because it has been registered. It is possible that a buyer of a capital asset would be expected to search the register but not one who buys stock-in-trade. We think that it is desirable to clarify the law by providing that a buyer should be bound by a registered fixed charge.¹⁶⁸

Although expressed with considerable uncertainty, this passage states, in essence, that current English law is probably the same as current American law. In both systems “a buyer of a capital asset would be expected to search the register but not one who buys stock-in-trade” and a debtor would be able to sell a capital asset free of the security interest if the creditor authorized the sale, but not otherwise.¹⁶⁹ This interpretation effectively imposes a burden on English buyers of capital assets in the ordinary course to search for fixed charges just as American buyers must.¹⁷⁰

2. Proceeds

After an authorized disposition, the security interest of both an American secured creditor and an English fixed charge holder will continue in any proceeds. On the American side, U.C.C. § 9-315(a)(2) states, “a security interest attaches to any identifiable proceeds of collateral.”¹⁷¹ On the English side, the Law Commission has stated that “if a sale was authorized . . . the [creditor’s] only claim will be to the proceeds.”¹⁷²

168 LAW COMMISSION, *supra* note 56, ¶ 3.217 (footnotes omitted).

169 *Id.* (footnote omitted).

170 Beale and his coauthors state:

It seems generally agreed that purchasers in the ordinary course of business should not have constructive notice but it is not entirely clear who are such purchasers. In particular, it is not clear whether it is limited to purchasers of stock-in-trade (inventory) or whether it includes purchasers of capital equipment.

BEALE ET AL., *supra* note 163, ¶13.04 at 435.

171 U.C.C. § 9-315(a)(2) (2012).

172 LAW COMMISSION, *supra* note 56, ¶ 3.51 (stating that “[i]f the sale was authorized . . . because the . . . chargee had consented to the particular disposition, the chargee’s only claim will be to the proceeds”); *see also* *Buhr v. Barclays Bank Place*,

American law and English law take slightly different approaches if the creditor did not authorize the disposition of the collateral. Under U.C.C. § 9-315(a), the security interest continues in the collateral and in any identifiable proceeds of the collateral. The secured creditor can pursue both and “collect its money where it can” up to the amount owing.¹⁷³

Like an American secured creditor, an English law fixed charge holder initially has an interest in both the original collateral and its proceeds after an unauthorized disposition.¹⁷⁴ However, as soon as the English secured creditor performs “an unequivocal act showing that [it] has chosen one [it] cannot afterwards pursue the other.”¹⁷⁵ The creditor loses its interest in whichever of the original collateral or the proceeds was not pursued.¹⁷⁶ Therefore, unlike an American

[2001] EWCA Civ. 1223, ¶¶ 11, 39 (quoting Professor Goode and accepting as correct his statement that “security in an asset extends to the proceeds of sale of an authorized disposition by the debtor”).

173 Professors LoPucki and Warren provide the following example to illustrate how the value of collateral can multiply upon disposition in the United States:

Nevertheless, the multiplication of collateral that can result from the rules of U.C.C. §§ 9-102(a)(12) and (64) and 9-315(a) is striking. Assume, for example, that ZBank has a security interest in Jack’s cow. Without authorization from ZBank, Jack sells the cow to Barbara for \$2000. Zbank’s security interest continues in the collateral (the cow) and also in the identifiable proceeds of that sale (the \$2000). If Jack then uses the \$2000 of proceeds to buy some beans, the beans will also be proceeds under U.C.C. § 9-102(a)(64) (recall that the proceeds of proceeds are proceeds) and Zbank’s security interest will continue in the beans under U.C.C. § 9-315(a). ZBank can foreclose against the cow and the beans, and collect its money where it can.

LOPUCKI & WARREN, *supra* note 12, at 171.

174 *See, e.g.*, Foskett v. McKeown, [2001] A.C. 102 at 127 (Lord Millett) (stating in the context of trusts that a beneficiary “is entitled to a continuing beneficial interest not merely in the trust property but in its traceable proceeds also, and his interest binds every one who takes the property or its traceable proceeds except a bona fide purchaser for value without notice”).

175 *United Australia, Ltd. v. Barclays Bank, Ltd.*, [1941] A.C. 1 at 30 (explaining that when a party has two inconsistent rights an “unequivocal act” showing that it is pursuing one means that it no longer has the other).

176 The choice of a fixed charge holder between pursuing an interest in the original collateral or in the proceeds has been characterized as one between two inconsistent rights, which cannot both be pursued:

Suppose that C has taken a specific mortgage of D’s motor car and D wrongfully sells the car to E. In the absence of any applicable exception to the *nemo dat* rule C can recover his vehicle from E. Alternatively he can adopt the wrongful sale and treat his security interest as attaching to the proceeds received by D. But can he claim security in both the car and the proceeds at the same time? No, because the remedies are inconsistent. C’s equitable tracing claim to the proceeds rests on his implied adoption of the wrongful

secured creditor, an English law fixed charge holder is not entitled to collect the money owed to it “where it can.” Once it has elected to pursue its interest in either the collateral or the proceeds it loses its interest in the other.

This distinction between English and American law may seem significant on its face. It is, however, merely a default rule. As the Law Commission has noted, a creditor need elect between pursuing a right either in the original collateral or in the proceeds only when the “charge does not cover the proceeds as a distinct category of asset.”¹⁷⁷ According to Professor Ferran, “well-drafted security documentation will include express provision for the security to cover receivables and their proceeds.”¹⁷⁸ For example, if a debtor sold fixed charge collateral to a buyer on credit, the debt owing from the buyer would be proceeds. The security agreement would likely provide that the debtor has charged all debts owing to the debtor to the secured creditor, by way of fixed charge.¹⁷⁹ Thus in the example under discussion, the fixed charge holder would be able to pursue its interest in both the collateral sold and the debt owing for its purchase price. The holder’s claim to each would be as original collateral. As a result, we doubt that the difference in default rules makes a significant difference in the functioning of secured credit in the two jurisdictions.

B. *Encumbrance of Collateral*

With respect to both American security interests and English fixed charges, the basic principle governing priority is that first in time is first in right.¹⁸⁰ That is, if the holder of the security interest or

sale. He cannot have his cake and eat it. He must elect which right to pursue

GULLIFER, LEGAL PROBLEMS, *supra* note 150, ¶ 1-62, at 45-46.

The view that a creditor must elect between pursuing an interest in the collateral and the original proceeds of an unauthorized disposition has been endorsed by the Court of Appeal in *Buhr v. Barclays Bank Plc* as “supported by principle and authority.” [2001] EWCA Civ 1223, ¶ 39.

177 LAW COMMISSION, *supra* note 56, ¶ 3.50.

178 FERRAN, *supra* note 65, at 368.

179 See, e.g., GOODE, *supra* note 34, at 634 (sample credit agreement providing that the debtor grants a fixed charge in “all trade debts now or in the future owing to you; all other debts now or in the future owing to you”).

180 See, e.g., FERRAN, *supra* note 65, at 393 (“[W]here the equities are equal the first in time prevails. This is the priority rule that governs . . . priority disputes between two fixed equitable charges on the same property. The charge that was created first has priority”); GULLIFER & PAYNE, *supra* note 64, at 273 (“The basic priority point in English law is the date of creation. This is articulated in relation . . . to equitable interests by the proposition that the first in time has priority.”).

fixed charge takes whatever steps are necessary to perfect its interest, the holder will have priority over competitors who establish interests later.

Both the English and American systems determine the order of priority by assigning priority dates to each competing interest. That “priority date” is the date and time when the creditor took some particular step, or one of alternative steps necessary to perfect its interest.

1. Competing Secured Creditors

In competitions between American security interests, the first to file or perfect has priority. In competitions among English fixed charges, the first charge created has priority, provided that it is registered within twenty-one days. As was previously discussed, the English rule creates a period of invisibility. Except with respect to accounts receivable, the English rule does not cause any other difference in the functioning of English fixed charges and American security interests. Both have priority over all later interests, with the exception, in both systems, of property tax liens.

With respect to priority in accounts receivable as collateral, the American rule is that the first to file or perfect has priority. Priority does not depend on notifying the account debtors, and secured creditors rarely notify them unless or until the secured creditors seek direct payment from them. The English priority rule is that, as between two charges registered within twenty-one days of their respective dates of creation, priority goes to the creditor who is first to notify the account debtor of its charge, regardless of the order in which the charges were created or registered.¹⁸¹ The effect of the English rule is “that a receivables financier must make enquiries of the ‘account debtor,’ and notify the debtor of the arrangement, or risk losing out to a second financier.”¹⁸² The ultimate effect is that English account financiers will give individual notice to each account debtor, while American account financiers will merely file a financing statement.

Individual notice may be of some benefit to English account debtors who would not have taken the time to run searches. But the costs of providing individual notice may be greater than the benefits, and

181 *Dearle v. Hall*, [1827] 38 ER 475, 482–83 (stating that the order in which creditors notify the account debtor determines the priority of competing claims over accounts receivable); LAW COMMISSION, *supra* note 19, ¶ 2.48 (“Where the assets charged are debts, provided again that the charge is registered in the Companies Register within 21 days of its creation, priority depends on the date of notice to the debtor.”) (footnote omitted).

182 LAW COMMISSION, *supra* note 56, ¶ 14.

the Law Commission had no difficulty in reaching a recommendation that England adopt the American rule.¹⁸³ Aside from the additional costs of the English rule, we see no significant difference in system operation and no policy issue for resolution.

2. Lien Creditors

In both England and the United States, the basic principle is that fixed charges, American security interests, and execution liens rank in order of time. A security interest or fixed charge with an earlier priority date has priority over an execution lien with a later priority date. For example, with respect to English fixed charges, Gough states:

An execution creditor takes subject to previous legal and equitable interests in the property of the debtor, arising through disposition by the debtor or otherwise. This is true in respect of execution by a writ *fieri facias* over goods The rule applies regardless of whether the execution creditor has had notice of the prior interest [T]he priority issue is simply whether or not that proprietary interest exists at the relevant priority point in execution.¹⁸⁴

As one court put it, the “sheriff cannot by seizing [the collateral] get rid of the rights of third persons to which the property is subject when in the hands of the debtor.”¹⁸⁵ Thus, once perfected, security interests and fixed charges have priority over later executions.

Executions that predated the security interest or charge would, in theory, have priority over the security interest or charge. However, that rarely occurs. Judgments and executions are public records in both countries. Lenders conduct due diligence to discover and clear any judgments against their borrowers and executions against proposed collateral.

C. *Rights in Insolvency Proceedings*

Both English and American insolvency laws generally yield to and enforce the non-insolvency rights of security interest holders.¹⁸⁶ The

183 *See id.* ¶ 15.

184 WILLIAM JAMES GOUGH, *COMPANY CHARGES* 13 (2d ed. 1996); *see also* LAW COMMISSION, *supra* note 56, ¶ 3.201 (“Under current law, an execution creditor cannot seize property that is subject to a duly registered fixed charge.”).

185 *In re Standard Mfg. Co.*, [1891] 1 Ch. 627 at 641. *See also* GOUGH, *supra* note 184, at 13 (discussing priority over personal claims).

186 *E.g.*, *Tidewater Fin. Co. v. Moffett*, 356 F.3d 518, 521 (4th Cir. 2004) (“Yet, while federal law defines in broad fashion what property interests are included within the bankruptcy estate, state law determines the nature and existence of a debtor’s rights.”); ROY GOODE, *PRINCIPLES OF CORPORATE INSOLVENCY LAW* 69 (3d ed. 2005)

creditor's "secured claim" is defined in the United States as the amount of the debt owed to the creditor that is secured by collateral.¹⁸⁷ Any excess over the value of the collateral is treated as an unsecured claim and will rank pro-rata with the claims of other unsecured creditors.¹⁸⁸ English law takes the same approach. A creditor has a "secured claim" for purposes of insolvency law "to the extent that [the creditor] holds any security for the debt . . . over any property of the person by whom the debt is owed."¹⁸⁹ If the creditor "realizes [its] security [it] may prove for the balance of [its] debt, after deducting the amount realized"¹⁹⁰ for which it will rank pro-rata along with the unsecured creditors.¹⁹¹

Both systems, however, also modify those rights in some respects. In this section, we compare the functions of English fixed charges and American security interests in connection with insolvency proceedings. Although general differences in the insolvency procedures of the two countries may indirectly affect secured creditor recoveries, we confine our discussion to differences that directly affect secured creditor recoveries.

(stating as the "first principle" that English "corporate insolvency law recognizes rights accrued under the general law prior to liquidation").

187 See 11 U.S.C. § 506(a)(1) (2006).

An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim.

Id.

188 See *id.*

189 Insolvency Act, 1986, c. 45, § 383(2).

Subject to the next two subsections and any provision of the rules requiring a creditor to give up his security for the purposes of proving a debt, a debt is secured for the purposes of this Group of Parts to the extent that the person to whom the debt is owed holds any security for the debt (whether a mortgage, charge, lien or other security) over any property of the person by whom the debt is owed.

Id.

190 The treatment of the debtor's unsecured claim is set out in two identical provisions of the Insolvency Rules, 1986, c. 45 § 2.83, which applies in administration, and § 4.88, which applies in liquidation; both provide: "If a secured creditor realises his security, he may prove for the balance of his debt, after deducting the amount realised." Insolvency Act, 1986, c. 45, §§ 2.83, 4.88.

191 The *pari passu* nature of unsecured debt is set out in the Insolvency Act, 1986, c. 45, § 328(3) ("Debts which are neither preferential debts nor debts to which the next section applies also rank equally between themselves and, after the preferential debts, shall be paid in full unless the bankrupt's estate is insufficient for meeting them, in which case they abate in equal proportions between themselves.").

In the United States, three proceedings are commonly employed by business debtors: (1) Chapter 7 (liquidation), (2) Chapter 11 (reorganization), and (3) Chapter 13 (debt adjustment). We omit Chapter 13 debt adjustment from our comparison, because only individuals (natural persons) can file under Chapter 13.

In England, four proceedings are commonly employed by business debtors: (1) Winding-up (liquidation), (2) Administration (reorganization), (3) Administrative Receivership (reorganization), and (4) Bankruptcy (distribution of bankrupt's estate and discharge).¹⁹² We omit Administrative Receivership from our comparison, because recent legislation has sharply curtailed its use.¹⁹³ We also omit Bankruptcy from our comparison, because a bankruptcy order can only be made against individuals (natural persons).¹⁹⁴

Thus, following Segal,¹⁹⁵ we make essentially two comparisons. The first is of liquidation under American Chapter 7 with English Winding-up. The second is of reorganization under American Chapter 11 with English Administration.

In theory, floating charges crystallize upon the commencement of an insolvency proceeding and so become fixed charges. But for purposes of insolvency proceedings, the metamorphosis seems to make little difference. The Insolvency Act defines a floating charge as a charge that was a floating charge at the time of its creation,¹⁹⁶ and continues to treat the floating charge differently in many respects. Accordingly, in this section we compare the insolvency treatment of charges that were created as fixed charges with American security interests. The comparison of charges that were created as floating charges with American security interests is the subject of Part IV.C. below. There are, nevertheless, many respects in which floating charges are treated the same as fixed charges. For economy of presentation, we mention some of them here.

192 Individuals carrying on businesses are eligible to file bankruptcy. Insolvency Act, 1986, c. 45, § 265 (referring to bankrupts "carrying on of business").

193 See GULLIFER & PAYNE, *supra* note 64, at 285 ("[T]he official statistics show [] a rapid drop-off in [administrative] receiverships after [15 September] 2003 [the date on which the relevant provisions of the Enterprise Act 2002 entered into force], coupled with a rapid rise in administrations, indicating that charges were preferring to appoint an administrator rather than an administrative receiver, even [in the limited circumstances in which they continue to have] the right to do so.").

194 Insolvency Act, 1986, c. 45, § 264(1) ("A petition for a bankruptcy order to be made against an individual may be presented to the court in accordance with the following provisions of this Part . . .").

195 Segal, *supra* note 28, at 933 ("I have focused on the operation and effect of the administration and Chapter 11 regimes as they relate to secured creditors . . .").

196 See *supra* note 97

The insolvency treatment of English fixed charges is highly similar to the insolvency treatment of American security interests. We describe the similarities in subsection 1 before we turn to the differences in subsection 2.

1. Similarities in Treatment

Initiation. Secured creditors commonly initiate English insolvency proceedings.¹⁹⁷ They seldom do so directly in the United States. In the United States, unsecured creditors—which include secured creditors for the amounts by which their claims exceed the amounts of their collateral—have the legal right to initiate “involuntary” insolvency cases.¹⁹⁸ But American law is hostile toward direct creditor-initiation. Creditor petitions probably account for fewer than three percent of American business bankruptcies.¹⁹⁹

This difference in the ability of English and American secured creditors to directly initiate insolvency proceedings is, however, of little functional importance. Once the debtor is in default, an American secured creditor can force the debtor to file a “voluntary” petition by moving against the collateral, or merely threatening to move against the collateral. For example, an American creditor with a security interest in accounts can notify account debtors to pay the secured creditor directly, thus depriving the debtor of its cash flow.²⁰⁰ An American creditor with a security interest in goods can file an action for replevin and probably have the sheriff poised to seize the debtor’s property within ten to twenty days.²⁰¹ The debtor must then file a

197 Goode states:

In the normal case, administration is initiated by the appointment of an administrator by the holder of a qualifying floating charge The alternative route to administration is the appointment of an administrator by the court on application by the company, the directors, one or more creditors . . . or a combination of these persons.

GOODE, *supra* note 34, at 928–29. (footnotes omitted).

198 11 U.S.C. § 303(b) (2006) (specifying the unsecured creditors eligible to file an involuntary petition).

199 LoPUCKI & WARREN, *supra* note 12, at 94 (reporting otherwise unpublished finding of Warren and Westbrook).

200 U.C.C. § 9-607(a) (2012) (“If so agreed, and in any event after default, a secured party . . . may notify an account debtor . . . to make payment . . . to or for the benefit of the secured party”); U.C.C. § 9-406(a) (“After receipt of the notification, the account debtor may discharge its obligation by paying the assignee and may not discharge the obligation by paying the assignor.”).

201 *E.g.*, *Del’s Big Saver Foods, Inc. v. Carpenter Cook, Inc.*, 603 F. Supp. 1071 (W.D. Wis. 1985) (writ of replevin issued and served on the same day the case was filed).

“voluntary” bankruptcy to avoid the seizure. Thus, although they use different devices, secured creditors commonly initiate both English and American insolvency proceedings.

Automatic stay. In both England²⁰² and the United States,²⁰³ the filing of an insolvency case stays the efforts of secured creditors to collect the debts owing to them, except through the insolvency case. In both systems, secured creditors are entitled to protection against loss resulting from the delay in realizing their collateral.²⁰⁴ In both systems, secured creditors can petition the insolvency court for relief from the stay.²⁰⁵

202 In administration, the Insolvency Act of 1986 provides: “No legal process (including legal proceedings, execution, distress and diligence) may be instituted or continued against the company or property of the company except—(a) with the consent of the administrator, or (b) with the permission of the court.” Insolvency Act, 1986, c. 45, sch. B1 ¶ 43(6). Goode states that:

The effect of administration, whether out of court or by court order, is to place an almost total freeze on the enforcement of real and personal rights, including enforcement of security rights, rights of repossession under hire-purchase agreements, a landlord’s right of forfeiture, or any legal process, including proceedings, execution or distress, except with the consent of the administrator or the approval of the court.

GOODE, *supra* note 34, at 930. Segal argues that:

The automatic stay resulting from the commencement of either a Chapter 11 or an administration proceeding are broadly similar as they relate to secured creditors. Still, the ambit of the Chapter 11 stay is clearly wider in a number respects. In particular, it protects the debtor from informal acts to recover pre-petition claims.

Segal, *supra* note 28, at 929.

In liquidation, the Insolvency Act of 1986 provides: “When a winding-up order has been made or a provisional liquidator has been appointed, no action or proceeding shall be proceeded with or commenced against the company or its property, except by leave of the court and subject to such terms as the court may impose.” Insolvency Act, 1986, c. 45, § 130(2).

203 In the United States, Bankruptcy Code § 362(a) enacts a stay “applicable to all entities” which prohibits “any act” to collect a pre-bankruptcy debt. 11 U.S.C. § 362(a) (2006). Section 362(d) provides that secured creditors can move to lift the stay if there is no equity in the collateral or if it is not necessary for an effective reorganization. *Id.* § 362(d).

204 Segal, *supra* note 28, at 929 (“[W]hile both jurisdictions allow secured creditors relief from the automatic stay on broadly similar grounds, the adequate protection doctrine is more clearly articulated under the Bankruptcy Code.”).

205 English law gives the court wide discretion in determining whether to grant relief:

The court is given a general discretion and, in accordance with ordinary principles, it must have regard to all relevant circumstances. If, having regard to those circumstances, it can be seen to be appropriate that the secured creditor should be given leave to enforce its security, then, even if

After-acquired property. After-acquired property, as the term is used here, refers to property that the debtor acquires after the commencement of the insolvency case and that fits within the security agreement description of collateral. In American insolvency proceedings, property acquired after the commencement of the case is not the secured creditor's collateral. Bankruptcy Code § 552(a) provides that "[P]roperty acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case."²⁰⁶ Such property is, however, subject to such a lien if it is also the proceeds, products, offspring, profits, or rents of collateral in existence at the time the insolvency proceeding was filed.²⁰⁷ The purpose of the American rules is to distinguish situations in which the after-acquired property represents the value of the secured creditor's prepetition collateral, from situations in which the new value is contributed by the debtor's estate.²⁰⁸

English law makes essentially the same distinction in Winding-up proceedings. As Professor Goode states:

So firmly is this principle [that security interests created prior to the insolvency proceeding are unaffected by the winding up] applied that where the instrument of charge provides for security in after-acquired property the secured creditor can assert rights even over moneys or other assets falling in after the commencement of the winding-up, *provided that the consideration for these was already executed before that time, as opposed to being furnished by the liquidator himself, e.g., by performance of a contract entered into by the company.*²⁰⁹

there be no criticism capable of being made of the administrator, I do not see why leave should not be given.

Royal Trust Bank v. Buchler (*Re Meesan Inv. Ltd.*), [1989] BCLC 130, [1988] BCC 788 (Ch. D. 1988).

Segal described English law as "without any statutory explanation as to how the discretion should be exercised," and acknowledges that "while both jurisdictions allow secured creditors relief from the automatic stay on broadly similar grounds, the adequate protection doctrine is more clearly articulated under the Bankruptcy Code." Segal, *supra* note 28, at 929.

206 11 U.S.C. § 552(a) (2006).

207 *Id.* § 552(b).

208 See LOPUCKI & WARREN, *supra* note 12, at 182-93; *see, e.g., In re Wiegmann*, 95 B.R. 90, 94 (Bankr. S.D. Ill. 1989) ("The lender is entitled to the same percentage of the proceeds of the post-petition milk as its capital contribution to the production of the milk bears to the total of the capital and direct operating expenses incurred in producing the milk.") (citing *In re Delbridge*, 61 B.R. 484, 491 (Bankr. E.D. Mich. 1986)).

209 GOODE, *supra* note 186, at 72 (emphasis added).

Doctrinally, English law reaches this result through the construct that assets in the hands of a liquidator in Winding-up are subject to a statutory trust and so the company never becomes the beneficial owner of the after-acquired property.²¹⁰

Although authority with respect to fixed charges in Administration is sparse, Segal describes the scope of the English charge holder's right in after-acquired property as broader than the corresponding American right: "[W]here a post-petition product is made using assets or cash not previously subject to the lender's security interest, the new product will not be subject to the lender's lien. This is different from the position in an English administration . . ." ²¹¹ Segal does not say how, but does confirm that "the practical significance of the differences between the two systems is limited."²¹²

If we include authority regarding floating liens, the picture is clearer. The English statute addressing the sale of floating charge collateral employs the term "acquired property" essentially to mean "proceeds." The statute provides:

§ 70 (1) The administrator of a company may dispose of or take action relating to property which is subject to a floating charge as if it were not subject to the charge.

(2) Where property is disposed of in reliance on sub-paragraph (1) the holder of the floating charge shall have the same priority in respect of acquired property as he had in respect of the property disposed of.

210 See Segal, *supra* note 28, at 931 ("[A]n English winding up . . . divests the debtor of the beneficial interest [in] its property. It is at least arguable that upon the commencement of the winding up, such assets become subject to a statutory trust so that products created therefrom or their proceeds are not property of the debtor to which the security interest can attach.") (footnote omitted). See also *In re Collins*, [1925] Ch. 556 (Eng.) (holding that monies to be earned in the course of business were included in bankruptcy); *Ayerst (Inspector of Taxes) v. C. & K. Constr. Ltd.*, [1976] A.C. 167, 178 ("[A] person could only be the legal owner without being at the same time the beneficial owner in cases where it was possible to identify some other person or persons in whom the beneficial ownership had become vested. Executorship of an estate during administration provides one example . . ."); GOODE, *supra* note 186, at 72 n.13 (stating that when the liquidator receives money as a result of procuring performance on the company's contract this money does not fall into the after acquired property clause). Segal is less supportive of our thesis elsewhere in his article. See, e.g., Segal, *supra* note 28, at 955 ("The after acquired property clause is effective to catch property coming into the company's hands after the commencement of the winding up . . .").

211 Segal, *supra* note 28, at 930-31.

212 *Id.* at 930.

(3) In sub-paragraph (2) “acquired property” means property of the company which directly or indirectly represents the property disposed of.²¹³

Under this provision, a floating charge holder retains its priority date only with respect to property “which directly or indirectly represents the property disposed of.”²¹⁴ That is essentially the American concept of “proceeds.” Segal’s example confirms this interpretation:

Accordingly, if the administrator, for example, sells plant machinery subject to the floating charge, the proceeds of the sale will fall within the floating charge and the holder of the charge will be entitled to the same priority as against third parties (e.g., holders of subsequent floating charges) in respect of the proceeds as he had over the disposed of plant machinery.²¹⁵

Thus, the distinction that after acquired property clauses continue to operate in English insolvency proceedings but cease to operate in American insolvency proceedings may make no difference. Whether the charge is fixed or floating, the English charge holder, like the American secured creditor, has effectively only the right to proceeds of its collateral during insolvency proceedings.

Administrators. In a Chapter 7 liquidation case the United States Trustee, a government official, appoints a disinterested trustee to administer the liquidation. In a voluntary Winding-up, the debtor appoints a liquidator;²¹⁶ in an involuntary Winding-up the creditors appoint a liquidator.²¹⁷ The objectives of the three kinds of cases are similar: to liquidate the debtor’s property and distribute it in accord with statutory priorities.²¹⁸ In Administration, a “qualified insolvency practitioner”—typically an accounting firm chosen by the qualifying floating charge holder who initiates the proceeding—is placed in con-

213 Insolvency Act, 1986, c. 45, sch. B1, ¶ 70.

214 *Id.*

215 Segal, *supra* note 28, at 961 (footnote omitted).

216 Insolvency Act, 1986, ch. 45, § 91(1) (“In a members’ voluntary winding up, the company in general meeting shall appoint one or more liquidators for the purpose of winding up the company’s affairs and distributing its assets.”).

217 Insolvency Act, 1986, ch. 45, § 100(1), (2) (“The creditors and the company at their respective meetings . . . may nominate a person to be liquidator for the purpose of winding up the company’s affairs and distributing its assets The liquidator shall be the person nominated by the creditors”).

218 *E.g.*, GOODE, *supra* note 186, ¶ 1-24, at 24 (“The principal role of the liquidator is to collect in and realise the assets, ascertain claims, investigate the causes of failure[,] and, after covering the expenses of the liquidation, to distribute the net proceeds by way of dividend to creditors in the order of priority laid down by the Insolvency Act and the Insolvency Rules.”).

rol.²¹⁹ The administrator has the power to remove and appoint directors.²²⁰ In Chapter 11, the debtor's managers formally remain in office, and administer the reorganization. But this formal difference is mitigated by practices in both countries. In England, the administrator may retain the debtor's management in a subordinate position. And in the United States, the debtor-in-possession's attorneys—who must pledge loyalty to the debtor company, not its managers²²¹—sometimes arrange with creditors for the managers' and directors' removal.²²² Despite these mitigations, we think managers do have greater control in American Chapter 11 cases than in English Administrations.

The two proceedings nevertheless remain similar in fundamental respects. Although left in control, the American debtor-in-possession is a fiduciary bound to act in the interests of all parties.²²³ The same is true of the English administrator.²²⁴ During the insolvency proceedings, both are obligated to serve as “neutrals,” working in the interests of all parties.²²⁵

Sale of collateral. English administrators and liquidators and American debtors in possession and trustees all have the practical abil-

219 GOODE, *supra* note 34, at 929 (“The holder of a qualifying floating charge has first choice in appointing an administrator.”); Segal, *supra* note 28, at 944 (“[T]he holder of a qualifying floating charge is given the right to appoint an administrator, chosen by him, merely by serving a notice at court with the requisite statutory declaration.”).

220 GOODE, *supra* note 186, at 369.

221 *See, e.g., In re KenDavis Indus. Int'l, Inc.*, 91 B.R. 742, 762 (Bankr. N.D. Tex. 1988) (requiring debtors' attorneys to disgorge two million dollars in fees because they had represented the interests of the debtors' principals rather than the interests of the debtor company).

222 For example, the debtor-in-possession's attorneys in Enron describe a management succession process in which they, not the debtors' board, chose the new CEO: “Ken Lay did not choose a successor. The Enron statutory creditors' committee named two potential successors, neither of whom Ken Lay knew, and Enron's attorneys selected Stephen F. Cooper from that list.” Martin J. Bienenstock et al., *Response to “Routine Illegality in Bankruptcy Court, Big-Case Fee Practices,”* 83 AM. BANKR. L.J. 549, 552 (2009).

223 *See, e.g., Ford Motor Credit Co. v. Weaver*, 680 F.2d 451, 462 n.8 (6th Cir. 1982) (“A trustee in bankruptcy or a debtor in possession, as a fiduciary, represents both the secured and unsecured creditors of the debtor.”).

224 *See* Insolvency Act, 1986, ch. 45, sch. B1, ¶ 3(2) (requiring that “the administrator of a company must perform his functions in the interests of the company's creditors as a whole”); *Royal Trust Bank v. Buchler (Re Meesan Invs. Ltd.)*, [1989] BCLC 130, [1988] BCC 788 (“The administrator has to have regard to the interests not only of secured creditors but also of unsecured creditors.”).

225 *See* Westbrook, *supra* note 24, at 825 (arguing that “neutrality” of the administrator is a “core idea” of a bankruptcy priority regime).

ity to sell secured creditors' collateral for a price in excess of the amount of the secured debt. That is because, in both the English and American systems, the debtor is entitled to redeem the collateral from the security interest by paying the full amount owing.²²⁶ In addition, American insolvency law specifically authorizes sale of the collateral free of liens if the sale price exceeds the "value of the liens:"

The trustee may sell property . . . free and clear of any interest in such property of an entity other than the estate, only if . . . such entity consents; [or] such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property²²⁷

Sale of the collateral by the administrator for more than the amount of the secured obligation will, in both systems, entitle the secured creditor to payment in full. To the extent estates can sell free of security interests in either system, they can do so only with court approval.²²⁸

In the English system, an administrator can sell the collateral free of a fixed charge for a price that is less than the amount owing to the secured creditor provided that the price is at least the market value of the property.²²⁹ It appears that a liquidator cannot.²³⁰

226 See *supra* note 96 (presenting English and American authority for the right to redeem).

227 11 U.S.C. § 363(f)(2)–(3) (2012).

228 For the United States, see 11 U.S.C. § 363(b)(1) ("The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate"). For England, see BEALE ET AL., *supra* note 163, ¶ 15.11, at 528–29 ("The administrator has power to dispose of these assets for the purposes of the administration but, except in the case of floating charge assets, must first apply to the court for permission to do so.").

229 Insolvency Act, 1986, Schedule B1 ¶ 71 provides in relevant part:

- (1) The court may by order enable the administrator of a company to dispose of property which is subject to a security (other than a floating charge) as if it were not subject to the security.
- (2) An order under sub-paragraph (1) may be made only—
 - (a) on the application of the administrator, and
 - (b) where the court thinks that disposal of the property would be likely to promote the purpose of administration in respect of the company.
- (3) An order under this paragraph is subject to the condition that there be applied towards discharging the sums secured by the security—
 - (a) the net proceeds of disposal of the property, and
 - (b) any additional money required to be added to the net proceeds so as to produce the amount determined by the court as the net amount which would be realised on a sale of the property at market value.

Insolvency Act, 1986, ch. 45, sch. B1, ¶ 17.

In the American system, no distinction is made between reorganization and liquidation. The majority rule is that neither debtors-in-possession nor trustees can sell collateral free of a security interest for a price less than the face amounts owing the secured creditors.²³¹

Thus, English law differs from American law principally in the ability of English administrators to sell for less than the amounts of the liens. As we explain below, we consider this difference to be compensatory for the English lack of cramdown.

Insolvency Priorities. Both English and American insolvency laws create priorities in favor of certain classes of creditors. They include administrative expenses and certain debts owing to employees. But these priorities are not priorities over English fixed charges or American security interests.

In an insolvency proceeding under English law:

[A] secured creditor is not a contender in the priority stakes. Assuming his security to be valid against the liquidator and creditors, he is entitled to have recourse to it before anyone else. Even the costs of the liquidation cannot be taken out of an asset given as security before the secured creditor has realized what is necessary to pay his debt.²³²

As will be discussed in Part IV.C. below, floating charges are subordinate to administrative expenses, preferential creditors, and an unsecured creditors' prescribed share, but fixed charges are senior to all creditors except prior fixed charges.

The same is true of security interests in American insolvency proceedings. Security interests are senior to expenses of administration, creditors with statutory bankruptcy priorities, and unsecured creditors.²³³

230 GOODE, *supra* note 186, at 71 ("As a corollary of the rule that only the company's assets are available for its creditors, the liquidator has no power *as liquidator* to sell assets not beneficially owned by the company or subject to a security interest . . .").

231 The sale must meet one of the requirements of 11 U.S.C. § 363(f). See *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25, 29 (B.A.P. 9th Cir. 2008) (holding that a sale meets the requirement of § 363(f)(3) only if it is for the face amount of the lien); *In re Boston Generating, LLC*, 440 B.R. 302, 331 (Bankr. S.D.N.Y. 2010) (holding that a sale meets the requirement of § 363(f)(3) if it is for the collateral's fair value).

232 GOODE, *supra* note 34, at 914 (footnotes omitted).

233 4 COLLIER ON BANKRUPTCY ¶ 507.02[4][a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2011) ("The rights of holders of priority claims are subject to the rights of holders of liens against property. The right to priority does not grant or imply any right to affect the rights of holders of secured claims . . .").

Expenses of collateral preservation and disposition. In both the United States and England, insolvency administrators often incur expenses in preserving and disposing of secured creditors' collateral. Under American law, the estate—and the unsecured creditors claiming through the estate—generally bear these expenses. The expenses are imposed on the secured creditor only “to the extent of any benefit to the holder of [the secured] claim.”²³⁴

To illustrate the operation of this “benefit” test, assume that the trustee incurs expenses of \$10,000 in preserving and selling an asset for \$100,000, and that the asset is subject to a security interest in the amount of \$75,000. The trustee cannot recover the \$10,000 from the secured creditor's \$75,000 share of the proceeds because the expenditures do not benefit the secured creditor. They do not benefit the secured creditor because, even if the trustee had not incurred them, the secured creditor would have incurred them, added them to the amount of the secured debt,²³⁵ and collected the entire \$85,000 through foreclosure. Thus, whether the trustee spends the \$10,000 or the secured creditor spends the \$10,000 and adds it to the amount of the secured debt, the ultimate outcome is the same. The expenses are paid, the secured creditor receives \$75,000 and the estate receives \$15,000.²³⁶

If, instead, the amount of the secured debt had been \$100,000, the trustee would have been able to recover the \$10,000 from the \$100,000 proceeds of sale. That is because the expenditures would have benefitted the secured creditor. The expenditures would have done so because, if the trustee had not paid them, the secured creditor would have had to pay them. The secured creditor could not have recouped them by adding them to the debt and collecting them from the sale proceeds, because the sale proceeds would have been insufficient to pay both the costs and the secured debt. As one American court put it in holding a trustee entitled to recover the commission it

234 11 U.S.C. § 506(c) (2006). The entire provision reads:

(c) The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of all ad valorem property taxes with respect to the property.

Id.

235 Security agreements generally provide that expenses of preserving a selling collateral are included in the secured obligation.

236 LOPUCKI & WARREN, *supra* note 12, at 120–22 (presenting a similar example regarding the sale process of an asset and assignment of the sale expenses).

paid to a broker to sell the collateral of such an undersecured creditor:

[In bankruptcy,] Twin City did not have to foreclose on the property and incur the financial burdens, and time burdens, that are usually associated with such action. Instead, Twin City was freed from these problems by virtue of the broker's prompt disposition of the property. Further, had Twin city lifted the stay and taken possession of the realty and the personalty, it would have had to sell same and pay its broker a commission also.²³⁷

Thus, on the facts of this example, the trustee recovers the \$10,000 in expenses from the sale proceeds and the remaining \$90,000 goes to the secured creditor.

English law does not make the benefit distinction expressly. The express rule is that “[t]he [administrator or liquidator] receives his fees and costs incurred in realising assets subject to a fixed charge from the sale proceeds of the assets in question, rather than from the assets available to the creditors of the company as a whole.”²³⁸ But the English and American formulations are sufficiently similar that they produce the same result on the facts of our two prototypical examples. In the first of those examples, the administrator or liquidator incurs \$10,000 in expenses to sell collateral encumbered by a fixed charge in the amount of \$75,000 for \$100,000. We take the English authorities to mean that the first \$10,000 of the proceeds of sale go to reimburse the administrator or liquidator.²³⁹ The next \$75,000 goes to the fixed charge holder and the remaining \$15,000 goes to the estate—the same result as under American law.

In the second example—a fixed charge of \$100,000 against collateral sold for \$100,000—the administrator or liquidator would again take the first \$10,000 of proceeds to reimburse the expenses of liquidation. The fixed charge holder receives the remaining \$90,000—

237 *In re Wine Boutique, Inc.*, 117 B.R. 506, 508–09 (Bankr. W.D. Mo. 1990).

238 Practical Law Company, *How Are Assets Distributed to Creditors in Corporate Insolvency Procedures?*, available at <http://www.practicallaw.com/5-422-4145> (last visited Jan. 18, 2013); see also Insolvency Rules, 1986, S.I. 1986/1925, § 2.92 (in administration) (“(3) If the administrator redeems the security, the cost of transferring it is payable out of the assets.”); *id.* § 4.97 (in liquidation) (“(3) If the liquidator redeems the security, the cost of transferring it is payable [out of the assets].”).

239 See *In re Berkeley Applegate (Inv. Consultants) Ltd.* (No. 3), [1989] 5 B.C.C. 803, 805, per Gibson L.J. (“[E]xpenses that are referred to as being incurred in the winding up cannot be expenses in relation to what are not assets of the company.”); GOODE, *supra* note 186, ¶ 7-23, at 192 (“It is well established that where [an administrator or] a liquidator incurs expense in preserving or realising assets for the benefit of a third party, for example, where he sells assets subject to a security interest, the costs are to be recouped from the proceeds recovered for the benefit of that party.”).

again yielding the same result as under American law. Thus although the reasoning is different in the two systems, they seem to allocate the expenses of collateral preservation and disposition in essentially the same manner.

The remaining difference between the two systems is that the American system addresses the possibility of a difference in the price that the secured creditor and the bankruptcy administrator can get for the property. Assume, for example, that the secured creditor held a \$75,000 security interest in collateral that the administrator could sell for \$100,000 along with other estate property, but that the secured creditor could sell for only \$70,000. If the administrator sold the collateral for \$100,000, the secured creditor would be entitled to \$75,000 under the English rule, but only \$70,000 under the American rule. Under the American rule, the trustee could “recover from property securing an allowed secured claim”—that is, from the secured creditor’s share of the proceeds—“the reasonable, necessary . . . expenses of . . . disposing of[the] property to the extent of any benefit to the [secured creditor]”²⁴⁰—that is, the \$5000 that the secured creditor could not have recovered without the trustee’s intervention.

2. Differences in Treatment

The treatment of fixed charges in English insolvency cases does differ significantly from the treatment of security interests in American insolvency cases in two important respects.

Cramdown. American security interests are subject to modification in Chapter 11 cases through “cramdown.” Cramdown is typically the substitution of a new debt for the previously secured debt.²⁴¹ The new debt may be in a smaller amount or payable on a different schedule with interest at a different rate, provided that the present value of the new debt is equal to the lesser of the amount of the previously secured debt or the value of the collateral.²⁴² The secured creditor is entitled to retain its lien.²⁴³

240 11 U.S.C. § 506(c) (2006).

241 *See id.* § 1129(b)(2)(A).

242 The relevant Code section requires that:

With respect to a class of secured claims, the plan provides . . . that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder’s interest in the estate’s interest in such property

Id. § 1129(b)(2)(A)(i)(II).

243 *Id.* § 1129(b)(2)(A)(i)(I) (requiring that “the holders of [secured] claims retain the liens securing such claims”).

Segal points out that “[i]n England, in an administration and company voluntary arrangement (CVA), the secured creditor’s right to enforce his security is entrenched and cannot be prejudiced by the administrator’s proposals or the terms of the CVA, without the consent of the secured creditor.”²⁴⁴ Segal concludes, “English law does not have a true equivalent to the cram-down that arises in Chapter 11 proceedings.”²⁴⁵

English law does, nevertheless, have a functional equivalent. The administrator can sell the collateral.²⁴⁶ To understand the equivalency, consider the example of a debtor that owns \$500,000 in collateral that is subject to a security interest in the amount of \$900,000. In an American Chapter 11 case, the debtor in possession could propose a plan that paid the secured creditor \$500,000 plus interest at the market rate, treated the remaining \$400,000 in the same manner as other unsecured claims, comply with the absolute priority rule by cancelling the equity, and cram the plan down over the secured creditor’s objection.²⁴⁷ In an English Administration, the administrator could, with the court’s approval, sell the collateral for \$500,000 on credit, transfer the fixed charge to proceeds of sale, and treat the remaining \$400,000 as an unsecured claim. The sale need not be to a third party. It can be a “phoenix sale”²⁴⁸ to a shell corpo-

244 Segal, *supra* note 28, at 932.

245 *Id.*

246 *See supra* notes 229–230 and accompanying text.

247 The Chapter 11 requirement is that:

With respect to a class of secured claims, the plan provides—

(i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder’s interest in the estate’s interest in such property

11 U.S.C. § 1129(b)(2)(A). Under 11 U.S.C. § 1111(b)(2), a secured creditor can elect to have its entire claim treated as secured and be paid the secured *amount*. But the debtor can pay it without interest over time, with the result that the secured creditor is usually not entitled to any more *value*. *Id.* § 1129(b)(2)(A)(i)(II).

248 The term “phoenix sale” generally refers to the “tendency for a bankrupt business to start up again under a new ‘identity’ with the same owners.” INT’L ASS’N OF INSOLVENCY REGULATORS, THE REGULATION OF PHOENIX COMPANIES 5 (2004), *available at* http://www.insolvencyreg.org/sub_publications/docs/Report%20on%20Phoenix%20Companies%20Final41029.pdf.

ration owned by the same persons who own the debtor.²⁴⁹ The two transactions produce identical results.

Thus, both the English and the American systems accept the basic principle that a secured creditor should not be able to prevent a restructuring that benefits others without harming the secured creditor. In the American system, the debtor can retain the collateral. In the English system, the debtor must sell the collateral, but the sale can be to the debtor's principals.

Priming. In the English system, the administrator cannot grant liens with priority over pre-existing fixed charges. With respect to English Administration, Segal notes:

[W]here the administrator needs to borrow funds for the purpose of the [A]dministration, these provisions allow him to do so, and to create new, post-[A]dministration security interests, with priority over pre-[A]dministration floating charge assets. However, there is no ability to prime and subordinate assets subject to a pre-[A]dministration fixed charge.²⁵⁰

In the American system, the administrator can grant such liens with priority over a pre-existing security interests.

(d)(1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if—
 (A) the trustee is unable to obtain such credit otherwise; and
 (B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.²⁵¹

To grant a priming lien, the American debtor-in-possession or trustee must obtain court approval and must provide adequate protection against resulting loss to the holder of the security interest. But the secured creditor nevertheless may suffer uncompensated losses if the protection turns out to be inadequate. For that reason, this power

249 See Adam Gallagher & Margaret Rhodes, *Pre-pack Sales in the U.K.: Smoke Without Fire*, AM. BANKR. INST. J., May 2009, at 38 (“The purchaser will sometimes be an unconnected third party, but often it will be a special-purpose vehicle owned by the secured creditors or the owner of the failing entity.”); *id.* (“If the purchasing company has the same owner as the selling company, the pre-pack is sometimes known as a ‘phoenix’ because it involves the same business being born again from its own ashes.”); Sally Willcock, *UK Pre-Pack Proposals Given the Thumbs Down*, BANKRUPTCY BLOG (Aug. 1, 2011), <http://business-finance-restructuring.weil.com/cross-border-update/uk-pre-pack-proposals-given-the-thumbs-down/#axzz1lSzPowIb> (discussing pre-packaged sales of businesses by English administrators to the business’ former owners).

250 Segal, *supra* note 28, at 967.

251 11 U.S.C. § 364(d)(1)(A)–(B) (2006).

to “prime” a secured creditor does constitute an important functional difference in the operation of security between the two systems.²⁵² But the difference is incidental in the sense that, if the American system functions as intended, secured creditors would suffer no losses as a result of the priming.

IV. FLOATING CHARGES COMPARED WITH ARTICLE 9 FLOATING LIENS

Abstract concepts play an important role in English legal reasoning. The theoretician imbues a concept with characteristics and then the concept behaves in accord with them, sometimes seeming to determine concrete outcomes. This has been especially so with floating charges. The following passage is, for example, a classic explanation of the floating charge:

A specific charge, I think, is one that without more fastens on ascertained and definite property or property capable of being ascertained and defined; a floating charge, on the other hand, is ambulatory and shifting in its nature, hovering over and so to speak floating with the property which it is intended to affect until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp.²⁵³

From this explanation, one jurist concluded that “[i]t 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 the company’s business while still keeping his security a floating security; he cannot at once give freedom and insist on servitude.”²⁵⁴ Alternatively, the floating charge is sometimes described as “a licence or permission by the [creditor] to the [debtor] to deal with the [collateral] . . . as though a [charge] had not been executed” until that license is revoked by crystallization of the floating charge.²⁵⁵ These conceptualizations are sometimes said to lead to the concrete conclusion that “third parties dealing with the [debtor] in the course

252 Segal, *supra* note 28, at 967 (“[T]here is no ability [in an English Administration proceeding] to prime and subordinate assets subject to a pre-[A]dministration fixed charge.”).

253 *In re Spectrum Plus Ltd.*, [2005] 2 A.C. 680, 718 (Lord Scott) (quoting *Illingworth v. Houldsworth*, [1904] A.C. 355, 358 (Lord Macnaghten) (internal quotation marks omitted)).

254 *Evans v. Rival Granite Quarries Ltd.*, [1910] 2 K.B. 979, 998, (Moulton, L.J.).

255 *In re Yorkshire Woolcombers Ass’n, Ltd.*, [1903] 2 Ch. 284, 298 (Cozens-Hardy, L.J.); *see also In re Spectrum Plus Ltd.*, [2005] 2 A.C. 680, 722 (Lord Scott) (stating that until crystallization “the [debtor] is left free to use the charged asset and to remove it from the security”).

of their business [can] ignore [floating charges].”²⁵⁶ In keeping with this conceptualization of the floating charge as conveying no rights in the collateral until crystallization, Lord Scott said in *Spectrum Plus*, that

[t]here can . . . be no difference in categorisation between the grant of a fixed charge expressed to come into existence on a future event in relation to a specified class of assets owned by the [debtor] at that time and the grant of a floating charge over the specified class of assets with crystallisation taking place on the occurrence of that event.²⁵⁷

Seemingly inconsistently, English judges and commentators also maintain that a floating charge is “a present security, which presently affects all the assets of the company expressed to be included in it.”²⁵⁸ “[T]he floating charge, though ambulatory, is a present security, not a mere contract right, so that restrictions contained in it will constitute an equity binding those who have notice of them.”²⁵⁹

Of course, no concrete outcomes flow from such legal conceptualizations except those that judges decide, in particular cases, to allow. Legal doctrine and metaphor are almost infinitely malleable. As we develop in this Part, sophisticated third parties dealing with the debtor do not ignore floating charges, and those third parties who do ignore them do so at their peril.

A comparison of the English floating charge with the American floating lien in revolving assets illustrates the point. The American floating lien is regarded as attached to each specific account or item of inventory. The lien exists and is a “property,” or in English terminology a “proprietary,” interest in the collateral. Yet, even if the American floating lien is fully perfected, the American grantor, like its English counterpart, remains free to sell goods that are collateral in the ordinary course of business.²⁶⁰ The American grantor, like its English counterpart, is also free to modify or substitute accounts if the

256 *Cretanor Mar. Co. v. Irish Marine Mgmt. Ltd.*, [1978] 3 All E.R. 164, 173 (Buckley, L.J.). See, e.g., GULLIFER, *LEGAL PROBLEMS*, *supra* note 150, ¶ 5-38 (“[W]hilst the [floating] charge is a present security it is non-specific and in principle does not affect third parties at all while it continues to float.”).

257 *In re Spectrum Plus Ltd.*, [2005] 2 A.C. 680, 720–21 (Lord Scott).

258 *Evans v. Rival Granite Quarries Ltd.*, [1910] 2 K.B. 979, 999 (Buckley, L.J.).

259 *Nat'l Westminster Bank PLC v. Spectrum Plus Ltd.*, [2004] EWCA (Civ) 670, [29] (Lord Phillips MR) (quoting ROY GOODE, *LEGAL PROBLEMS OF CREDIT AND SECURITY* ¶ 5-40 (3d ed. 2003)), available at <http://www.bailii.org/ew/cases/EWCA/Civ/2004/670.html>.

260 U.C.C. § 9-320(a) (2012) (“[A] buyer in ordinary course of business . . . takes free of a security interest created by the buyer’s seller, even if the security interest is perfected and the buyer knows of its existence.”).

underlying contracts have not yet been fully performed²⁶¹ and to collect or compromise accounts if the underlying contracts have been fully performed.²⁶² The American floating lien neatly slips off each item of collateral as the debtor disposes of inventory or substitutes or collects accounts. It attaches to each new item of collateral as the debtor acquires it. The English floating charge only hovers; the American floating lien lands and attaches. But the consequences are virtually the same.

In this Part, we seek to infer the true nature of the English floating charge by comparing those consequences with respect to buyers of the collateral, competing security interests, execution creditors, insolvency administrators and other claimants in insolvency cases. We conclude that the English floating charge is sufficiently effective in those competitions that it is the functional equivalent of an American floating lien.

A. *Sale of Collateral*

1. Original Collateral

As we noted in Part III., buyers of collateral generally take subject to English fixed charges and American security interests. But buyers of inventory in the ordinary course of business take free of both English floating charges and American security interests, even if buyers know that the charges or interests exist.²⁶³ The American rule is found in U.C.C. § 9-320(a), which provides that “a buyer in ordinary course of business . . . takes free of a security interest created by the buyer’s seller, even if the security interest is perfected and the buyer knows of its existence.”²⁶⁴ The English rule is found in judicial interpretation. “It is in the nature of a floating charge that the company retains, until crystallisation, the power to dispose of its assets in the ordinary course of business free of the charge, and thus a purchaser will take free of the charge”²⁶⁵

261 *Id.* § 9-405(a) (“A modification of or substitution for an assigned contract is effective against an assignee if made in good faith.”).

262 *Id.* § 9-404(a)(1)–(2) (“[T]he rights of an assignee are subject to . . . all terms of the agreement between the account debtor and assignor and . . . any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives a notification of the assignment”).

263 *See supra* Part III.A. (explaining the treatment of a U.S. security interest upon disposition of collateral).

264 U.C.C. § 9-320(a) (2012).

265 LAW COMMISSION, *supra* note 19, ¶ 2.59, at 39–40.

In neither system can a buyer take free if the buyer is aware that its purchase violates the security agreement. American law defines “buyer in ordinary course of business” to mean “a person that buys goods in good faith, without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course from a person . . . in the business of selling goods of that kind.”²⁶⁶ The English rule with respect to floating charges is that “a purchaser will take free of the charge unless she has actual knowledge that it has crystallised or that the disposition is not permitted because of some explicit restriction in the charge.”²⁶⁷

As previously noted, the “buyer in ordinary course” concept is narrower under American law than under English law. We doubt, however, that debtors’ ability under English law to transfer capital assets to ordinary course buyers free of floating charges makes any significant difference in system function. That ability exists only with respect to floating charges against capital assets,²⁶⁸ which is to say, only in situations in which the secured creditor, by making the charge floating, consents to the debtor selling the collateral free of the charge.²⁶⁹ If the secured creditor consents to sale in the American system, the result would be the same, even if the sale is not considered to be in the ordinary course of business.²⁷⁰

Accounts receivable are another category of assets that debtors may be more able to sell free of a security interest under English than American law. Although American debtors have the right to collect, compromise, and substitute accounts until the secured creditor notifies the account debtor to the contrary, American debtors have no right to sell the accounts to third parties.²⁷¹ English debtors arguably do because “[i]t is in the nature of a floating charge that the company retains, until crystallisation, the power to dispose of its assets in the

266 U.C.C. § 1-201(b)(9) (2012).

267 LAW COMMISSION, *supra* note 19, ¶ 2.59, at 40 (footnote omitted).

268 *See supra* Part III.A.1.

269 *See* the discussion of *Ashborder*, *supra* note 166 and accompanying text.

270 U.C.C. § 9-315(a)(1) (2012) (stating that “a security interest . . . continues in collateral notwithstanding . . . disposition . . . unless the secured party authorized the disposition free of the security interest”).

271 Absent agreement of the secured creditor, only buyers of goods and nonexclusive licenses take free of security interests under American law. *Id.* §§ 9-320(a), 9-321. Some sales of accounts are excluded from Article 9 coverage. *See id.* § 9-109(d)(4) (excluding sale of accounts as part of a sale of the business out of which they arose); *id.* § 9-109(d)(5) (excluding sale of accounts for the purpose of collection only); *id.* § 9-109(d)(7) (excluding an assignment of a single account in satisfaction of a preexisting indebtedness). Exclusion from Article 9 coverage may or may not mean that no security interests exist in such accounts.

ordinary course of business free of the charge, and thus a purchaser will take free of the charge”²⁷² Thus, in theory, an English debtor that granted a floating charge over its accounts could later sell or grant a fixed charge in those accounts.

We doubt the practicality of that transaction. First, “transactions which are intended to bring to an end, or have the effect of bringing to an end, the company’s business are not transactions in the ordinary course of its business.”²⁷³ Thus, if an English debtor sold its accounts or inventory in bulk as part of a plan to terminate its business, the transaction would be outside the ordinary course. The buyer would take subject to the floating charge, just as the buyer would under American law. Only the doctrinal explanation would be different.

Second, security agreements in both countries are likely to restrict sales of accounts free of security interests. For example, the sample Debenture (security agreement) in Goode, *Commercial Law*, imposes these restrictions:

4.1 You must collect and realise all Receivables and immediately on receipt pay all money which you receive in respect of them into your bank account with us, or into any other account designated by us You may not, without our prior written consent, charge, factor, discount, assign, postpone, subordinate[,] or waive your rights in respect of any Receivable in favour of any other person or purport to do so. . . .

5 You must not, except with our prior written consent . . . 5.2 sell, assign, lease, license or sub-license, or grant any interest in, your Intellectual Property Rights, or purport to do so, or part with possession or ownership of them, or allow any third party access to them or the right to use any copy of them.²⁷⁴

One who buys with actual knowledge of these restrictions, buys subject to the charge—even if the sale is in the ordinary course. The Law Commission states that

It is in the nature of a floating charge that the company retains, until crystallisation, the power to dispose of its assets in the ordinary course of business free of the charge, and thus a purchaser will take free of the charge unless she has actual knowledge that it has crystallised or that the disposition is not permitted because of some explicit restriction in the charge.²⁷⁵

272 LAW COMMISSION, *supra* note 19, ¶ 2.59, at 39–40.

273 Singh Sandhu v. Jet Star Retail Ltd., [2011] EWCA Civ 459, ¶ 10 (Moore-Bick L.J.).

274 GOODE, *supra* note 34, at 636–37.

275 LAW COMMISSION, *supra* note 19 ¶ 2.59, at 39–40 (footnote omitted).

Although the Law Commission's view was that the doctrine of constructive notice "does not apply to restrictions in the charge as these are not registrable," at least some commentators think otherwise.²⁷⁶ The gist of their argument is that restrictions against extraordinary transactions are so common that buyers expect such restrictions, and to avoid conflicts, search for them. Nolan maintains that:

Even before a floating charge crystallises, the equitable interest created by it is capable of binding a third party who acquired property within the scope of the charge other than in the ordinary course of the company's business, and *with actual or constructive notice* both of the nature of the charge and of the circumstances of the transfer.²⁷⁷

Thus it is an exaggeration to say that until crystallization of a floating charge, the debtor "is left free to use the charged asset and to remove it from the security"²⁷⁸ or that "third parties dealing with the [debtor] in the course of their business [can] ignore" floating charges.²⁷⁹ Although the Law Commission recites that "a buyer of goods in the ordinary course of business cannot be expected to search against her seller in the Companies Register,"²⁸⁰ if the transaction is more than a routine purchase of goods from inventory, the buyer would be well-advised to do so.²⁸¹ Once the buyer has conducted a search, it will have actual knowledge of the restrictions, and so will be bound by them. Thus, when the security agreement includes customary restrictions, the English rule's application yields results virtually indistinguishable from the results of the American rule's application.

276 LAW COMMISSION, *supra* note 56 ¶ 3.219 n.274, at 83.

277 R.C. Nolan, *Property in a Fund*, 120 L.Q. REV. 108, 127 (2004) (emphasis added). Ferran, on the other hand, "suggests that the relevant dicta in these cases are unsound, but that the effect of a charge on a third party in the circumstances can be justified on the grounds that the charge had crystallised." *Id.* at 127 n.84 (citing Eilís Ferran, *Floating Charges—The Nature of the Security*, 47 CAMBRIDGE L.J. 213, 231–33 (1988)). See, e.g., *Hamilton v. Hunter* [1982] 7 A.C.L.R. 295; *Reynolds Bros. (Motors) Party Ltd v. Esanda Ltd.*, [1983] 8 A.C.L.R. 422; 1 A.C.L.C. 1, 333.

278 *In re Spectrum Plus Ltd.*, [2005] 2 A.C. 680, ¶ 111 (Lord Scott L.J.).

279 *Cretanor Mar. Co. v. Irish Marine Mgmt. Ltd.*, [1978] 3 All E.R. 164, 173 (Buckley, L.J.).

280 LAW COMMISSION, *supra* note 19, ¶ 2.60, at 40.

281 See LAW COMMISSION, *supra* note 56, ¶ 3.217, at 83 ("There is some doubt as to when a purchaser who does not have actual knowledge of the charge will be put on notice of it because it has been registered.").

2. Proceeds

An American floating lien attaches to “any identifiable proceeds of [the] collateral.”²⁸² Thus, if an American debtor sells inventory in the ordinary course of business on credit, the floating lien does not continue in the inventory, but does attach to the accounts receivable thus created.

An English floating charge does not attach to the proceeds of sale.²⁸³ Thus, Professor Goode states that “[a] floating charge covering assets of a particular description will not carry through to proceeds of a different description, for this would be inconsistent with the power of disposition inherent in the floating charge.”²⁸⁴ As Professor Ferran points out, however, charge holders can opt out of the default rule by drafting the security agreement to expressly cover “receivables and their proceeds.”²⁸⁵ In practice, it is likely that most professionally drafted security agreements will do so. We see no reason why the typical floating charge, which includes “all your undertaking, property, assets, rights[,] and revenues,” would not be adequate to do so.²⁸⁶ Accordingly, there may not be a functional difference between a U.S. security interest and an English floating charge with respect to the ability to reach the proceeds of collateral sales.

B. Encumbrance of Collateral

1. Competing Secured Creditors

In a competition among American security interests, each has priority as of the date of registration or perfection, whichever occurs first.²⁸⁷ Thus an American floating lien will have priority over any later taker of a security interest in the same collateral.

Similarly, an English floating charge holder has priority over any later taker of a floating charge.²⁸⁸ The order in which the floating

282 U.C.C. § 9-315(a)(2) (2012).

283 LAW COMMISSION, *supra* note 56, ¶ 3.52, at 45 (stating that in the event the collateral is sold “if the charge were merely a floating charge . . . the court would infer that the charge did not cover the proceeds”).

284 GOODE, *supra* note 34, at 659 n.142.

285 FERRAN, *supra* note 65 at 368.

286 GOODE, *supra* note 34, at 632.

287 U.C.C. § 9-322(a)(1) (2012) (“Conflicting perfected security interests . . . rank according to priority in time of filing or perfection.”).

288 *In re Benjamin Cope & Sons Ltd.*, [1914] 1 Ch. 800, 807 (“[I]t would in my view be as incompatible with the company’s bargain with the [floating charge holders] to put their debentures behind or on the same footing as subsequent debentures giving a charge of the same character as if the debentures had constituted a specific

charges crystallize does not matter.²⁸⁹ The recent case of *Griffiths v. Yorkshire Bank PLC.*,²⁹⁰ held to the contrary—that a later created floating charge that crystallized before an earlier created floating charge did take priority over the first charge. But commentators have uniformly disapproved *Griffiths* and we doubt the precedent will survive.²⁹¹

An English law floating charge holder does not, however, have priority against subsequent fixed charge holders.²⁹² The earlier floating charge “can be displaced by a [later created fixed charge].”²⁹³

Floating charge holders can attempt to achieve priority over subsequent fixed charge holders through the use of automatic crystallization and “negative pledge” clauses in their security agreements. We previously discussed the use of automatic crystallization clauses.²⁹⁴ A negative pledge prohibits the creation, without the consent of the floating charge holder, of subsequent charges that would rank ahead of the floating charge.²⁹⁵

A subsequent fixed charge holder may take subject to an automatically crystallized floating charge even if it lacks actual notice of

charge and it were then attempted to create a subsequent specific charge ranking *pari passu* with them or in priority to them.”); *see also In re Household Products Co.*, [1981] 124 D.L.R. 3d 325 (holding that a later charged debenture is subordinate to earlier floating charge debenture).

289 GOODE, *supra* note 34, at 733 (“By contrast, the grant of a subsequent floating charge ranking in priority to the first floating charge is *prima facie* against the intention of the earlier charge and, even if the later charge is the first to crystallize, it is ineffective *vis-à-vis* the holder of the earlier charge except in so far as thereby authorized.”).

290 [1994] 1 W.L.R. 1427.

291 *See* FERRAN, *supra* note 65, at 388 (“Although there is one case [*Griffiths*] that suggests otherwise, the better view is that crystallization does not affect the priority of a floating charge against other interests in the same property which pre[-]date crystallization.” (footnote omitted)); *id.* at 393 n.281 (“*Griffiths*, which is to the effect that a second floating charge can take priority by being the first to crystallize, is inconsistent with earlier authorities.” (citation omitted)); GOODE, *supra* note 34, at 733 n.79 (stating that two earlier cases “were, unfortunately, not drawn to the attention of Morritt J in *Griffiths*”).

292 LAW COMMISSION, *supra* note 56, ¶ 3.177, at 73 (“Under current law, the general rule is that a floating charge will lose priority to a subsequent fixed charge.”).

293 *In re Benjamin Cope & Sons*, [1914] 1 Ch. at 806; *see also In re Ind, Coope & Co.*, [1911] 2 Ch. 223 at 234 (holding that “[t]he effect of . . . the debenture[] . . . being a floating security only, was to reserve . . . a power to the [debtor] to give a security on a particular asset in priority to the debenture[]”); *Wheatley v. Silkstone & Haigh Moor Coal Co.*, [1885] 29 Ch. 715 at 724 (holding that a later created mortgage was “not subject to [a] claim created by [a preexisting floating charge]”).

294 *See supra* Part II.C.

295 *See* GOUGH, *supra* note 184, at 225.

crystallization. Thus, in the *Brightlife* case, “the effect of the validity of . . . automatic crystallization . . . was such that it did in a quite profound way affect the other third party creditors of the company, notwithstanding the fact that they may not have known (although the company did) that the floating charge had crystallised.”²⁹⁶

A subsequent fixed charge holder’s actual notice of a floating charge that incorporates a negative pledge clause prohibiting or restricting the grant of additional higher-ranking security is sufficient to give the floating charge holder priority over the subsequent fixed charge.²⁹⁷ Constructive notice is not sufficient,²⁹⁸ but actual notice can be imputed if the fixed charge holder has been “willfully” negligent to an extent that “amounts to evidence of fraud.”²⁹⁹ Merely failing to make an “investigation or inquiry” does not amount to the willful negligence required for notice to be imputed.³⁰⁰

These rules suggest that the courts would usually find creditors taking subsequent fixed charges to have priority over earlier floating charges. But “usually” is not enough to make the taking of subsequent fixed charges commercially feasible. The Law Commission stated:

We understand that in practice a subsequent creditor will not take the risk that there may be a negative pledge or automatic crystallisa-

296 Andrew Wilkinson, *Automatic Crystallisation of Floating Charges*, 8 COMPANY LAW 75, 77 (1987); see also Charles Mayo & Elis Ferran, *Registration of Company Charges—The New Regime*, J.B.L. Mar. 1991, 152, 165–66 (explaining that one argument against automatic crystallization is that it is “unfair to other persons dealing with the company who are unable to discover the true position” and thus, without notice, may take subject to a crystallized floating charge).

297 *In re Spectrum Plus Ltd.*, [2004] Ch. 337 at 365–66 (Lord Phillips MR) (citing Professor Goode and endorsing the proposition that “[i]f [a floating charge] imposes restrictions on sales or subsequent encumbrances and the particular sale or charge, though in the ordinary course of business is in breach of such restrictions, the floating charge will, on crystallisation, retain its priority if the buyer or encumbrancer took with notice of the restrictions, whether his interest is legal or equitable”). But see *Siebe Gorman & Co. v. Barclays Bank Ltd.*, [1979] 2 Lloyd’s Rep. 142 (Ch.D.) 157 (holding that a negative pledge clause would not operate to subordinate a later created fixed charge as “neither Siebe Gorman nor its solicitors had any actual knowledge of any of the [relevant provisions] of the debenture”).

298 See *Wilson v. Kelland*, [1910] 2 Ch. 306 at 306 (stating that registered particulars “would have amounted to constructive notice of a charge affecting the property but not of any special restrictions upon dealings by the company with its property in the usual manner when the subsisting charge is a floating security”).

299 *English & Scottish Mercantile Inv. Trust Ltd. v. Brunton*, [1892] 2 Q.B. 1 at 10.

300 *Wilson*, [1910] 2 Ch. at 306 (holding that a fixed charge holder’s failure to make an “investigation or inquiry” into whether a negative pledge clause existed did not subordinate the fixed charge to a preexisting floating charge).

tion clause and that it might be found to have had notice of it. If it wants to ensure its priority it will make a subordination agreement with the floating charge-holder.³⁰¹

Thus, as a practical matter, an English floating charge is sufficient to deter the taking of subsequent fixed charges that might have priority. Here again, the differences in legal doctrine between the English and American systems largely disappear in actual practice.

2. Lien Creditors

As previously discussed,³⁰² English fixed charges and American security interests have priority over execution liens with later priority dates. Before lending, secured creditors generally discover and clear execution liens with earlier priority dates. As a result, English fixed charges and American security interests almost invariably have priority over execution liens.

On its face, the English system appears to operate differently with respect to floating charges. Even after registration, English law gives floating charges no priority over subsequent lien creditors so long as the charges float.³⁰³ As the Law Commission put it, “[i]n principle an execution creditor takes free of a floating charge if it has completed execution before crystallisation of the charge.”³⁰⁴ The English rules led Professor Picker to conclude that English judgment creditors could obtain priority over floating charge holders through execution and that, as a result, there was a functional difference between the English and American systems:

The Article 9 security interest in inventory is good against the lien creditor, both genuine lien creditors under Revised section 9-317(a) and hypothetical lien creditors under section 544 of the Bankruptcy Code. The uncrystallized floating charge is not good against a lien creditor nor is it spared from the invasion of claims given a statutory preference in a liquidation. The structure of this system means that a group of assets—those that can be subject to no more than a floating charge—are always up for grabs.³⁰⁵

301 LAW COMMISSION, *supra* note 56, ¶ 3.179, at 74.

302 *See supra* Part III.B.2.

303 *See* LAW COMMISSION, *supra* note 19, ¶ 2.41, at 34 (“Further an uncrystallised floating charge has no priority against execution creditors, landlord’s distress, set-offs and possessory liens.”).

304 LAW COMMISSION, *supra* note 56, ¶ 3.201, at 79.

305 Randal C. Picker, *Perfection Hierarchies and Nontemporal Priority Rules*, 74 CHI.-KENT L. REV. 1157, 1185 (1999) (footnote omitted).

The Law Commission takes a different view. They start with the observation that the judgment creditor must “complete” its execution before crystallization to have priority over the floating charge.³⁰⁶ Goode concurs.³⁰⁷ The English authorities are vague as to when an execution is complete.³⁰⁸ Completion seems to be a reference to the Insolvency Act, which states that “[f]or purposes of this Act . . . an execution against goods is completed by seizure and sale”³⁰⁹ An execution against goods may not be complete until the collateral is sold,³¹⁰ or even until the proceeds of sale are distributed.³¹¹

As a practical matter, floating charge holders can crystallize their charges before judgment creditors can complete their executions. They can do so in two ways. The first is through automatic crystallization:

In practice the attempted execution is likely to trigger an automatic crystallisation clause in the floating charge. An automatic crystallisation clause is likely to be effective in this type of case, since the rights of the execution creditor do not depend on whether it had notice of the clause or of the crystallising event. Thus if there is such a clause the execution creditor will be unable to claim any of the debtor’s property.³¹²

306 See LAW COMMISSION, *supra* note 56, ¶ 3.201, at 79.

307 See GOODE, *supra* note 34, at 733 (“Since no specific asset is affected by the floating charge until crystallization, it follows that an execution creditor who completes his execution before crystallization gets priority.” (footnote omitted)).

308 See, e.g., Supreme Court Act, 1981, c. 54, § 138 (“(1) Subject to subsection (2), a writ of fieri facias or other writ of execution against goods issued from the High Court shall bind the property in the goods of the execution debtor as from the time when the writ is delivered to the sheriff to be executed.”); Bankers Trust Co. v. Galadari, [1987] Q.B. 222 at 224 (“It should be noted that the property in the goods is bound from the time of delivery of the writ and not from the time when the sheriff obtains possession under the writ.”).

309 Insolvency Act, 1986, c. 45, § 183(3). Goode follows this trail. See GOODE, *supra* note 34, at 733 n.79 (offering cross reference from crystallization to the Insolvency Act definition).

310 See *In re Opera, Ltd.*, [1891] 3 Ch. 260 (Lord Lindley).

[T]he rights of the [floating charge holder] must prevail even as against the execution creditor, at least before sale. What the position of the [floating charge holder] is after the property is sold and the money handed over, I do not know, and I will not say at this moment

Id. at 263. For further discussion on the academic literature and the scarce case law authority on this point, see GULLIFER, LEGAL PROBLEMS, *supra* note 150, ¶ 5-44, at 201.

311 See *Robinson v. Burnell’s Vienna Bakery Co.*, [1904] 2 K.B. 624 (holding that a creditor with a crystallized floating charge could not pursue money received by an execution creditor after seizure and sale of the collateral).

312 LAW COMMISSION, *supra* note 56, ¶ 3.201, at 79.

The second is by discovering the execution in progress and giving notice of crystallization before the execution is complete. Discovery is not difficult because execution sale is a public event.³¹³ Because the floating charge holders can act more quickly than the execution creditors, no assets are “up for grabs” in any meaningful sense.

The competition between floating charges and garnishment works in essentially the same way. The garnishing creditor is entitled to keep any money received prior to crystallization, but loses any money not received prior to crystallization.³¹⁴ The floating charge holder can prevail through the use of the same two strategies.

To employ these strategies, the secured creditor must crystallize the charge with respect to all of the charged assets.³¹⁵ That may force the debtor to close its business or to file an insolvency proceeding. Thus, crystallization strategies are not costless for the secured creditor. But secured creditors are likely to prefer an insolvency proceeding when their debtor is unable to resolve an execution. Crystallization followed by de-crystallization after the collateral has been released from the execution is another possible strategy.³¹⁶

In summary, floating charge holders can, through legal strategies, gain the very priorities over buyers, competing charge holders, and execution creditors that legal doctrine denies to them. As a result, in the absence of insolvency proceedings, the English floating charge functions in essentially the same manner as the American floating lien. Both allow the debtor to sell inventory free of the security interest in the ordinary course of business without the secured creditor’s consent. Both, as a practical matter, make it difficult or impossible for

313 See, e.g., *Cuckmere Brick Co. v. Mut. Fin. Ltd.*, [1971] Ch. 949 at 950 (holding that duty of care to “obtain a proper price” in exercising his power of sale was violated where mortgagee failed to properly advertise collateral to be sold at public auction); *Standard Chartered Bank Ltd. v. Walker*, [1982] 1 W.L.R. 1410 (holding that it was a triable issue of fact whether receiver had violated duty of care and been negligent in preparing and conducting public auction sale at short notice and with minimum publicity).

314 See, e.g., *Cairney v. Back*, [1906] 2 K.B. 746 (holding that a garnishment order did not transfer the accounts receivable to the lien creditor as property and that the holder of the crystallized floating charge was entitled to the proceeds of the accounts receivable in priority to the lien creditor); *Robson v. Smith*, [1895] 2 Ch. 118 at 126 (holding that a lien creditor is entitled to garnishment proceeds if a floating charge is uncrystallized).

315 *Evans v. Rival Granite Quarries, Ltd.*, [1910] 2 K.B. 979, 982 (Lord Williams L.J.) (“The debenture-holder cannot pick out one particular asset of the company and make his charge attach to that asset, while allowing the company to go on carrying on business and the charge to remain a floating charge as concerns other assets . . .”).

316 See *supra* Part II.C.

other buyers, competing secured creditors, or lienholders to gain priority over the floating charge or floating lien once they have been perfected through registration.

C. *Rights in Insolvency Proceedings*

In Part III.C., we argued that the treatment of English fixed charges in insolvency proceedings is highly similar to the treatment of American security interests in insolvency proceedings. The differences—cramdown and priming—are unlikely to reduce secured creditors’ recoveries.

In this section, we compare the treatment of English floating charges in insolvency proceedings to the treatment of American security interests in insolvency proceedings. Because we have already compared fixed charges with American security interests, we limit this discussion to aspects of floating charges that differ from fixed charges.

1. Initiation

In Part III.C.1., we noted that, although fixed charge holders have greater rights to directly initiate insolvency proceedings than do American secured creditors, the difference is unimportant. American secured creditors can easily initiate insolvency proceedings indirectly by proceeding against their collateral.

The holders of floating charges have even greater rights in the initiation of insolvency proceedings than do the holders of fixed charges.³¹⁷ The holder of a fixed charge must have court approval to initiate;³¹⁸ the holder of a qualifying floating charge does not need court approval. Unlike the holder of a fixed charge, the holder of a floating charge who initiates an Administration can choose the insol-

317 See Insolvency Act, 1986, c. 45, sch. B1 ¶ 14 (“*Power to appoint*[:] (1) The holder of a qualifying floating charge . . . may appoint an administrator of the company. (2) . . . [A] floating charge qualifies if created by an instrument which—(a) states that this paragraph applies to the floating charge, [or] (b) purports to empower the holder of the floating charge to appoint an administrator of the company. . . . (3) . . . [A] person is the holder of a qualifying floating charge . . . if he holds one or more debentures of the company secured—(a) by a qualifying floating charge which relates to the whole or substantially the whole of the company’s property . . .”).

318 See *id.* ¶ 12(1) (“An application to the court for an administration order in respect of a company . . . may be made only by . . . one or more creditors of the company”); *id.* ¶13(1) (“On hearing an administration application the court may make the administration order sought; . . . dismiss the application; . . . make any other order which the court thinks appropriate.”).

veny practitioner who will serve as administrator.³¹⁹ Unlike a fixed charge holder, a floating charge holder can apply to remove a debtor company from compulsory Winding-up into Administration.³²⁰ Together, these rights confer on floating charge holders considerable control over their insolvent debtors. They may partly explain the British banker saying reported by Westbrook: “The fixed charge for priority; the floating charge for control.”³²¹ As previously noted, however, the additional control does not easily translate into a higher recovery, because the administrator chosen is required to conduct the case in the interests of all parties, not the floating charge holder’s interests.³²²

2. Administrative Expenses

Administrative expenses are the expenses of the insolvency process. In both the English and American systems, they include the expenses of operating the business during the insolvency case and the fees and out-of-pocket expenses of some of the professionals who work during the insolvency case.

For purposes of this analysis, they do not include the expenses of preserving and disposing of collateral. As stated by Lord Millett in *Buchler v. Talbot*:

The costs of realising a particular property, however, must be distinguished from the general expenses of the winding up or receivership. The costs of realisation are deductible from the proceeds of the property realised, whether it is realised by the liquidator or the

319 *Id.* ¶ 36 (requiring that the court grant the application of a floating charge holder “to have a specified person appointed as administrator . . . unless the court thinks it right to refuse the application because of the particular circumstances of the case”).

320 The Insolvency Act of 1986 further provides:

(1) This paragraph applies where the holder of a qualifying floating charge could appoint an administrator under paragraph 14 but for paragraph 8(1)(b) [because a winding-up order has been made in respect of the company].

(2) The holder of the qualifying floating charge may make an administration application.

(3) If the court makes an administration order . . . the court shall discharge the winding-up order

Id. ¶ 37.

321 Westbrook, *supra* note 24, at 795; *see also* *Buchler v. Talbot*, [2004] 1 All E.R. 1289 (H.L.) at 1293 (Lord Nicholls) (“Typically a floating charge extends to substantially all the assets of a company. On its face this gives a charge holder a high degree of control over the assets and fortunes of a company.”).

322 *See supra* note 224 and accompanying text.

receiver, for it is only the net proceeds of the property which are comprised in the winding up or receivership as the case may be.³²³

Expenses of preserving and disposing of collateral were discussed in Part III.C., above.

In the American system, secured debts have priority over administrative expenses.³²⁴ In the English system, fixed charges have priority over administrative expenses,³²⁵ but floating charges are subordinate to administrative expenses. The latter is true even if the floating charge crystallized prior to insolvency.³²⁶ These priorities are, by statute, applicable in both Administration³²⁷ and Winding-up.³²⁸

The subordination of floating charges to administrative expenses causes the English system to operate differently from the American system. Neither system provides significant public funding for the administration of particular estates. In either country, a company with no unencumbered assets with which to pay insolvency professionals may be unable to reorganize or liquidate in insolvency proceedings.³²⁹ A common strategy is to deplete or fully encumber a company's assets before placing the company in bankruptcy, leaving no assets available to pay administrative expenses.³³⁰ The insolvency

323 *Buchler v. Talbot*, 1 All E.R. at 1304-05 (Lord Millett).

324 *See supra* note 233 and accompanying text.

325 *See supra* note 232 and accompanying text.

326 *See* Insolvency Act, 1986, c. 45, § 251(b) (“[F]loating charge’ means a charge which, as created, was a floating charge . . .”).

327 Schedule B1 ¶ 99(3) provides:

The former administrator’s remuneration and expenses shall be—

- (a) charged on and payable out of property of which he had custody or control immediately before cessation, and
- (b) payable in priority to any security to which paragraph 70 applies.

Id. sch. B1 ¶ 99(3). Paragraph 70 applies to floating charges. *Id.* ¶ 70.

328 Section 176ZA provides:

The expenses of winding up in England and Wales, so far as the assets of the company available for payment of general creditors are insufficient to meet them, have priority over any claims to property comprised in or subject to any floating charge created by the company and shall be paid out of any such property accordingly.

Insolvency Act, 1986, c. 45, § 176ZA.

329 *E.g.*, *In re Jer/Jameson Mezz Borrower II, LLC*, 461 B.R. 293, 306 (Bankr. D. Del. 2011) (“[T]he Debtors’ budget proves that any net operating income that is being realized is insufficient to cover the costs of this case. Allowing such a case to remain in chapter 11 when it is administratively insolvent is not appropriate.”).

330 INT’L ASS’N OF INSOLVENCY REGULATORS, *supra* note 248, at 7 (“In some insolvency situations, unscrupulous directors may deliberately deplete a company’s assets, so as to result in insufficient assets being left to justify the appointment by a creditor of an insolvency practitioner to the insolvent company.”).

case will be dismissed and the company liquidated through less-effective procedures. The resulting losses may be substantial.

Most businesses have revolving assets. Under *Spectrum*, those assets cannot be encumbered by fixed charges. In most cases, those unencumbered assets assure the availability of at least some funding for the continued operation of a viable business, the orderly liquidation of a non-viable one, the bringing of necessary litigation on behalf of the estate,³³¹ and the general functioning of the insolvency process.³³² That increases the likelihood that the insolvency system can function as intended.

The American rule does not assure the availability of funds to pay administrative expenses. Most debtors in need of insolvency proceedings have already fully encumbered their assets.³³³ Because they have no funds with which to pay administrative expenses, many are unable to file and are liquidated.³³⁴ Others find a work-around. The owners of the business may fund the insolvency proceeding, either because they personally guaranteed debts or because they seek to buy the business back from the bankruptcy court at a discount.³³⁵ Secured creditors may agree to “carve-out” some portion of the collateral to fund a

331 With the approval of the court, floating charge collateral can be used to pay the expenses of litigation brought by the estate. See Insolvency Rules, 1986, S.I. 1986/1925, ¶¶ 4.218A–4.218E.

332 Segal, *supra* note 28, at 936 (“The combination of this provision of the Enterprise Act and the *In re Spectrum* decision means that in many cases, administrators will now have access to funds to cover the costs of the administration without the need to obtain the consent of the secured creditor.”).

333 See Claire A. Hill, *Is Secured Debt Efficient?*, 80 TEX. L. REV. 1117, 1176 (2002) (“Among lower-quality firms, the use of secured credit is virtually ubiquitous. Almost all the firms secure all their assets, giving ‘blanket liens’ to a lender. The divergence of interest between lenders and firms is sufficiently high that lenders need the level of constraints blanket liens provide.”). Hill’s definition of “lower-quality firms” is firms with bond ratings lower than BBB+. *Id.* at 1136. Thus, she probably looked principally at the largest 10% of firms in the relevant population. See Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 AM. BANKR. L.J. 499, 543 (1999) (stating 91% of Chapter 11 bankruptcies involve cases with assets less than \$5 million).

334 For example, Westbrook states:

The existence of the cases where the secured party agreed to carve-out necessarily implies other cases—one would think a substantial majority of those involving a dominant secured party—in which the secured party would have no interest in a bankruptcy proceeding, would refuse a carve-out, and would therefore leave the proceeding unfinanced and unsustainable.

Westbrook, *supra* note 24, at 817 n.72.

335 See *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434, 458 (1999) (requiring that such buy-backs be subjected to some kind of market test); see generally LYNN M. LOPUCKI & CHRISTOPHER R. MIRICK, STRATEGIES FOR CREDI-

reorganization or liquidation that has been scripted to the secured creditors' requirements.³³⁶ If funds are unavailable to pay bankruptcy professionals to investigate the debtor's financial affairs, the obligation to conduct such an investigation routinely goes unfulfilled.³³⁷ Thus, in the common situation in which the debtor's assets are fully encumbered, the American insolvency system is subject to manipulation.

3. Preferential unsecured debts

In both the English and American systems, some unsecured debts that do not have priority in the absence of insolvency proceedings are given priority in their presence. In the English system, these debts are principally obligations owing to, or payable on behalf of, employees for back pay, benefits, or pension contributions. They are referred to as "preferential unsecured debts."³³⁸ In the American system these debts cover a broader range, include some debts owing to or on behalf of employees for pay or benefits, and are referred to as "bankruptcy priority claims."³³⁹

TORS IN BANKRUPTCY PROCEEDINGS § 11.11[B] (5th ed. 2007) (describing the techniques debtors employ and creditors' responsive strategies).

336 *E.g.*, *In re Debbie Reynolds Resorts, Inc.*, 255 F.3d 1061, 1064 (9th Cir. 2001) ("In effect, RFI attempted to buy 'closure' by agreeing to a \$50,000 surcharge in exchange for assurance that there would be no further challenges to collection of its secured debt."); *In re Ocean Power Corp.*, 2007 WL 949598, at *4 (Bankr. S.D.N.Y. 2007) (finding carve-out conditioned on sale of the debtor's property to the secured creditor).

337 On the English side, Armour notes that "[l]iquidators frequently investigate fraudulent conduct by company directors, and if floating charge assets are not available to them, they may not be able to do so." John Armour, *Should We Redistribute in Insolvency?*, in *COMPANY CHARGES: SPECTRUM AND BEYOND*, *supra* note 15 at 189, 222. On the American side, LoPucki explains:

The job of discovering, investigating, and litigating over dishonesty by a Chapter 7 debtor is delegated to the trustee. The trustee is paid for these tasks from the debtor's estate. If there is no money in the estate, the trustee is paid \$60 of the filing fee paid by the debtor to commence the case. The \$60 is paid on the trustee's representation that the trustee has performed whatever of these services were necessary in the particular case; the trustee earns no more by discovering dishonesty and litigating over the discharge. Hence, in a no-asset case, the trustee has a strong economic *disincentive* to discover fraud of a nature that requires objection to discharge.

Lynn M. LoPucki, *Common Sense Consumer Bankruptcy*, 71 AM. BANKR. L.J. 461, 467 (1997) (footnotes omitted).

338 *See* Insolvency Act, 1986, c. 45, § 386, sch. 6.

339 11 U.S.C. § 507(a) (2006).

In the American system, bankruptcy priority claims are subordinate to secured claims.³⁴⁰ In the English system, preferential unsecured debts are subordinate to fixed charges, but have priority over floating charges in both administration³⁴¹ and liquidation.³⁴² The probable result is that preferential unsecured debts are more often paid in English than in American insolvencies.

4. General Unsecured Creditor Carve-outs

As previously noted, English law creates an insolvency carve-out from floating charge collateral in favor of general unsecured creditors. To the extent of the “prescribed part,” general unsecured creditors rank ahead of floating charge holders. The Prescribed Part Order specifies that extent:

- (1) The prescribed part of the company’s net property to be made available for the satisfaction of unsecured debts of the company . . . shall be calculated as follows —
 - (a) where the company’s net property does not exceed £10,000 in value, 50% of that property;³⁴³
 - (b) subject to paragraph (2), where the company’s net property exceeds £10,000 in value the sum of—
 - (i) 50% of the first £10,000 in value; and
 - (ii) 20% of that part of the company’s net property which exceeds £10,000 in value.
- (2) The value of the prescribed part of the company’s net property to be made available for the satisfaction of unsecured debts of the

340 See *supra* note 233.

341 The Insolvency Act, 1986, c. 45, sch. B1 ¶ 65(1) (in Administration), provides that “[t]he administrator . . . may make a distribution to a creditor of the company” and that “Section 175 shall apply in relation to a distribution under this paragraph as it applies in relation to a winding up.” *Id.* ¶ 65(2). Section 175 gives preferential debts priority over floating charges in winding up.

342 The Insolvency Act, 1986, c. 45, § 175(2)(b) (in Winding-Up). (2) Preferential debts . . . (b) so far as the assets of the company available for payment of general creditors are insufficient to meet them, have priority over the claims of holders of debentures secured by, or holders of, any floating charge created by the company, and shall be paid accordingly out of any property comprised in or subject to that charge.

343 The Insolvency Act, 1986, c. 45, § 176A(3)(a), subject to the discretion of the administrator, requires a minimum amount of value before applying the prescribed part calculation. The Insolvency Act, 1986, (Prescribed Part) Order 2003 ¶ 2, defines “the minimum value of the company’s net property” as “£10,000.” The interaction between these provisions seems to leave the administrator with broad power to control the amount, if any, payable under this subparagraph.

company pursuant to [the statutory provision] shall not exceed £600,000.³⁴⁴

As of this writing, the exchange rate is that £1 is equal to \$1.57. The Insolvency Act requires that in both administration and liquidation the prescribed part be paid to unsecured creditors before any distributions are made to floating charge holders.³⁴⁵

Carve-outs from secured creditors' collateral in favor of unsecured creditors exist under the laws of many other countries.³⁴⁶ The United States is not, however, among them. Professor Elizabeth Warren proposed a carve-out for the United States that would have

344 Insolvency Act, 1986, (Prescribed Part) Order 2003 ¶ 3.

345 Insolvency Act, § 176A provides that:

(2) The liquidator, administrator or receiver—

(a) shall make a prescribed part of the company's net property available for the satisfaction of unsecured[] debts, and

(b) shall not distribute that part to the proprietor of a floating charge except in so far as it exceeds the amount[] required for the satisfaction of unsecured debts.

Insolvency Act, 1986, c. 45, § 176A(2)(a)–(b). .

346 See, e.g., CODE DU TRAVAIL [C. TRAV.], arts. L. 143-10, L. 143-11, L. 742-6, L. 751-15 (Fr.) (granting, by French labor code, of absolute superpriority to employees' claims for wages covering the last 60 days' wages prior to opening of insolvency proceedings); CODE DE COMMERCE [C. COM.], art. 622-17 (providing in the French commercial code for priority of administrative expenses, employees' claims for wages and approved post-petition funding over secured and unsecured pre-petition claims in *procédure de sauvegarde*, the French equivalent of U.S. Chapter 11 and English Administration proceedings); INSOLVENZORDNUNG [Insolvency Statute], Oct. 5, 1994, BGBl. I at 2866, §§ 170, 171 (Ger.) (imposing on secured creditors, by German statute, a cumulative 9% surcharge against collateral to permit the estate to recoup the costs of determination and disposition of collateral in insolvency proceedings plus turnover tax at the rate of 19%, for a total possible cost to the secured creditor of 28%); Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, §§ 81.1–2 (providing, in Canadian statute, for priority over secured creditors of claims by unpaid suppliers, farmers, fishermen and aquaculturists under defined circumstances); *id.* at § 81.3 (1) (providing employees with “security on the bankrupt's current assets on the date of bankruptcy for six months of prepetition wages up to \$2,000); *id.* at § 81.3 (4) (stating that “a security under this section ranks above every other . . . charge or security against the bankrupt's current assets — regardless of when that other . . . charge or security arose”); *id.* at 81.5 (1), (2) (providing same with respect to certain pension contributions required but not made); Ley de Concursos Mercantiles [LCM] [Bankruptcy Law], Diario Oficial de la Federación [DO], 12 de Mayo de 2000, art. 217 (Mex.), translated in INTERNATIONAL STATEMENT OF MEXICAN BANKRUPTCY LAW 261-64 (A.L.I. 2003) (providing, in Mexican law, for the payment of “creditors having a security interest”); *id.* at 224, 225 (providing for the payment of certain wages and administrative expenses “prior to any debts referred to in Article 217”).

applied in or out of insolvency proceedings.³⁴⁷ Not a single member of the Uniform Commercial Code drafting committee thought it should even be considered.³⁴⁸ A few American bankruptcy courts have imposed such a carve-out informally, as a condition of bankruptcy relief in cases the filing of which might not otherwise have been appropriate.³⁴⁹ As one such court noted:

“Historically, bankruptcy courts do not view themselves as an alternative to a state court foreclosure process. That is to say if the DIP or Trustee is proposing a sale where the only parties to benefit are the secured creditors and the professionals, the court will generally disapprove the sale. To that end, sellers should propose a ‘carve out’ for priority or unsecured creditors. This carve out can range from 1% to over 20% . . . [.] One can also reasonably anticipate that in sales where there are significant issues about employee retention, courts may be sympathetic to a reduction in the proposed carve out.”³⁵⁰

Such imposition is, however, rare. Generally speaking, the American system is one in which the priority of secured creditors over unsecured creditors remains absolute.

CONCLUSION

English charges are often portrayed as fundamentally different from American security interests.³⁵¹ But, as we have shown in this

347 See Memorandum from Elizabeth Warren, Council Member, Am. Law Inst., to the Council of the Am. Law Inst., Article 9 Set Aside for Unsecured Creditors (Apr. 25, 1996), reprinted in LOPUCKI & WARREN, *supra* note 12, at 679–81.

348 See LOPUCKI & WARREN, *supra* note 12, at 682 (quoting Professor Charles Mooney as saying that the Warren carve out proposal “died for lack of a first” in the drafting committee).

349 *E.g.*, Order Authorizing the Sale of Assets of the Debtor Free and Clear of Liens, Claims, Encumbrances, and Other Interests and Memorandum in Support at 3, *In re Pulliam Motor Co.*, No. 07-01555-dd (Bankr. D.S.C. Apr. 17, 2007) (“From the proceeds of the Sale, the Debtor will create a carveout for distribution to the unsecured creditors of the estate in an amount not less than \$300,000 (the ‘Carveout’), which the Debtor estimates is approximately 20% of the known unsecured claims.”).

350 *In re Merit Grp., Inc.*, 464 B.R. 240, 251 (Bankr. D.S.C. 2011) (citations omitted) (quoting *In re StarTrans Inc.*, Case No. 09-07468 (Bankr. D.S.C. Nov. 5, 2009)).

351 See Jeanette L. Goldsberry, *Perfection of Nonpossessory Security Interests Under Revised Article 9: Consequences of the Practical and Conceptual Incompatibility of US and English Secured Transactions Law*, 3 CHI. J. INT’L L. 241, 244 (2002) (referring to uncrystallized floating charges as “an ‘intermediate state of perfected but non-specific or floating’ prior to crystallization of the floating charge, which is not accommodated within the Article 9 notice filing system” (citation omitted)); *id.* at 243–44 (“The floating charge is much broader [than the Article 9 floating lien], potentially covering ‘all

Article, the two function in essentially the same way. In both countries, creditors generally require that their debtors grant security interests in all of the assets of their businesses. If the English security interest is in revolving assets—inventory, accounts receivable, and bank deposits—it can, as a practical matter, be only a floating charge. If it is in other assets, it can be both a floating charge and a fixed charge. Typically, the result is that the English secured creditor has a floating charge on the revolving assets and a fixed charges on the capital assets.³⁵² Together, the charges combine to cause all of the assets to secure all of the debt.

Following any necessary registration, American security interests and English fixed charges have priority in existing and after-acquired collateral. Their priority is over later-created security interests, the liens of judgment creditors, and the rights of unsecured creditors.

In theory, English floating charges do not have priority over later-created security interests or lien creditors who obtain interests before the floating charges crystallize. But in practice, creditors employ the English floating charge in combination with negative pledges and automatic crystallization provisions to achieve a de facto priority. As a result, even before crystallization, the floating charge effectively reserves priority over the later lenders and purchasers. In 2005, the Law Commission recommended this de facto priority be converted to full, formal priority.³⁵³ Adoption would eliminate this often-asserted difference between English and American security interests.

In both countries, debtors can sell inventory in the ordinary course of business, free of security interests. Absent insolvency proceedings, in neither country can the debtor sell capital assets without the secured creditor's consent.

the property of the debtor, in all countries of the world.” (citation omitted)); Brian M. McCall, *Money, Money Everywhere but Not a Drop to Secure: A Proposal for Amending the Perfection Rules for Security Interests in Money and Deposit Accounts*, 74 TENN. L. REV. 669, 705 (2007) (“Unlike Article 9, though, English law allows a secured party to take a floating charge over the revolving pool of money and deposit accounts held by a debtor without having to take possession or control of them.”).

352 GOODE, *supra* note 34, at 630 (“Typically, a debenture will contain both a fixed and a floating charge, the former covering fixed assets and debts, the latter covering the remaining types of asset”); Segal, *supra* note 28, at 937 (“Banks and other secured lenders in England will frequently be granted an all assets debenture containing both a fixed and a floating charge.”); Westbrook, *supra* note 24, at 819 (“The creditor who holds the floating charge in this system almost always has a ‘fixed’ charge as well, often over most, if not all, of the debtor’s assets.”).

353 LAW COMMISSION, *supra* note 56, ¶ 3.179; *id.* ¶ 3.180 (“We recommend that the priority of a charge against another charge or a pledge should depend on the date of registration of the financing statement whether the charge is fixed or floating.”).

Under current law in both countries, the filing of an insolvency proceeding stays enforcement of security interests. In both countries, the court has broad discretion to decide when the secured creditor can proceed with enforcement. In both countries, the security interest remains effective during the bankruptcy case and retains its priority, with three exceptions.

First, in the American system, the court can permit a new lender to prime prepetition secured creditors. An English court has no corresponding power. But the American adequate protection requirement limits the practical importance of this difference.

Second, in the American system, the court can cram down, over the objection of the secured creditor, a reorganization plan that pays less than the full amount owing to the secured creditor. In the English system the court can accomplish the same thing, but only somewhat awkwardly, by approving a sale of the collateral for less than the amount of the secured debt.

Third, the English system has a carve-out in favor of unsecured creditors. The American system does not. The English Carve-out is a statutory subordination of floating charges to expenses of administration, preferential creditors, and the unsecured creditors' prescribed share.

Both England and the United States award priority in order of time. Both use security interest registration systems to alert those who later deal with a debtor to the security interests and liens in favor of those who earlier dealt with the debtor. Neither set of registration systems employ state of the art technology. Both make exceptions to the registration requirement that result in secret liens.

There are, however, important differences in those registration systems. First, the registration exceptions are not, as one would expect, with respect to the same kinds of collateral. Second, English law creates an "invisibility period" of up to twenty-one days during which a charge has priority but cannot be discovered through a search. The American system generally gives effect to filings only when made, and so does not create such an invisibility period.³⁵⁴ Third, the English view their system as serving the public. The Americans view their system as serving only debtors and secured creditors. As a result, the English make more information available to a wider range of users than do the Americans.

Our claim is that the differences we have identified between the English and American systems represent a range of policy choices

³⁵⁴ *But see* U.C.C. § 9-324(a) (2012) (allowing a 20-day grace period to perfect a purchase money security interest).

within which reform is practical. To recommend the nature of that reform requires another step. Researchers must evaluate the alternative functions that have been shown to exist. That evaluation, though in some respects already under way, is beyond the scope of this Article.

We nevertheless offer some preliminary observations. Both secured and unsecured creditors perform the function of lending money. Whether secured creditors perform some additional function, such as monitoring, remains unclear. Yet the American system gives secured creditors absolute priority over nearly every other party.

American policymakers did not reason their way to the conclusion that absolute priority was desirable. They adopted it because they could see no way to avoid it.

The widespread nineteenth century prejudice against the floating charge was based on a feeling, often inarticulate in the opinions, that a commercial borrower should not be allowed to encumber all his assets present and future, and that for the protection not only of the borrower but of his other creditors a cushion of free assets should be preserved. That inarticulate premise has much to recommend it. This [a]rticle decisively rejects it not on the ground that it was wrong in policy but on the ground that it was not effective. In pre-Code law there was a multiplication of security devices designed to avoid the policy: field warehousing, trust receipts, factor's lien acts and so on. The cushion of free assets was not preserved. In almost every state it was possible before the Code for the borrower to give a lien on everything he held or would have. There have no doubt been sufficient economic reasons for the change. This [a]rticle, in expressly validating the floating charge, merely recognizes an existing state of things.³⁵⁵

Grant Gilmore, the principal draftsman of Article 9 later famously asked “does it make any sense to award everything to a secured party who stands idly by while a doomed enterprise goes down the slippery slope into bankruptcy?”³⁵⁶

355 U.C.C. § 9-204, cmt. 2 (1994).

356 Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605, 627 (1981). [The floating charge] is similar in many ways to the scheme contemplated by *Benedict*, and all of this suggests that we should be cautious in embracing Article 9's choice in favor of perfected floating security interests on inventory and receivables without the secured creditor exercising some control over the collateral. See Picker, *supra* note 305, at 1185. Other scholars have also noticed that the rule requiring English floating charge holders to exercise control over their collateral is essentially the same rule the American courts adopted in *Benedict v. Ratner*, only to be overturned by adoption of the Uniform Commercial Code. See Segal, *supra* note 28, at 937–38.

On the English side, the critique has been even sharper. Addressing the floating charge, the English Cork Report concluded that it “is capable of working great injustice”³⁵⁷ and “had given rise to a widespread and long-standing sense of grievance in the commercial community.”³⁵⁸ The report continued:

[t]he matter for wonder is that such a device should ever have been invented by a Court of Equity. It is not easy to discern on what principle of equity the holder of a floating charge should obtain security over goods for which his money has not paid, in priority to the claim of the unpaid supplier of the goods.³⁵⁹

The secured credit carve-outs adopted in England and many other legal systems³⁶⁰ are the principal response to these perceived inequities. To the extent it is effective, the English Carve-out solves the problem of financing the operation of the insolvency system, insures the employees of payment of at least part of their wages without requiring public funds, and restores more appropriate incentives to business owners by forcing the maintenance of a “cushion of assets.”

The question raised by the Article 9 drafters in the comment cited earlier—whether it is possible to force maintenance of a cushion of assets—has not been answered. Professor Armour has argued that the English Carve-out has not made floating lien collateral available to unsecured creditors, but merely caused debtors to avoid the Carve-out by selling their accounts receivable rather than by borrowing against them.³⁶¹ He charges that “the statutory scheme is an expensive, and not particularly effective, way of protecting the interests of its ‘beneficiaries[.]’”³⁶² This charge should be a principal focus of future research.

With respect to the filing system, there seems to be a consensus that security interests should rank in order of filing and have priority as of the date of filing. The key policy choice remaining is between the American view—that security agreements should be private because the filing system exists only for the benefit of secured creditors and their debtors—and the English view that security agreements

357 Cork Report, ¶ 105.

358 *Id.* ¶ 106.

359 *Id.* ¶ 107.

360 *See supra* note 346.

361 Armour, *supra* note 337, at 203–05; *id.* at 204 (noting that “invoice discounting has grown dramatically over the period since [1999]”); *id.* at 199–200 (describing studies showing that banks have reduced their exposure to the English Carve-out by reducing their reliance on floating liens).

362 *Id.* at 206.

should be public because the filing system exists for the benefit of everyone affected by security interests. We prefer the English view because it better enables affected parties to adjust to the harsh reality of secured creditor privilege.

With respect to cramdown, we are inclined toward the American view. In reorganization in either country, the debtor can, with court approval, sell the collateral. Thus the debtor can limit the secured creditor's recovery to the value of the secured creditor's collateral, plus the secured creditor's pro rata share of the estate with respect to the uncollateralized portion of its claim. That is the same limit cramdown imposes on the secured creditor. The virtue of cramdown is that it strips the secured creditor of its "hold-up" rights. By "hold-up rights" we mean the right of the secured creditor to veto a plan that pays the secured creditor as much as the secured creditor would get through sale. Because such a veto can destroy the value that would otherwise be available to pay the unsecured creditors, its threat can enable the secured creditor to demand more than its legal entitlement. In the countries with which we are familiar, insolvency law has evolved steadily in opposition to secured creditor hold-up rights.³⁶³ The American cramdown is simply the logical ending point for that evolution.

Comparison of legal systems that use sharply different doctrinal explanations can be difficult. In this Article, we have demonstrated that the systems approach can provide a solution to this problem in at least some circumstances. Even the systems with the sharpest doctrinal differences may exhibit surprising similarities in function. Despite their doctrinal differences, the security systems of England and the United States function in essentially the same ways. To understand one of these systems functionally is, in a very real sense, to understand them both.

363 See, e.g., John Armour et al., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699, 1738 (2002) (saying of the pre-2002 administrative receivership regime in England that "[t]he pivotal right a secured creditor has, once there has been a default, is a license to seize and sell the security to satisfy the amount owed"); LoPucki & Triantis, *supra* note 27, at 277 ("The CCAA scheme of reorganization became more popular than reorganization under the Canadian Bankruptcy Act because it was capable of binding secured creditors.").

