**Chapter 20**

**Debt Capital and Security**

Here, basic guidance to the end-of-chapter questions will be provided.

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| 1. **Define the following terms:**  * **gearing;** * **security;** * **debt securities;** * **debenture;** * **fixed charge;** * **floating charge;** * **crystallisation;** * **book debts.** |

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| **Term** | **Definition** |
| gearing | The ratio of a company’s debt capital to its share capital |
| security | Where a creditor acquires some form of right over an asset or assets of a debtor |
| debt securities | Tradeable financial instruments that a company can issue in order to raise finance – the persons to whom debt securities are issued are creditors and not usually members |
| debenture | A document that creates or acknowledges a debt |
| fixed charge | A charge taken over a specific asset that restricts the chargor’s ability to deal with that asset. If the debtor defaults, the chargeholder can usually seize the charged asset and sell it to recover the sum owed |
| floating charge | A charge, usually taken over a class of assets or the entire undertaking of the company, that floats over the charged asset until some specified event occurs, at which point it becomes fixed |
| crystallisation | The process by which a floating charge becomes a fixed charge |
| book debts | Sums of money owed to a bankrupt, partnership or company, usually for good supplied or services undertaken |

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| 1. **State whether each of the following statements is true or false and, if false, explain why:**  * **a company cannot deal in assets subject to a fixed charge, unless the chargeholder agrees;** * **a floating charge cannot be taken over the exact same assets as a prior floating charge, unless the terms of the prior floating charge allow for this;** * **only companies and partnerships can grant floating charges;** * **if a charge instrument provides that a charge is fixed or floating, then that categorisation will be conclusive;** * **it is possible to take a floating charge over revolving assets, such as book debts;** * **a company must keep a register of charges.** |

* **A company cannot deal in assets subject to a fixed charge, unless the charge-holder agrees:** This statement is true (although, technically, the company could deal with the charged assets by simply paying off the debt owed to the fixed charge-holder).
* **A floating charge cannot be taken over the exact same assets as a prior floating charge, unless the terms of the prior floating charge allow for this:** This statement is true.
* **Only companies and partnerships can grant floating charges:** This statement is false. Only incorporated bodies (e.g. companies and LLPs) can grant floating charges.
* **If a charge instrument provides that a charge is fixed or floating, then that categorisation will be conclusive:** This statement is false. The classification of charge specified in the charge instrument is relevant, but not conclusive.
* **It is possible to take a floating charge over revolving assets, such as book debts:** This statement is true.
* **A company must keep a register of charges:** This statement is false. Companies may keep a register of charges, but they are not required to do so.

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| 1. **‘The current system providing for the registration of charges is a significant improvement over the pre-2013 system of registration.’ Discuss this statement.** |

**Introduction**

* Every essay should begin with a succinct introduction that demonstrates that you understand the essay question. Briefly explain what the essay is about and set out what the essay will discuss and how it will be structured.
* This essay requires you to compare the current system for the registration of charges with the system that existed before 2013.

**The pre-2013 system**

* First, discuss the pre-2013 system. Pre-2013, companies were required to keep a register of charges and register charges with Companies House, and a failure to do so was a criminal offence.

**The current registration system**

* The current system seeks to remedy the flaws in the pre-2013 system whilst reducing the administrative burden of maintaining a register of charges. The current system of registration applies to charges with some limited exceptions – this is an improvement over the previous system, which applied only to specified charges, but it was not always clear which charges it applied to.
* Under the current system, companies do not need to register charges with Companies House, nor do they need to keep a register of charges. Instead, companies may register the charge with Companies House if they so choose.
* Discuss what registration involves, namely providing Companies House with a statement of particulars and a copy of the charge instrument.
* As the charge no longer needs to be registered, it might be thought that this would reduce transparency, but this is not the case for two reasons:

1. Companies must keep a copy of the charge instrument and any member or creditor can inspect this instrument free of charge (other people can inspect it upon paying a fee).
2. If a company does not register a charge, the charge is void against any liquidator, administrator or creditor of the company.

* As a result, there is a very strong incentive to register the charge.
* There is, however, a notable flaw in the new system. In order for the registration of a charge to be valid, it must be registered within a 21-day period, beginning after the date on which the charge was created. Once registered, the charge will then appear on the register maintained by Companies House. This means that there could be a period of up to 21 days where a charge will exist, but it will not appear on the register. Accordingly, prudent creditors should contact the company and ask if there are any charges that have not yet been registered.

**Conclusion**

* Every essay should end with a conclusion. Briefly summarise the main points/arguments and, if possible, come to a conclusion regarding the essay topic (i.e. which of the opposing views has the stronger arguments).

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| 1. **Dragon Technologies Ltd (‘DT’) is in the business of building personal computers using components that it purchases from third parties. DT’s articles provide that ‘the company may only borrow amounts in excess of £20,000 if the members so agree by passing a resolution.’ DT is experiencing significant financial difficulties and quickly needs an injection of capital if it is to survive. Accordingly, the directors of DT (who also own all DT’s shares) apply to Bronze Bank for a loan of £30,000. The bank agrees to the loan, which is granted on the following secured basis:**  * **The bank acquired a fixed charge over DT’s corporate headquarters and this charge was registered with Companies House a month later.** * **The bank acquired a charge expressed as a fixed charge over ‘all the components used to manufacture personal computers.’ This charge was registered with Companies House two days later.** * **The bank acquired a floating charge over all the assets of DT, and this charge was registered with Companies House two days later.**   **It is a condition of the above charges that DT periodically updates Bronze Bank as to DT’s financial position. DT’s financial position has continued to deteriorate and Bronze Bank seeks your advice regarding the following:**   1. **Were the directors of DT empowered to borrow the £30,000 from Bronze Bank?** 2. **Discuss the validity and status of the three charges held by Bronze Bank.** 3. **Could Bronze Bank appoint an administrator and, if so, what effect would this have on the above charges?** 4. **Could Bronze Bank have DT liquidated and, if so, what effect would this have on the above charges and would it have priority over the claims of any other creditors?** |

**The £30,000 loan**

* The first issue is whether the directors were empowered to borrow £30,000 on behalf of DT. This will depend upon the articles or whether specific borrowing powers have been bestowed upon the directors.
* If the articles contain a general managerial power clause similar to that found in art 3 of the model articles, then the directors will be empowered to exercise DT’s borrowing powers.
* However, there is a problem here as the articles also specify that the company cannot borrow more than £20,000 unless the members approve by passing a resolution and it appears that no such resolution took place. Accordingly, the company has acted ultra vires by borrowing £30,000.
* In terms of the loan contract itself, this will remain valid as s 39 provides that the validity of an act done by the company shall not be called into question on the ground of lack of capacity by reason of anything in the company’s constitution.
* However, the directors have exceeded the powers bestowed upon them and so may find that they are in breach of the s 171(a) duty to act within the constitution.

**The charges held by Bronze Bank**

* Discuss each of the three charges. Focus on the status of the charge and the degree to which it can be enforced.

*The charge over DT’s headquarters*

* Bronze Bank took a fixed charge over DT’s headquarters and registered it a month later. The issue here is not the status of the charge as there is nothing to indicate it is not a fixed charge.
* The issue here is that it was registered a month after its creation. In order for a charge to be validly registered, it must be registered within a 21-day period beginning on the date after the charge was created.
* If the charge was registered outside of this period, then it will be void against a liquidator, administrator or creditor of the company. The money will still be owed to Bronze Bank, but the debt could lose its secured status.

*The charge over the components*

* The issue here is the status of the charge. The charge is expressed as being a fixed charge, but it is taken over the components used to manufacture personal computers.
* The charge may be expressed as being a fixed charge, but this is not conclusive (*Street v Mountford*). Focus on the rights and obligations of charge, especially whether the company is free to deal with the charged assets.
* Here, the charge has been taken over revolving assets (namely the PC components), which DT is presumably free to use the components subject to the charge (if it were not free, it could not engage in its core business). In *Agnew v Inland Revenue Commissioner*, the court held that a purported fixed charges was actually a floating charge as the company was free to use the charged assets.
* Accordingly. it is likely that the purported fixed charge is, in fact, a floating charge.

*The charge over all the assets of DT*

* Bronze Bank has acquired a floating charge over all the assets of DT. There is nothing to indicate that this charge is not valid.

**Can Bronze Bank appoint an administrator?**

* There are several ways in which an administrator can be appointed. Schedule B1, para 14 of the IA 1986 provides that an administrator can be appointed by a qualifying floating charge-holder. A floating charge will be qualifying if two conditions are satisfied.
* First, the charge must, alone or in combination with any other forms of security, cover the whole or substantially the whole of the company’s property. As Bronze Bank’s floating charge covers all the assets of DT, this condition is satisfied.
* Second, the charge instrument must (i) state that para 14 applies to the charge, or; (ii) empower DT to appoint an administrator, or; (iii) empower DT to appoint an administrative receiver. We are not told what the charge instrument states.
* If DT does enter administration, then the most notable effect for our purposes is that no creditor may take steps to enforce their security over the company’s property whilst the company remains in administration.

**Can Bronze Bank have DT liquidated?**

* Bronze Bank could apply to the court for an order winding up DT. Section 124 of the IA 1986 provides that a creditor can apply for a winding up order, but only for the grounds specified in s 122(1).
* For most creditors, the relevant ground is that the company is unable to pay its debts. We are not told whether DT is able to pay its debts, but if it cannot pay a debt owed, then Bronze Bank could petition the court for an order winding up DT.
* In terms of the effect this would have on the charges, the principal effect is that it would cause the floating charges to crystallise. However, it is possible for a liquidator to avoid certain floating charges made prior to the company entering liquidation (IA 1986, s 245).
* Whether the charge can be avoided depends upon when it was made. Here, as the charge was made to someone who is unconnected to the company, a floating charge could be set aside if it was made within a period of 12 months ending on the date of insolvency.
* If a floating charge were held invalid, the debt would still be owed, but Bronze Bank would lose the secured status that the charge provided.