SHOULD WE REDISTRIBUTE IN INSOLVENCY?

Centre for Business Research, University Of Cambridge
Working Paper No. 319

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March 2006

This working paper forms part of the CBR Research Programme on Corporate Governance.

Abstract
The characterisation of a security interest as 'fixed' or 'floating' has generated much litigation in English courts. This is because a floating charge is subordinated by statute to other claims in the debtor's insolvency, whereas a fixed charge is not. This paper uses the example of the floating charge to argue that such statutory redistribution between claimants in corporate insolvency is generally undesirable. If particular types of voluntary transaction are subjected to statutory 'taxation', then parties may be expected to structure their affairs so as to avoid the ambit of the legislation. The paper traces the history of the floating charge, showing how both its use by business, and the litigation that has shaped its juridical 'nature', have been driven by the desire to avoid redistribution in insolvency. This has resulted in relatively little money reaching the intended beneficiaries of the statutory redistribution. It has also engendered significant costs: the direct costs of litigation and the opportunity costs of a constrained choice of financial structures.

JEL Codes: G32, G33, H23, K22, N43

Keywords: Corporate insolvency, law and finance, history of floating charge, bankruptcy priorities, secured credit

Acknowledgements
I am grateful to Josh Getzler, Jenny Payne and Adrian Walters for their helpful comments on an earlier version. I also thank participants in a symposium on company charges held at Oxford University in September 2005 for discussion following my presentation.

Should We Redistribute in Insolvency?

A. Introduction

The House of Lords' recent decision in *Re Spectrum Plus*[1] concerned the appropriate characterization of a security over book debts as a fixed or floating charge. The question matters primarily because a floating charge is subordinated by statute to various other claims in the insolvency of the debtor, whereas a fixed charge is not. This paper uses the example of the floating charge to argue that such statutory redistribution between claimants in corporate insolvency is generally undesirable.

Floating charges are created by voluntary transactions between lenders and borrowers. If the legislature subjects particular types of voluntary transaction to statutory 'taxation' (as through the prospect of redistribution in insolvency), then sophisticated parties may be expected to structure their affairs differently so as to avoid the ambit of the legislation. In the case of insolvency, such 'avoidance action' has resulted in relatively little funds reaching the intended beneficiaries of the statutory redistribution. What is worse, the law's redistributive policy has engendered significant costs. Indeed, the juridical history of the floating charge is largely a product of litigation driven by such avoidance action. The *Spectrum* decision is only the most recent (and unlikely to be the final) chapter in a long series of such cases, which have, over the years, consumed many thousands of hours and pounds.

In addition to the *direct* costs engendered by transaction planning and litigation, such statutory redistribution may also give rise to *opportunity* costs. These arise where parties choose not to use a transaction structure which would otherwise be useful, solely so as to avoid the statutory 'taxation'. This paper argues that there are opportunity costs associated with the current scheme, which renders the floating charge very unattractive to lenders.

A floating charge over circulating assets can facilitate so-called 'relationship' lending by a concentrated creditor—that is, lending on the basis of the debtor's business prospects, as opposed to collateral values. Such a lender is best able to make informed decisions about the company's future in times of financial distress. Making it impossible for such a lender to take worthwhile security over circulating assets without exercising specific control will mean that companies find it cheaper to finance receivables from asset-based lenders, who are better placed to exercise such control. This paper argues that the statutory scheme, when coupled with the hardened judicial line confirmed in *Spectrum*, will lead to further fragmentation in small businesses' borrowing. There is little reason for thinking that this will be a positive step.

The rest of this paper is structured as follows. Section B looks at how redistribution is effected in English corporate insolvency law, and its historical relationship with the development of the floating charge. Section C turns to the impact of the scheme on corporate financing practice, and Section D argues that redistribution cannot be justified by reference to the benefits it brings to its recipients. Section E concludes.

At the outset it should be made clear that this paper does not question whether the House of Lords' decision in *Spectrum* is consistent with existing legal principle. In contrast, the point in issue is whether the statutory policy of treating floating charges differently from fixed, which is given teeth through the characterization rules articulated in cases such as *Spectrum*, is desirable (see Calnan, 2004).

B. Redistribution and the history of the floating charge

1. How does English corporate insolvency law redistribute?

'Redistribution' is taken in this paper to mean the transfer of wealth from one party to another. English corporate insolvency law requires redistributive payments to be made out of floating charge assets in a variety different ways. The three most important of these may be summarised as follows. First, the claims of *preferential creditors* are statutorily elevated above those of other unsecured creditors and those of the holder of a floating charge.[2] Secondly, the Enterprise Act 2002 has introduced a requirement that a '*prescribed part*' of assets subject to a floating charge must be set aside for payment to unsecured creditors.[2] Thirdly, until recently, the *expenses of liquidation* were also thought to be payable out of floating charge assets,[3] even though the procedure exists for the benefit of unsecured creditors alone. Although this instance of redistribution was recently brought to an end by the House of Lords,[4] the government intends to restore it shortly.[5]

A crucial (but frequently overlooked) point is that imposing *ex post* obligations on parties to certain sorts of transaction gives those parties powerful incentives to adjust their affairs *ex ante* so as to fall outside the scope of the 'tax'. For these reasons, it is commonly thought that attempts to use the law governing voluntary transactions to effect distributive justice are unlikely to be successful (Kronman, 1980; cf. Kennedy, 1982). The history of the relationship between the floating charge and the redistributive provisions of insolvency law provides a salutary example.

2. The early history of the floating charge

The advent of incorporation by registration in the mid-nineteenth century meant that shareholders, shielded by limited liability, were able to carry on business with reduced risk consequent on corporate failure.[6] Unlike modern listed companies in the UK, with share ownership dispersed amongst many investors, voting control in Victorian companies was almost always in the hands of the board of directors (Franks *et al*, 2005). This, coupled with the lack of reliable information about the finances and prospects of such businesses meant that investment in 'outside' equity was often a hazardous affair unless the investor had some pre-existing knowledge of, or geographic proximity to, the business opportunity in question (Baskin and Miranti, 1997: 146-151). For these reasons, debentures were widely considered to be a safer investment. The protection of debenture-holders' interests was therefore crucial to the facilitation of investment.

Whilst company law—through the doctrines of *ultra vires* and capital maintenance—did impose rules which can usefully be understood in terms of the interests of outside investors (and creditors in particular), the actual level of protection they gave was strictly limited (see Cheffins, 1997: 526-537). The continuing need for debenture-holder protection was met in part through the use of ever-broader security interests (Baskin and Miranti, 1997: 147-148). An innovation that seems to have occurred, for limited companies incorporated by registration, at some point during the mid-1860s was the grant to debenture-holders of a charge over the 'entire undertaking' of the company (or words to that effect) (Cutris, 1941; Pennington, 1960; Gregory and Walton, 2001; Nolan, 2004). It seems likely that such charges were inspired by provisions commonly included in the private Acts of Parliament that were used to incorporate railway companies (Gregory and Walton, 2001: 137). These provisions, which had their source in the Companies Clauses Act 1845, permitted such companies to grant mortgages over their 'undertakings'.[7]

There appears, at the outset, to have been considerable uncertainty as to efficacy of, and if so, the appropriate form of words for, such 'entire undertaking' charges granted by registered companies. Early examples of such charges contained clauses expressly stipulating that the company should be free to deal with the charged assets until some future event—such as default on the debt secured, winding-up, or cessation of the business (Nolan, 2004: 120-124).[8] It was commonly thought that in the absence of such a clause, an implied term would prevent the chargor from disposing of the charged assets without the chargee's consent.[9] A clause expressly granting a power to deal avoided immediate paralyzation of the company's business, and, at the same time, deterred a court from concluding that the parties 'could not have intended' to create a charge over the company's *assets* at all, as opposed to the income therefrom.[10] As the courts became more familiar—and comfortable—with this combination, so that the existence of such a power could readily be implied from the grant of a security over 'all the property' of the company.[11] Over time, the term 'floating charge' came to be used as shorthand for a type of security which comprised this package of rights and powers (Nolan, 2004: 123-124).

Closely related was the development of contractual receivership. Traditionally, a receiver was appointed on a petition to the court of Chancery to oversee the income arising from mortgaged property. However, it became common for parties to stipulate in a debenture that the chargee should, on default by the chargor, be entitled to appoint a receiver out of court, who would then be deemed to be the agent of the company.[12] In an important development, the Court of Appeal held, in *Re Henry Pound*,[13] that a debenture-holder was entitled to exercise a contractual power to appoint a receiver, notwithstanding that the company had already gone into winding-up. Thus the holder of a floating charge was assured of being able to control its enforcement, and the important legal preconditions for its utility had been established.[14]

Evidence on the commercial use of the floating charge can be obtained from prospectus advertisements in *The Times* for issues of debentures.[15] The first such advertisement was placed by the Royal Exchange Shipping Company Ltd on 4 May, 1880, announcing an issue of debentures secured by a 'floating charge on the whole of the ships, undertakings, and effects of the Company'.[16] The terminology must still have seemed novel amongst the investment community, for it provoked a letter from a reader enquiring what was meant by the term 'floating charge'. *The Times* thought the question sufficiently important to solicit and publish a response from the company's lawyers, Messrs Ashurst, Morris, Crisp & Co, which explained:[17]

> '[S]uch a charge is now very familiar to commercial lawyers, and has been upheld by the Courts, including the Court of Appeal, on several occasions.'
> 'The effect of it, as well settled by these decisions, is that all the property of the company, both present and future, is liable for payment of the debenture-holders …'

Railway companies, which as we have seen did not utilise 'true' floating charges,[18] accounted for a large portion of the capital raised by British enterprises until the end of the nineteenth century (Fishman, 1985: 392; Grossman, 2002: 129-131). This was perhaps one of the reasons why it appears to have taken fifteen more years for the floating charge to achieve ubiquity.

With the exception of two issues advertised in 1882, no further 'floating charge' debentures were advertised in *The Times* until 1887, when there were six. The years that followed saw companies other than the railways starting to raise capital in much larger amounts than before (DeLong and Grossman, 1996; Grossman, 2002). Much of this was debt finance, and the numbers of advertisements in *The Times* for 'floating charge' debentures soared, suggesting these securities had become commonplace (see Figure 1, below p.7).

The position of debenture-holders was thereby protected. What, though, of unsecured creditors? The attitude of the nineteenth century judiciary appears at first to have been sanguine: it was the unsecured creditor's responsibility to enquire whether or not security had been granted. As Malins V-C put the matter in an early floating charge case, *Re General South America Co*, decided in 1876:[19]

> '[A] person dealing with a company knows also its powers of borrowing, and that the company has power to pledge every part of the property of the company. … Now if the creditors had been told that every particle of the property of this company was pledged to secure £72,000, could they have complained? And were they not told all this by the fact of its being a limited company? Were they not bound to make all these inquiries?'

3. Legislative rebalancing

Leaving financial creditors to their own vigilance was one thing, but what of those classes of creditor—in particular, employees—that had been deemed worthy of preferential status in liquidation, on the basis that their ability to protect themselves *ex ante* was limited? The decision in *Richards v Overseer of Kidderminster*,[20] in which it was held that preferential creditors' claims did not extend to assets that were subject to security, provoked a swift statutory response (Keay and Walton, 1999). The Preferential Payments in Bankruptcy Amendment Act 1897 introduced, for the first time, redistribution from floating charge assets, by making them expressly subject to preferential debts.[21]

In the Parliamentary debates on the 1897 Act, there was discussion as to whether the priority so granted should not extend to fixed as well as floating security.[22] There was, however, concern that subordinating fixed security would be a step too far.[23] Ultimately the argument that permitted a distinction to be drawn between fixed and floating security was based on a labour theory of value: workmen should be permitted to have a prior claim for unpaid wages against stock-in-trade, which would fall within the floating charge, because their labour had contributed to its production.[24]

Meanwhile, in what was perhaps a sign of changing judicial attitudes, Lord Macnaghten called, in *Salomon's Case*, for more general redistribution in favour of unsecured creditors:[25]

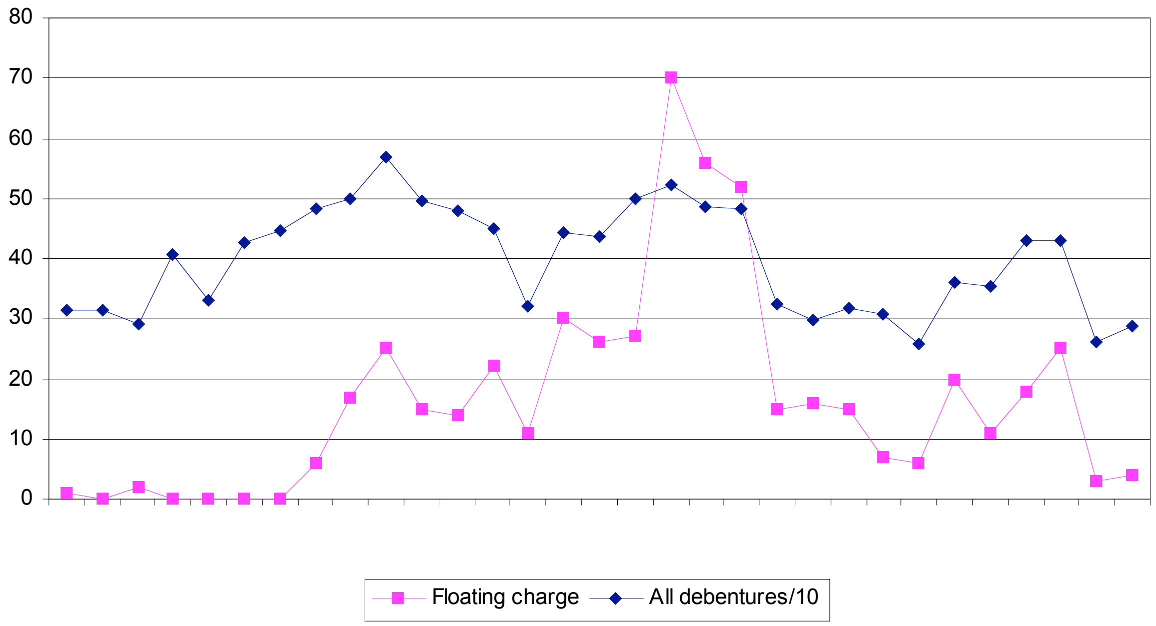
> 'For such a catastrophe as has occurred in this case some would blame the law that allows the creation of a floating charge. But a floating charge is too convenient a form of security to be lightly abolished. I have long thought, and I believe some of your Lordships also think, that the ordinary trade creditors of a trading company ought to have a preferential claim on the assets in liquidation in respect of debts incurred within a certain limited time before the winding-up. But that is not the law at present. Everybody knows that when there is a winding-up debenture-holders generally step in and sweep off everything; and a great scandal it is.'

His suggestion was not taken up by the legislature of the time, although the debenture taken by Aaron Salomon over the assets of his own company laid bare the weaknesses of the contemporary notice system,[26] and seems likely to have formed the impetus for the introduction in the Companies Act 1900 of a public registration requirement for floating (and other) charges granted by a company.[27] Moreover, a few years later, the Companies Act 1907 introduced a provision whereby a floating charge granted within a 'twilight period' shortly prior to the commencement of winding-up proceedings, otherwise than for new money, might be set aside by a liquidator.[28]

It is worth pausing here to reflect on the thinking that underpinned both the 1897 Act and Lord Macnaghten's call for redistribution in favour of unsecured creditors. Both appear to proceed from the assumption that insolvency is a common misfortune that must be borne by the creditors. If this is the case, then it naturally seems unfair that one party—the debenture-holder—should be able to take everything. A call for a fairer balance seems quite appealing. It seems reasonable that workmen should have a right to be paid out of assets to which they have contributed value, but equally it might be tipping the balance too far in the opposite direction were *all* security to be so subject.

The problem with such thinking is that it neglects the fact that subjecting voluntary transactions to redistributive liabilities gives parties to those transactions a powerful incentive to structure their affairs differently (Baird, 1998). Figure 1 provides some suggestive evidence. It shows (the lower line) the number of pages in *The Times* on which advertisements appeared for debentures secured by 'floating charges' during the period 1880-1910. This gives a proxy for the frequency for which floating charges were used. To be sure, not all issues of securities would be advertised in *The Times*. However, by also measuring the number of pages on which advertisements for 'debentures' appear (with floating charges or otherwise), it is possible to give an indication of the *relative* frequency with which floating charges were used in debt finance. This is also reported (divided by 10 so as to render the scales comparable) in Figure 1.

Figure 1: Advertisements for debenture prospectuses in *The Times*, 1880-1910



During the period 1887-1897, advertisements for floating charges grew relative to advertisements for all debentures. This growth is particularly dramatic in 1897, in which year the floating charge measure reaches more than one-tenth of the measure for all debentures. This growth trend is then reversed, such that the measure for floating charges fell off very quickly relative to that for all debentures after 1897, then tracked the overall measure fairly closely for the remainder of the period until 1910. The growth until 1897 is consistent with a pattern of increasing uptake of the floating charge following both its established legal efficacy and the increasing demand for finance by 'non-railway' companies in the 1890s. After 1897, the capitalisation of these companies did not stop growing (DeLong and Grossman, 1996: 12; Michie, 1999: 88-89; Grossman, 2002: 128). This implies that the most likely explanation for the sudden decline in the floating charge's relative popularity thereafter was that the 1897 Act made it less attractive to investors who wanted a secure protection against risk.

4. Secured creditors respond

During the first half of the twentieth century, public companies' relations with investors were transformed by, amongst other things, improvements in the quality of information available to investors (Baskin and Miranti, 1997; Franks *et al*, 2005). As a result, it became unnecessary to offer security to persuade lenders to advance funds to listed companies. Secured debentures now came to be seen as the transaction structure of choice for banks lending to private companies (see Collins and Baker, 2005: 165-167), reflecting the relative lack of information available about such borrowers.

Over the years, the range of taxes which attracted preferential status in corporate insolvency was increased (Keay and Walton, 1999: 89).[29] And in 1970, the Court of Appeal held, in *Re Barleycorn Enterprises*,[30] that liquidation expenses were payable in priority to the claims of the holder of a floating charge. It seems likely that the cumulative effect of these developments was to spur banks towards developing new transactional forms intended to remove the assets from the reach of the statutory provisions.

One example was the increasing use of so-called 'semi-automatic' and 'automatic' crystallization clauses. These provided for the crystallization of the floating charge either on demand by the debenture holder (semi-automatic), or simply on the happening of a specified event (automatic). They had been conceived following the decision 30 years earlier in *Re Griffin Hotel Co Ltd*,[31] in which Bennett J had held that once a charge had crystallized, it ceased to be 'floating' for the purposes of the legislative scheme. The idea was for the debenture-holder to use such a clause to crystallize the charge before liquidation commenced, and thereby avoid being subject to statutory redistribution. The efficacy of such clauses was finally recognised by the courts in the mid 1980s.[32] However, this was a Pyrrhic victory for banks, because the legislature closed the loophole in 1985 by providing that a 'floating charge' should henceforth mean, 'a charge which, as created, was a floating charge'.[33] What now matters is the character of the charge at the time of creation, rather than at the commencement of liquidation.

The second, and more far-reaching, innovation was that banks sought to create 'fixed' charges over circulating assets. This development appeared to receive judicial sanction in *Siebe Gorman Ltd v Barclays Bank*,[34] when Slade J declared that a debenture creating a 'fixed charge' validly took effect as such over the chargor company's book debts. However, in *Re Brightlife*,[35] Hoffmann J signalled a more restrictive judicial approach to the application of the statutory regime. His Lordship considered that the labels given by parties to their transaction should not be determinative. Rather, whether a charge was fixed or floating should be determined by reference to the characteristics of the security the parties had created. Crucial, in the case of book debts, was the question of who had control over the proceeds of payment from debtors.[36] A requirement that the proceeds be paid into an account from which the chargor was permitted to withdraw funds in the ordinary course without the consent of the chargee would not suffice as 'control'. There followed further attempts to avoid statutory redistribution through the drawing of an artificial distinction between debts and their proceeds, some of which found favour for a while with the judiciary,[37] but the basic approach articulated in *Brightlife* was subsequently affirmed by the Privy Council in *Agnew v CIR*.[38]

However, the position was thought by many to be different as regards charges over receivables granted to clearing banks. In *Brightlife*, Hoffmann J had carefully distinguished *Siebe Gorman* on the basis that the account in question was with the company's bank, and contained an implied term that the bank should be able to prevent the company from making withdrawals from the account if it was overdrawn.[39] This distinction was not judicially challenged until *Spectrum*. It meant that for a clearing bank lending on an overdraft basis, it was possible to take security over book debts that did not become subject to statutory redistribution.

That commercial lenders took advantage of this possibility is strongly suggested by empirical evidence from a new study of bank recoveries in France, Germany and the UK. Davydenko and Franks (2005) report, amongst other things, on the extent to which different classes of asset were taken by banks as collateral for loans during the period 1996-2003. They find that between three and four times as much money was lent by banks on the security of receivables than on stock in trade. Stock in trade is of course another of the classical categories of circulating asset, but one in relation to which it was not thought that a *Siebe Gorman*-style fixed charge would be feasible.

In addition to structuring transactions *ex ante* so as to avoid security being characterized as a 'floating charge', it appears that banks also took steps *ex post*—that is, once the debtor had become financially distressed—to minimise the amount of redistributive exposure that they faced. Most small businesses that go into receivership have first spent some time in the hands of their bank's 'intensive care' unit, which will have tried to orchestrate a rescue, if possible (Armour and Frisby, 2001: 91-95; Finch, 2002: 211-218). One suggestive finding from Franks and Sussman's empirical study of bank rescues was that, for those debtors that the intensive care unit was unable to save, banks tended to reduce their exposure over time, with the result that the companies instead incurred greater amounts of trade credit (Franks and Sussman, 2005: 85-86). It seems therefore that banks have considerable opportunity to minimise their floating charge exposure during this period. Findings from the same study regarding receiverships are also suggestive of avoidance action by banks: it seems to have been common for receivers to allocate a disproportionate amount of their expenses to floating charge assets rather than fixed charge assets. In effect, this meant that the expenses were paid by the preferential creditors rather than the bank (Franks and Sussman, 2005: 93).

Through a combination of these tactics, it appears that banks were remarkably successful in minimising their exposure to statutory redistribution. Thus data from the Association of Business Recovery Professionals suggest that during the late 1990s, preferential creditors received full payment in less than 30 per cent of insolvencies, and in between 23 per cent and 40 per cent of cases, received nothing at all (Society of Practitioners of Insolvency, 1999: 17; Association of Business Recovery Professionals, 2000: 18). This impression of low recoveries is reinforced by data reported by Franks and Sussman (2005: 83), which suggest that the median recovery for preferential creditors in receiverships orchestrated by one of three banks studied was only 1 per cent of the debtor company's assets.

These findings are, in a sense, unsurprising: they reflect the more general point that if one type of commercial transaction is subjected to a redistributive liability, commercial parties will take steps so as to structure their affairs differently. This receives more general confirmation from Davydenko and Franks (2005), an international study of bank recoveries, which reports that both the overall amount, and the types, of collateral taken by banks varies significantly by country, according to the extent to which it is subject to liabilities to preferential creditors. Similarly, studies of venture capital contracting practices in different countries suggest that national taxation may affect the way in which transactions are structured and indeed the level of funds invested (Gilson and Schizer, 2003; Armour and Cumming, 2006).

5. The legislature strikes back

The past few years have seen a dramatic series of legislative and judicial developments affecting floating charges. The Enterprise Act 2002, which came into force on 15 September 2003, made three major changes. First, it abolished the Crown's preferential status, leaving only employee claims as preferential creditors. Secondly, it introduced a requirement that a 'prescribed part' of floating charge assets, initially set at 20 per cent,[40] must be set aside for unsecured creditors. This idea had a long history. It was first suggested by Lord Macnaghten as long ago as 1896 (above, p.6), and later formed one of the more controversial recommendations made by the Cork Committee (Insolvency law

Review Committee, 1982). Its introduction in the Enterprise Act was intended to serve as a *quid pro quo* for the abolition of Crown preference: the government wanted to ensure that the recoveries given up by the Crown would go, not to the banks, but to unsecured creditors (Insolvency Service, 2001: 12).[41]

The Enterprise Act's third change was to abolish the institution of receivership, long understood as being the fall-back mechanism by which a floating charge holder might exit from a distressed business, in favour of a new 'streamlined' administration procedure.[42] Whilst the holder of a qualifying floating charge has a right to appoint an administrator of his choosing out of court,[43] his enthusiasm to do so will be tempered by the fact that the office-holder will be under a statutory duty to all creditors, and that the costs of their efforts are payable out of floating charge assets.[44]

Shortly afterwards, in *Buchler v Talbot*,[45] the House of Lords overruled the Court of Appeal's 1970 decision in *Barleycorn Enterprises* (above, p.8), holding that the insolvency legislation did not mandate liquidation expenses to be paid out of floating charge assets after all. This was a positive development from banks' point of view. However, the government have indicated their intention to reverse this decision by legislation, so it seems likely that in due course the former position will be restored.[46]

Finally, in 2005, the House of Lords decision in *Spectrum Plus* has confirmed the correctness of the view, widely held since the *Agnew* decision, that *Siebe Gorman* could no longer stand. The judicial approach to the application of the statute has hardened over time, in a way that may be summarised as a move from *description* to *prescription*. The legal connotations of the term 'floating charge' have correspondingly shifted from referring to a particular body of commercial transactions to a presupposition that a single reified concept can be applied to all cases involving security over which the debtor has control. The effect is to make it much more difficult, if not impossible, for banks to take security over receivables without micro-managing the debtor company's dealings in those assets.

6. How will the market respond?

It seems unlikely that banks will respond to *Spectrum* by taking floating, rather than fixed, charges to secure receivables financing. It is of course true that the recent statutory developments have not been unequivocally bad for floating charge holders. The abolition of Crown preference and the decision in *Buchler*, for example, have both ameliorated the debenture-holder's position. However, these benefits are obscured by countervailing steps in the opposite direction. The Crown preference moneys are to be 'rerouted' to unsecured creditors.[47] And receivership, a procedure that was undoubtedly of great benefit to floating charge holders, is being replaced by the new administration procedure, which is funded from floating charge assets. Moreover, the respite from liquidation expenses is due to end. The floating charge is therefore unlikely to become any more attractive to banks. Whilst they may wish to structure their lending so as to include a 'lightweight' floating charge over corporate assets, so as to be able to appoint an administrator,[48] banks will be unlikely to wish to lend significant sums against the security of a floating charge.

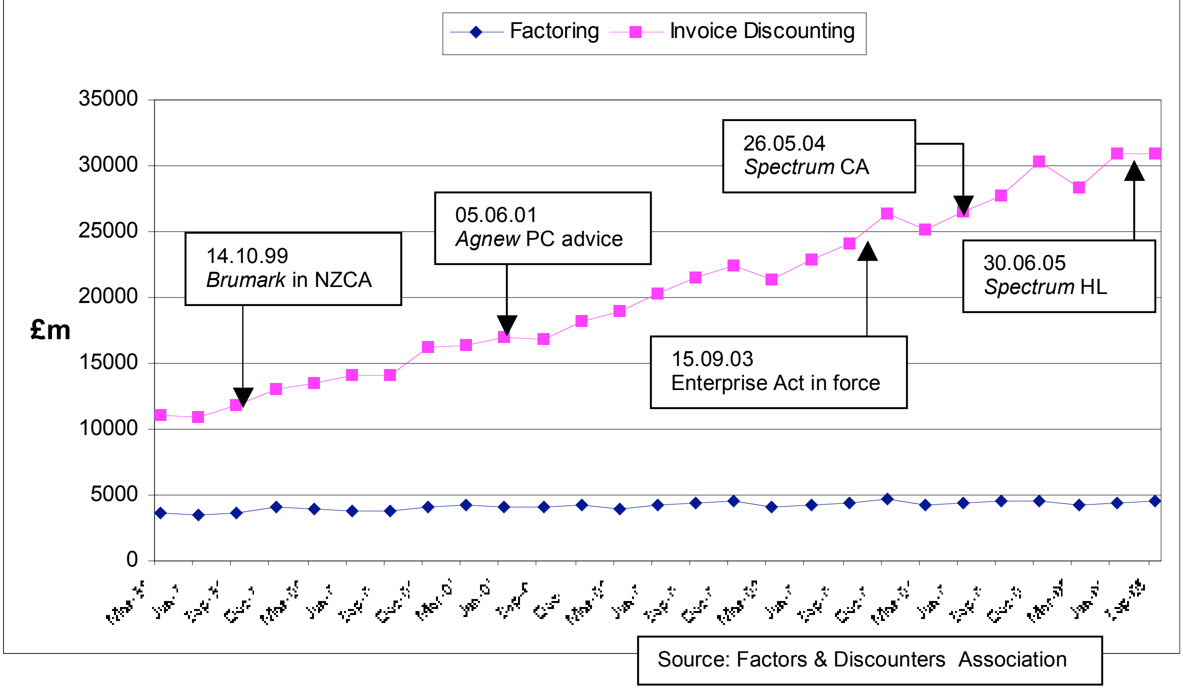
It also seems unlikely that banks will respond by assuming day-to-day control over their customers' spending so as to ensure that a charge over receivables would be characterized as 'fixed' after *Spectrum*. The exercise of such control would be likely to be uneconomic for banks, whose overdraft lending operations are not organized on this basis (see below, section C.3). Moreover, if such control requires the making of regular and repeated decisions about the wisdom of the debtor's spending, then lenders may be concerned about the possibility of attracting liability as shadow directors.[49]

These considerations might seem to imply that *Spectrum* will make it more difficult to raise finance against receivables. If banks will not wish to lend against floating charges, or to exercise day-to-day control, and can no longer take fixed security over receivables, will this not mean that they are less willing to lend against receivables at all? Posing the question in this way, however, omits the possibility of financing receivables by other means. From the point of view of a small company seeking finance, the most likely outcome would be to forego that proportion of its overdraft finance that it might formerly have raised on the security of a fixed charge over book debts, and instead to enter into an asset-based finance arrangement in relation to receivables.

Such an arrangement could take the form either of invoice discounting or factoring. Invoice discounting involves the company agreeing to assign receivables to a financier by way of outright sale, and is therefore not subject to statutory redistribution. The 'price' paid by the financier is the face value of the receivable, minus a finance charge. This is paid in two stages: an upfront payment on assignment, of some proportion of the face value of the debt, and the remainder when the receivable is collected. The company collects as agent for the financier, and pays the proceeds into a trust account, from which it may then draw the remainder of the 'price' owing. The financier will make ongoing decisions about withdrawals by the company from this account, which will be based on assessments of the value of the receivables transferred. Such a financier, specialising in lending against receivables, may be expected to have a comparative advantage in performing such assessments over banks lending on an overdraft basis, which specialise in making general assessments about debtors' business prospects. Moreover, by specifically linking withdrawals to the ultimate value realised from the receivables which have been 'sold', this transaction avoids any real risk of constituting the financier a shadow director.

Invoice discounting is functionally very similar to a loan of the amount of the upfront payment secured by a charge over the receivables.[50] It is therefore a close substitute for lending on the security of receivables (Mian and Smith, 1992: 171). As it is not subject to statutory redistribution, we might expect that, after *Spectrum*, companies would use more invoice discounting. This prediction receives preliminary support from data on invoice discounting for the past few years. Figure 2 reports the value of domestic UK invoice discounting finance and factoring during the period 1999-2005. It shows that invoice discounting has grown dramatically over the period since the *Agnew* decision was handed down by the New Zealand Court of Appeal in 2001.

Figure 2: UK Domestic Factoring and Invoice Discounting 1999-2005



On the other hand, factoring has not grown at all over the same period. Factoring is a another form of receivables funding arrangement offered by specialist financiers. It differs from invoice discounting in that the factor, for a fee, takes control over the company's credit assessment and debt collection functions, whereas under an invoice discounting arrangement, the company usually continues to collect its receivables as agent for the financier.[51] Invoice discounting is therefore a much closer substitute for secured lending against receivables, because the debtor retains control of its sales ledger in both cases, neither arrangement being disclosed to customers. Whilst these are simply 'raw' data and do not control for any other variables that might be causing the trend in invoice discounting, they are at the very least suggestive of the prediction made above. The comparison with factoring, a similar form of finance that is not so close a substitute for secured lending, suggests that the increase in invoice discounting is driven by substitution from secured lending, as opposed to macroeconomic conditions. The implication is that since banks first began seriously to question the efficacy of the *Siebe Gorman* debenture, they have been reducing their exposure against charges over receivables, and that borrowers have consequently been turning to invoice discounting instead,

This effect is probably best understood as a change at the margins of corporate finance. A shift towards invoice discounting does not imply that banks will entirely cease their involvement in receivables financing. Indeed, all the main clearing banks have asset finance divisions which offer invoice discounting products. Moreover, it seems a reasonably safe prediction that some banks will simply seek to structure as 'sales' what in reality may better be characterized as *loans* against the security of receivables,[52] and that these will be challenged as being in substance (floating) charges. In this event, *Spectrum* would not be the final chapter in litigation concerning the floating charge.

This section has emphasised the interrelationship between statutory redistribution and the juridical evolution of the floating charge. Sophisticated lenders have repeatedly altered their behaviour so as to reduce their exposure to statutory redistribution. This has not only resulted in relatively little actually reaching preferential creditors by way of recoveries, but has also generated substantial transaction and litigation costs. Our provisional assessment, therefore, might be that the statutory scheme is an expensive, and not particularly effective, way of protecting the interests of its 'beneficiaries' (Keay and Walton, 1999: 103-105).

C. The impact of redistribution on corporate finance

In this section, we address the question whether the tendency of the statutory scheme to deter lenders from using floating charges entails any opportunity cost. That is, does it make any difference to corporate affairs whether or not a floating charge tends to be used to finance receivables? Indeed, might it be that the floating charge is in some way pathological, such that we should think it *beneficial* that its use is restricted? These questions require us to consider why security is taken, and the particular circumstances in which we might expect a *floating* charge to be used in the absence of statutory 'taxation'.

1. How is secured credit used?

The grant of a security interest confers upon the lender two sets of entitlements, which relate respectively to *priority* of payment and to *control* of the collateral. The control rights are what economists call 'state contingent'—in this case, their extent depends on whether the debtor continues to meet their obligations under the loan. Provided the debtor is not in default, the secured creditor's control is of a purely negative variety, consisting of the ability to veto sales of the collateral. If the debtor is in default, then the secured creditor has a positive right (subject to any procedural restrictions imposed by insolvency law)[53] to control the liquidation of the collateral.

Granting security is therefore costly for a debtor. The creditor's veto rights will restrict the debtor's control over its business, and his priority will make it more difficult for the debtor to obtain finance in future. On the other hand, security is thought to be able to assist creditors in lowering 'financial agency costs'; that is, the costs of conflicts of interest between shareholders and creditors (Jensen and Meckling, 1976: 333-343; Triantis, 1994: 2158). For example, if the business is financially distressed, shareholders—or managers acting on their behalf—may have incentives to pursue highly risky strategies that actually have a negative net present value, simply because they stand to benefit from the upside in the unlikely event that the strategy is successful. By restricting the ability of a debtor to alienate collateral, security enables the creditor to prevent the debtor from selling assets of stable value to fund more risky business ventures (Smith and Warner, 1979a).

Security also restricts the debtor's ability to borrow to fund such ventures. By granting existing lenders priority to the firm's assets, security forces new lenders to look primarily to the value generated by the ventures they fund, and thereby to scrutinise more carefully the purposes for which the debtor is borrowing (Schwartz, 1989; Hart, 1995: 126-151).[54] The grant of security is thus a bond by the debtor not to engage in wealth-reducing transactions (Triantis, 1992). Such a bond is valuable to the debtor, because by 'tying its hands' to prevent itself entering such transactions *ex post*, it increases its borrowing capacity *ex ante*.[55]

Thus modern finance theory views security as closely related in function to loan covenants and contractual priority arrangements, which also impose restrictions on the debtor's freedom of action that may be justified as bonds against wealth-reducing transactions (Smith and Warner, 1979b; Barclay and Smith, 1995; Triantis, 2000). In each case, we would expect these arrangements to be agreed to only where the benefits to the debtor outweigh the costs—hence riskier firms, which we might expect to be more prone to financial agency costs, would be more likely to use loan covenants and security.

In this context, the utility of secured credit is a function of its advantages over and above contractual covenants (Scharwz, 1997). The key to the difference lies in the consequences if the debtor ultimately defaults. As security creates proprietary rights, it is 'self-enforcing', whereas loan covenants are not. Security also has another difference from loan covenants: it allocates control (subject to restrictions imposed by insolvency law) over the enforcement process (Scott, 1997). This permits creditors to allocate control over enforcement to those best-placed to maximise the value realised, and to deter other creditors from engaging in a wasteful 'race to collect' when the debtor is in financial difficulty (Picker, 1992). We would therefore expect security to be used by those firms which are riskiest, or about which creditors have least information. Risky firms are more likely to default, and hence more likely to go into insolvency proceedings. In keeping with these predictions, empirical studies from both the UK and other jurisdictions establish that security tends to be used principally in relation to smaller, younger, and riskier firms (Berger and Udell, 1990; Chen *et al*, 1998; Lasfer, 2000).

The ability of corporate debtors to grant security has the potential to yield social benefits extending beyond the parties to the security agreement (that is, 'positive externalities') (Triantis, 1992; Schwarcz, 1997; Mokal, 2002). *Ex ante,* by facilitating bonding and monitoring activity, security lowers the probability that the debtor will engage in wealth-reducing transactions, and helps to reduce the probability of default. This increases the value of all creditors' claims. *Ex post*, by facilitating efficient enforcement, it can increase the overall 'size of the pie' for distribution. As we shall see, the way in which these benefits may be generated depends in part upon the identity and lending strategy of the creditor and the scope of the collateral. In the discussion that follows, attention will be restricted to the context of small and medium-sized firms, since, as we have seen, these are the principal users of secured credit.

Asset-based lending: 'focal' monitoring and/or enforcement. Consider first a security interest in a single asset, or a particular class of assets. This would be a natural complement for a creditor following an asset-based lending strategy. Such a lender relies not upon its predictions about the debtor firm's creditworthiness, but on the ability of specific asset classes to cover repayment (Berger and Udell, 2005). In the modern business lending environment, such 'asset-based finance' encompasses hire purchase or leasing agreements and factoring arrangements, which together account for a share of the external finance sought by UK SMEs second only to banks (Cosh and Hughes, 2003: 80; Fraser, 2004: 61). It also includes trade credit granted on title retention terms. In practice each of these tends to utilise transactional structures that, strictly speaking, involve the financier having outright ownership of the asset, as opposed merely to a security interest (Bridge, 1992). In function, however, these are equivalent to security.[56]

Consider the effect of granting a security interest over a single asset or class of asset to a financier who has specialist knowledge about the asset class in question, and/or the market(s) in which it is sold. The lender's expertise would enable her to exercise her control rights effectively, and thereby facilitate the monitoring of the debtor's use of the collateral and—should default occur—enforcement against it. Moreover, the *priority* associated with the security interest can sharpen the lender's incentive to do so. As the lender's priority will be limited to the proceeds of sale of these assets, this will focus her attention on the fate of that asset, as opposed to that of the debtor company's business generally (Levmore, 1982; Longhofer and Santos, 2003). Thus a security interest in a particular asset is most usefully granted to a creditor with specialist knowledge regarding the asset class in question. It not only allocates control rights to the party best placed to exercise them, but also gives the lender a powerful incentive to care about how they are exercised.

The use of title retention clauses in conjunction with a grant of trade credit provides an intuitive example.[57] A trade creditor who supplies a particular type of input, being in the business of selling that product, is probably best-placed amongst the debtor's creditors to liquidate unused quantities of that input on the debtor's insolvency. On this view, the original supplier's comparative advantage makes it efficient for them to control enforcement against goods they have supplied, provided that in removing these inputs they do not destroy operating synergies with other assets belonging to the debtor.[58] It also provides a justification for the judicial limitation of such a creditor's priority to the original goods: there is no reason to suppose that the title retention creditor would have any comparative advantage in realising these.[59]

Relationship lending: general monitoring and/or enforcement. In contrast to asset financiers, the approach generally adopted by banks—which provide the majority of the external finance to SMEs in the UK (Cosh and Hughes, 2003: 80; Fraser, 2004: 61)—is to advance funds on the basis of the debtor's general business prospects. A bank's credit decision could either be made using publicly available financial information, or could involve the creditor developing a relationship with the debtor where 'soft' information may be gathered on an ongoing basis to assist in making decisions about further advances in the future—so called 'relationship' lending (Berger and Udell, 2005).

A lender advancing credit on business-based criteria may be expected to invest in specialist knowledge about business generally, or—in the case of relationship lending—the debtor's business in particular. Granting a general security interest to such a lender can assist in controlling financial agency costs (Scott, 1986; Armour and Frisby, 2001: 79-86). Where the debtor is relatively high-risk—as is the case with small businesses—then a relatively tight control is called for (see Carey *et al*, 1998). Giving veto rights to a range of creditors will lead to coordination costs in their decision-making. In contrast, concentrating the decision rights in the hands of a single, well-informed, creditor (which for simplicity we will call a 'bank') may be the most efficient way of managing the problem (Petersen and Rajan, 1994). Financial economists speak of the bank acting as a 'delegated' monitor on behalf of the other creditors (eg Diamond, 1984).

It might be thought that the priority associated with such a general security would weaken the bank's incentive to invest in gathering information about, and monitoring, the debtor's business (Jackson and Kronman, 1979: 1143-1161; Fama, 1990: S84; Finch, 2002: 258). The intuition is that if the bank is a senior claimant, it will not be sufficiently concerned with monitoring the debtor.. This intuition is based on two assumptions: (i) that more creditor control is always better than less; and (ii) that a junior creditor always has the strongest incentives to monitor. However, neither turns out to be reliable.

Creditor control has significant costs as well as benefits. These costs are the inverse of the costs of shareholder control. Just as the shareholders have an incentive to prefer excess risk, creditors have an incentive to prefer too *little* risk (Jensen and Meckling, 1976). And just as shareholder's incentives are misaligned from maximising the firm's value when it is financially distressed, creditors' incentives are misaligned from value maximisation when it is solvent. It follows that the more financially distressed the debtor's position, the greater will be the benefits of creditor control, and the lower the costs. Thus it makes sense to give a concentrated creditor an incentive to intervene which will become progressively greater with the severity of the firm's financial distress.

However, a junior creditor's incentive (and ability) to exert control does not increase in linear fashion with the financial difficulties of the firm as a whole. Rather, a junior creditor's incentive to intervene begins early, when its claim is 'close to the money'. This may result in too much creditor 'discipline' for the firm (Diamond, 1993). Moreover, if the firm's financial position deteriorates seriously, a junior creditor will find its incentive and ability to intervene will decline, at the very point when it is potentially most valuable. Its incentive will be dulled by the fact that the marginal benefit of its efforts will now go to creditors ranked above it (Park, 2000; Longhofer and Santos, 2000). Its ability to influence the debtor by threatening insolvency proceedings will weaken. The threat will cease to be credible as the creditor's likelihood of repayment in insolvency diminishes (Park, 2000; Elsas and Krahnen, 2002). Thus making bank debt senior gives the concentrated creditor an incentive to intervene when it matters most, and the ability to exert meaningful control.

That banks, with senior priority status, do in fact exercise this control when the debtor is financially distressed, in a way that is beneficial for other creditors, is apparent from empirical studies of banks' orchestration of informal rescues (Armour and Frisby, 2001; Baker and Collins, 2003; Franks and Sussman, 2005). Franks and Sussman (2005: 76-77) found that the average firm in their sample of financially distressed borrowers spent seven and a half months with banks' Business Support Units ('BSU's, or colloquially, 'intensive care'), and that (depending on the bank) about somewhere between half to three quarters of these firms emerged from the BSU without going into formal insolvency proceedings.

It is also worth reflecting on the consequences of the implicit alternative to giving seniority to a concentrated lender such as a bank. Making the bank junior would mean that a variety of other creditors, each with smaller claims, would be senior to it. If they were called upon to effect an informal rescue, it would be relatively costly for them to co-ordinate. They are more likely to seek to enforce, in order to protect their positions (Webb, 1991: 143-146). At best, this will frustrate informal rescues; at worst, it will bring about the break-up of the debtor. Franks and Sussman emphasise the passivity of junior creditors with small claims during the orchestration of an informal rescue by a concentrated senior creditor. This is because, being junior, they stand to gain nothing by seeking to enforce against the firm's assets (Franks and Sussman, 2005: 88-91).

2. Is secured credit harmful?

It is argued by some that a social loss may result from the use of secured credit in the presence of 'non-adjusting' creditors: that is, creditors whose decision to extend credit does not fully reflect the increased risk (to them) associated with the fact that the debtor has granted security (Scott, 1977; LoPucki, 1994; Bebchuk abnd Fried, 1996; Finch, 1999). The intuition is that, all other things being equal, a loan made on a secured rather than an unsecured basis will carry with it a lower rate of interest, reflecting the reduction in risk that the lender will bear. Moreover, all other things again being equal, an unsecured creditor is worse off if his debtor has granted security to another creditor. Thus unless unsecured creditors 'adjust' to reflect the increased risk it brings for them, a grant of security may result in a transfer of wealth—in an expected-value sense—from unsecured debtors to the borrower. By borrowing on a secured basis, the debtor obtains a lower interest rate; by failing to adjust, the 'cost' is borne by unsecured creditors.

This claim does not necessarily imply that the benefits of security discussed in the previous section do not exist. Yet at the very least it implies that, even if such benefits exist, the possibility of such wealth transfers will lead debtors to take 'too much' security (Bebchuk and Fried, 1996). The costs of granting such 'unnecessary' security will be wasted. Moreover, non-adjusting creditors who thereby end up bearing the additional risk may be poorly diversified and so least well-placed to bear it (Finch, 1999). Whilst the current state of the empirical evidence does not permit us to answer the question unequivocally, it does seem more likely than not that the benefits associated with security outweigh its costs.

As we have seen, security tends to be granted by firms which are at relatively greater risk of default. This seems consistent with the predictions of both theories that explain security by reference to its function in reducing agency costs and by reference to its potential for transferring wealth from non-adjusting creditors. The benefits of policing a debtor so as to reduce their likelihood of default will clearly increase with the debtor's riskiness. At the same time, the expected value of the 'insolvency share' of unsecured creditors, which the critics of security argue it permits to be 'sold' to secured creditors, also increases with the probability of the debtor's default. The pattern of security, in and of itself, could be explained by reference to either, or a combination of both, effects.

It has been suggested by some that the 'wealth transfer' theory may be rejected on the basis that a grant of security does not appear to result in any reduction in interest rates for borrowers. Thus, it is argued, debtors cannot stand to benefit from 'selling' the insolvency share of unsecured creditors to secured creditors (Mokal, 2002: 713). For example, Davydenko and Franks (2005) find no statistically significant relationship between loan interest margins and the presence of security; a finding which is robust for results relating to the UK, France and Germany. However, this might simply be because the authors have not controlled completely for the fact that security tends to be most valuable to lenders in relation to higher risk borrowers, and that therefore a firm borrowing on a secured basis tends in any event to be charged a higher interest rate (see Booth and Booth, 1996).

Another objection to the claim that security is harmful is that it seems unlikely that there are significant numbers of 'non-adjusting' creditors. Those claiming that security is used to transfer wealth typically assume that trade creditors' adjustment is only partial, on the basis that they face relatively high information and transaction costs relative to the amount at stake.[60] Yet we have seen that security tends to be ubiquitous amongst smaller, younger firms. It would be surprising if trade creditors could not use these borrower characteristics as readily observable proxies for whether or not security had been granted. Moreover, the assumption it is not consistent with the empirical data. Whilst trade creditors do tend to offer the same *terms* to all 'borrowers' (that is, customers who purchase on credit) (Ng *et al*, 1999), the non-adjustment idea is contradicted by evidence that trade creditors tend to adjust the *amount* of trade credit granted in accordance with the debtor's creditworthiness and the scope for misbehaviour by the debtor (Petersen and Rajan, 1997; Burkart *et al*, 2004). Thus it seems likely that the beneficial aspects of security are empirically more significant than the potentially harmful aspects.

3. The floating charge and security over receivables

The case for special treatment of floating charges turns on two points. First, it is argued that floating charges are likely to be of limited use in controlling debtor misbehaviour, and therefore give rise to less benefits than other forms of security (Mokal, 2003).[61] The debtor's ability to deal with the collateral in the ordinary course of business ('OCB') weakens the creditor's ability to control asset substitution. Moreover, the fact that a floating charge is subordinated to subsequent fixed charges clearly restricts its usefulness as a means of 'locking in' priorities.[62] Secondly, it is thought that the way in which the floating charge is typically general in its scope, and extends to after-acquired property, renders it particularly likely to be redistributive in effect. This may permit the holder of a floating charge to 'poach' the insolvency value of assets that the company has acquired with finance provided by subsequent lenders. To be sure, provided they are notified of the existence of the charge, subsequent lenders are able to protect themselves by adjusting the terms of their contracts, but clearly not all of them do so. Thus emerges the case against the floating charge: on this analysis, it appears to be more likely to be a mechanism for harming unsecured creditors than anything else.

However, both of these features need to be placed in context. The floating charge was, as we have seen, originally developed as a means of taking security over circulating assets. The way such assets are used in business is such that the costs of the control rights associated with a fixed security (in terms of impeding useful business activity) would, for many lenders, outweigh the benefits (in terms of avoiding harmful actions). As we shall see, the costs of exercising such control rights would only be manageable for a lender following an asset-based lending strategy, who has invested in specialist knowledge of this asset class. For a relationship lender, the floating charge may therefore be a useful form of security.

Asset-based lending: circulating assets. Consider first a financier specialising in circulating assets—such as receivables (see Mian and Smith, 1992). Such a financier—an invoice discounter, for example—will take either a security interest over, or ownership of, specified receivables, in return for which they will advance funds to the borrower company. The better the quality of the receivables, the greater the proportion of their face value which the financier will be willing to advance.[63] The financier will therefore need to engage in monitoring the quality of receivables, and will likely bring specialist knowledge to bear in making this assessment.[64] He will also wish to control what the borrower does with the proceeds of payment from receivable debtors—for example requiring the proceeds to be paid into a trust account, from which it would only be permitted to withdraw funds in excess of the amount advanced in respect of outstanding receivables. Because of the way such a financier is making continuous assessments of its exposure based on the quality of the receivables, and requiring payments into a trust account to control its exposure, such a financing arrangement could practicably be structured either on the basis of sale of the receivables, or through a fixed charge.

Relationship lending: circulating assets. Consider now the case of a lender advancing funds on the basis of the debtor's business prospects. As has been discussed, a relationship lender would wish, in order to maximise their influence, to take security over as much of the debtor's assets as possible. In relation to circulating assets, however, and lacking specialist knowledge, it would not be economic for such a lender to take fixed security, because of the need for frequent turnover of the assets.

Yet if the lender instead takes floating security, this does not imply it is powerless to prevent the debtor from acting contrary to its interests (cf Mokal, 2003). Recall that the nature of the monitoring performed by such a lender is different to an asset-based lender: a relationship lender's expertise lies in its ability to assess the debtor's business. What is useful is a veto over decisions that will change the debtor's line of business. Thus the usefulness of a floating security over receivables to such a lender lies not in the details of specific book debts, but in the lender's ability to control their use (along with all the debtor's other assets) in extraordinary circumstances.[65]

Such a lender would of course structure their debenture security as fixed charges over specific assets coupled with a residual floating charge.[66] Yet, because the debtor will not typically be alienating its fixed assets in the ordinary course of business, the circumstances under which the lender will be called upon to exercise its veto rights will actually be similar in relation to each type of collateral—that is, transactions outside the ordinary course of business. In addition, when coupled with the power to deny the debtor the ability to continue to use the circulating assets, this could act as a powerful threat to deter misbehaviour generally. Moreover, a floating charge will lock in the lender's priority to circulating assets, provided it is not possible to grant a fixed charge over such assets.[67]

Moreover, such a security is no more likely to be harmful to unsecured creditors than any other. The apparent generality of its scope is illusory—it will in reality only cover circulating assets, because fixed charges will be taken over the rest. To be sure, it captures after-acquired property, but this is only in return for other assets being permitted to leave the security. It is because of this that unsecured creditors can get paid by the debtor in the ordinary course of business without infringing the security.

Thus a floating charge would be most likely to be used by a relationship lender as part of a package of general security. However, the statutory 'taxation' imposed on floating charges means that they are rendered less attractive to lenders. After *Spectrum*, no longer able to avoid this by characterising their security as 'fixed', banks will find it difficult to couple a relationship lending approach with effective security over book debts. The likely effect, as suggested by Figure 2, will not be for small businesses to start borrowing on an unsecured basis from their banks. Rather, they are likely to find it cheaper to substitute asset-based finance over receivables, structured on the basis of an outright sale rather than security.[68]

4. Asset-based vs relationship lending?

Sections C.1 and C.2 have argued, respectively, that security is capable of leading to benefits in relation to both asset-based and relationship lending, and that these benefits outweigh the costs of the institution. However, section C.3 implies that statutory redistribution from the floating charge, coupled with the decision in *Spectrum*, will engender a shift towards asset-based finance in relation to receivables.

The most significant difference between these two types of strategy concerns decisions regarding a debtor in financial distress. Asset-based lenders are numerous, and they focus on specific collateral. Thus they have comparative advantage at liquidating that collateral, but have difficulty in co-ordinating to make decisions about the business as a whole. Relationship lenders, on the other hand, have comparative advantage in organising rescue operations and making difficult decisions concerning the fate of a troubled firm as a whole.

A typical small firm might use a mixture of relationship and asset-based finance.[69] All other things being equal, we would expect to see asset-based finance being used in relation to assets that are not complementary to the business as a whole: that is, they could be repossessed by the financier without inflicting harm on the business. In a period of financial distress, however, it would be the relationship lender to which the debtor would turn for extra funds. Once asset-based lenders become aware that the debtor is having financial difficulties, then their collective behaviour may be hard to control (Armour and Frisby, 2001: 79-86; Franks and Sussman, 2005: 88-91). There is a likelihood that at least one or two might seek to liquidate their collateral. This may precipitate corporate insolvency proceedings. To be sure, administration proceedings would impose a moratorium on such actions, but the very fact of having entered formal insolvency proceedings will be extremely destructive to the debtor's goodwill and greatly reduce its chances of being successfully rescued (Meeks and Meeks, 2004). Thus the debtor will be likely to seek additional finance from a relationship lender, which can be used to pay debts falling due to asset-based financiers in the interim. That way, distress does not become public knowledge.

The foregoing has three salient implications for our enquiry. First, pushing small firms towards asset-based finance in relation to receivables is likely to increase the level of payments that a bank funding a 'workout' must cover, in order to ensure that the company maintains current payments to all its creditors. Secondly, the reduction in a firm's exposure to its bank which this shift implies is likely to make the bank less willing to invest in the first place in gathering information about the debtor's business and prospects. Thirdly, receivables are likely to be highly complementary to a firm's business, and so the introduction of an asset-based lender may make rescue operations rather more difficult for this reason. The implication is that increasing fragmentation and a shift towards asset-based lending may make it more difficult for workouts to succeed.[70]

D. The impact of redistribution on recipients

We have seen that statutory redistribution from the floating charge has yielded direct costs in terms of avoidance action, and may distort borrowing patterns in a way that will generate further costs. However, in order to complete our assessment of redistribution in insolvency, we need now to consider the case for *making* payments to the various beneficiaries. If there are sufficiently large benefits for these groups, this may lead us to conclude that the costs of the scheme are worth bearing. Alternatively, if the benefits are not sufficiently large, but nevertheless positive, we may wish to consider ways of effecting payments to these groups which involve less distortion of lending practice.

1. Employees

Perhaps the strongest *prima facie* claim may be made in relation to employees. Statutory priority for employee claims forces the company (and through it, the other creditors) to insure them to a certain extent against the risk of failure. This may generate benefits where employees are risk-averse (Jackson and Scott, 1989), and particularly where they are asked to make investments in firm-specific human capital (which will be a risky investment) (Armour and Deakin, 2003: 444-446). The argument is that employees may be unwilling to make risky investments of this sort unless they are insured against the possibility of firm failure. Their elevation in insolvency increases their chance of repayment should the firm fail, thereby lowering the risk involved in such an investment.

A moment's reflection shows that the extent to which these theoretically-plausible benefits are captured by the statutory regime is negligible. Employees obtain priority for unpaid wage claims only up to a maximum of £800 per person.[71] This sum, which has not been increased since 1976 (Keay and Walton, 1999: 91), cannot sensibly be claimed to operate as any sort of insurance. However, employees also have entitlements under the Employment Rights Act 1996 to payments out of the National Insurance Fund in respect of unpaid wages where their employer has entered insolvency proceedings.[72] More than twice as much may be claimed under this Act, and the payments are usually made far more quickly than by a liquidator.[73] The National Insurance Fund is then subrogated to employees' preferential claims in their employers' insolvency where they have been paid under the 1996 Act.[74]

The existence (and effectiveness) of the employees' claims against the National Insurance Fund shows that, in order for employees to receive the insurance-related benefits which are claimed to be provided by their preferential status, it is not necessary to engage in redistribution between the claimants in insolvency. Rather, employees can (and, in fact, largely do) get the same benefits by means of direct payments from the state. Moreover, by a scheme structured in that fashion, the need for distorting effects on lending patterns would be avoided. If the benefits to employees of such insurance are real, then a case may be made for increasing the level of payments made by the state.

2. The Crown

The inclusion of Crown claims for tax amongst those preferentially entitled was said to be justified on the basis that the Crown is an 'involuntary' creditor, which cannot adjust the terms on which 'credit' for unpaid tax is extended (Insolvency Law Review Committee, 1982). This, however, is not really true, as the Crown has control over the resources dedicated to the enforcement of unpaid taxes, and can thereby very much affect the 'terms' debtors can expect to experience. Moreover, it seems that Crown preference created unanticipated costs in corporate rescue proceedings. The Inland Revenue was reported to take an unduly negative approach to reorganization proposals (milman and Chittenden, 1995). The Revenue would stand in most cases to be paid in full in liquidation, ahead of the holder of a floating charge, whereas in a CVA they would need to wait before receiving payment. They therefore lacked any incentive to agree. Bearing these points in mind, the abolition of Crown preference by the Enterprise Act 2002 seems clearly to be welcomed.

3. Liquidation expenses

It is commonly thought to be necessary to pay liquidation expenses ahead of unsecured creditors' claims in order to induce liquidators to undertake their work. Yet it is also desirable to ensure that they are not given incentives to incur more expenditure than is justified the value of the assets at stake. If liquidation expenses take precedence only over unsecured claims, then the unsecured creditors have both the incentive and the ability to control the liquidator's expenses. They appoint (and remove) the liquidator, and it is their money at stake.

Yet if liquidation expenses take priority over the claims of secured creditors, this creates an incentive for more to be spent than is justified by reference to the recoveries flowing to the unsecured creditors. The unsecured creditors will not be with expenses paid from funds which would not otherwise be available to them. Permitting liquidation expenses to be paid for out of secured assets therefore tends to encourage excessive expenditure (Bris *et al*, 2004; Schwartz, 2005: 1235-1238).

A particularly egregious form of overspending arises from attempts by the liquidator to increase the value available to the unsecured creditors, by challenging the validity of security. Paying liquidation expenses out of floating charge assets actually permits the liquidator to use the *chargee's* funds to challenge his own security.[75] Following a change to the Insolvency Rules in December 2002, the costs of such litigation brought by a liquidator would clearly be classified as 'expenses of the liquidation'.[76] A chargee faced with such a challenge would of course respond by spending money on defending their status. On neither side would the expenditure increase the size of the asset pool available for the creditors as a whole; in contrast, it would simply *deplete* the creditors' total recoveries.

It might be argued that a social benefit is derived from requiring liquidation expenses to be paid out of floating charge assets (Mokal, 2004). Liquidators 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. Such a concern certainly appears to have motivated the Court of Appeal in *Re Barleycorn Enterprises*.[77] However, this investigatory function is imposed on all office-holders—including administrators, who act for both debenture-holders and unsecured creditors (Armour and Walters, 2006). It is not clear why, in liquidation, it should be imposed on a party who does not stand to benefit from the proceedings. More generally, such a benefit would equally well be obtained if the cost of such 'public' aspects of insolvency proceedings were funded by the state.

4. Unsecured creditors generally

Some of those who emphasise the potentially harmful or inefficient aspects of security argue that a 'carve out' from secured credit—that is, a certain proportion of secured creditors' recoveries should be set aside for general unsecured creditors—would ameliorate these problems (Bebchuk and Fried, 1996: 904-912; Finch, 1999: 664-665). On first blush, the 'prescribed part' of floating charge assets set aside for unsecured creditors might look like the implementation of such a policy. However, if that is its purpose, it is likely to be inefficacious, even if we assume for the moment that security *is* harmful to unsecured creditors. This is because, as we have seen, the impact of statutory redistribution under English law is not to encourage debtors to take less security, but rather—because the redistribution is only from the floating charge—to encourage them to take different *kinds* of security. Indeed, once this adjustment has been made by sophisticated creditors, unsecured creditors may well be collectively *worse* off as a result of the redistributive scheme: on the one hand, they will receive only a trivially small increase in their expected payout on insolvency through the prescribed part (Mokal, 2001: 616-619; Association of Business Recovery Professionals, 2003: 11); on the other hand, if fragmented capital structures make it more difficult for banks to orchestrate workouts of financially distressed companies, this may increase the probability of default. Bearing in mind these costs, it seems difficult to justify the 'prescribed part' regime introduced by the Enterprise Act.

This does, however, raise a related question. Might it be desirable to extend the policy behind the prescribed part so that it applies to all security, as opposed simply to floating charges? Such a measure would suffer from two practical problems. First, such a move would not prevent avoidance activity entirely. Rather, it would simply shift the locus away from the divide between fixed and floating charges, and towards the question whether a transaction was security or a 'true sale'. Secondly, unless the funds 'carved out' are targeted specifically at non-adjusting creditors, such a measure gives adjusting unsecured creditors an opportunity to free-ride at secured creditors' expense.

E. Conclusions

This paper has considered the scope, effects, and merits of redistribution from the floating charge in English corporate insolvency law. The statutory policy is effected through the preferential debts regime, the 'prescribed part', and (if, as seems likely, *Buchler v Talbot* is legislatively overruled) the liquidation expenses regime. In relation to this policy, this paper has made three principal points.

First, it has examined the way in which the history of the floating charge has been closely intertwined with that of statutory redistribution in corporate insolvency. Against this context, it is clear that it was the statutory regime which provided the pressure for the constant litigation that has gradually hardened the juridical concept of the floating charge. The history of this litigation is that of sophisticated creditors seeking to adjust their affairs so as to fall outside the ambit of the statutory scheme. It appears that in so doing, they were remarkably successful, given the relatively low returns to preferential creditors. The House of Lords' decision in *Spectrum* has closed one of the most significant routes by which banks were able to avoid the legislative scheme: the 'fixed charge' over book debts. In the wake of this ruling, it seems likely that companies will now find asset-based receivables finance to be more attractively priced than overdraft lending on the security of a floating charge over receivables.

Secondly, it has been argued that the *ex ante* effect of the statutory scheme on corporate finance is to make the floating charge relatively unattractive as a means of securing lending. The effect of this, which we may expect to be intensified by *Spectrum*, is to engender increased fragmentation in corporate borrowing. For an asset-based lender, with specialist knowledge about a particular asset class, a floating charge is unnecessary: the lender has the necessary expertise to be able to exercise control sufficient for a fixed charge (or outright sale). On the other hand a creditor following a relational approach to lending will gather specialist knowledge about the debtor's business, as opposed to particular assets. It is this type of lender (typically a bank) for whom a floating charge may be the most useful means of taking security over circulating assets. If this cannot be done as cheaply as asset-based finance, because of the statutory 'tax' on floating charges, then small businesses will increasingly turn to invoice discounters and fragment further their borrowing. This may lead to difficulties in times of financial distress, when a single concentrated lender would be able to make the best-informed and most effective decisions regarding the firm's future.

Thirdly, it has been suggested that the *costs* created by the redistributive scheme (namely, the direct costs of avoidance action, and the opportunity costs of induced changes in corporate finance) are not counterbalanced by any significant *benefits* created by redistributive payments being received by the relevant groups. The case for redistribution in favour of unsecured creditors on the grounds of their 'non-adjustment' is unpersuasive, and even if it is accepted, it appears the position of unsecured creditors may well be worsened by the redistributive scheme. Both the payment of liquidation expenses and the former payment of Crown preference out of floating charge assets gave the recipients incentives to engage in wasteful rent-seeking activity: that is, no social benefit at all resulted from these measures. Employees are the only current recipient group for whom redistribution may create some benefit. However, their more successful cover by payments from the National Insurance Fund suggests that direct payments from the state can be used to achieve the benefits of providing employees with insurance, without the distortive effects and costs of redistribution.

In sum, the scheme of statutory redistribution in English corporate insolvency can hardly be called a success. This paper's analysis consequently provides support for recent calls for the abolition of the distinction between fixed and floating security (Calnan, 2004)—and with it, the redistributive scheme.

Notes

[1] [2005] UKHL 41; [2005] 2 AC 680, HL.

[2] Insolvency Act 1986 ss 40, 175, 386 and Sch 6, Sch B1 para 99(5). Following the Enterprise Act 2002, preferential debts no longer include claims by the Crown in right of unpaid taxes, and so now consist largely of employee claims.

[3] *Ibid*, s 176A.

[4] *Re Barleycorn Enterprises* [1970] Ch 465.

[5] *Buchler v Talbot* [2004] UKHL 9; [2004] 2 AC 298.

[6] Company Law Reform Bill 2005, cl 868.

[7] Incorporation by registration was first made generally available by the Joint Stock Companies Act 1844. Limited liability was made available to shareholders in such companies shortly afterwards: Limited Liability Act 1855. These statutes were later consolidated into the Joint Stock Companies Act 1856, which also laid the foundations of modern corporate insolvency law. See generally Gower (1992: 37-47).

[8] Companies Clauses Act 1845, s 38. This Act contained a set of default provisions for special Acts of Parliament incorporating enterprises.

[9] Some examples can be found amongst reported cases: see, eg, *Re General South American Co* (1876) 2 Ch D 337 at 338 (debentures issued in 1874); *Re Horne and Hellard* (1885) 29 Ch D 736, 739 (debentures issued in 1874).

[10] See eg *Re Marine Mansions Co* (1867) LR 4 Eq 605 at 609. The idea that such a term would be implied was based on thinking at the time in relation to general mortgages of personalty by individuals. Gregory and Walton (2001: 130-135, 144-146) argue that, rather than reflecting a timeless certainty, it can be traced to a single heretical decision (*Graham v Chapman* (1852) 12 CB 85).

[11] As in *Gardner v London, Chatham & Dover Railway Co* (1867) LR 2 Ch App 201, the leading decision on the interpretation of charges created in the form prescribed by the Companies Clauses Act 1845. This case created what a *Times* editorial two months later described as 'panic' in the investment community: *The Times*, 23 March 1867, 9.

[12] *Re Florence Land Co* (1878) 10 Ch D 530; *Re Colonial Trusts* (1879) 15 Ch D 465.

[13] *Gaskell v Gosling* [1896] 1 QB 669, 692-95.

[14] (1889) 42 Ch D 402.

[15] Two other significant steps were: (i) Jessel MR's ruling, in *Re Crumlin Viaduct Works Co* (1879) 11 Ch D 755, that the bankruptcy doctrine of 'reputed ownership'—which would have rendered such a charge vulnerable—did not

apply in company liquidations; and (ii) the Court of Appeal's decision, in *Re Standard Manufacturing Co Ltd* [1891] 1 Ch 627, that company charges were not registrable under the Bills of Sale Act 1878, the requirements of which would have made floating security impossible.

[16] These were located using *The Times Digital Archive*, which permits full-text searches of all content from 1785-1985.

[17] Classified Advertising, *The Times*, 4 March 1880, 13.

[18] Money-Market and City Intelligence, *The Times*, 10 March 1880, 6.

[19] They relied on the Companies Clauses Act power to grant mortgages of their 'undertaking': see above, nn 10-11.

[20] (1876) 2 Ch D 337 at 341-43.

[21] [1896] 2 Ch 212.

[22] Preferential Payments in Bankruptcy Amendment Act 1897, s 2.

[23] See, eg, Hansard, *Parliamentary Debates* (4th Series), 60 Vict., Vol XLVI (10 February 1897), 86 Col 2, 87 Col 1 (Sir Robert Findlay, Solicitor General).

[24] *Ibid*, 83 Col 1 (Mr Alfred Hopkinson MP).

[25] *Ibid*, 73 Col 1 (Mr George Kemp MP).

[26] [1897] AC 22 at 53.

[27] Companies were required to keep a register of charges at their place of business (Companies Act 1862 s 43), but only existing (as opposed to potential) creditors or members were entitled to look at the register: *Wright v Horton* (1887) 12 App Cas 371, 376.

[28] Companies Act 1900, s 14. See Editorial, *The Times,* 19 February 1900, 11.

[29] Companies Act 1907, s 13. See generally Bennett (2003: 183-184).

[30] See 'Legal Snags for the Liquidator', *The Times*, 23 November 1974, 20; 'The Rich Rewards of Insolvency', *The Times*, 5 October 1984, 22.

[31] [1970] Ch 465.

[32] [1941] Ch 129. It was followed in *Re Christonette International Ltd* [1982] 1 WLR 1245.

[33] *Re Woodroffes (Musical Instruments) Ltd* [1986] Ch 366, 374 (a concession); *Re Brightlife Ltd* [1987] Ch 200, 214-215.

[34] Insolvency Act 1986 s 251. This change was introduced by Insolvency Act 1985 s 108(3).

[35] [1979] 1 Lloyds Rep 142.

[36] [1987] Ch 200.

[37] At 209.

[38] The story of *Re New Bullas Trading Ltd* [1994] 1 BCLC 485 is too well-known to be repeated here. See generally, *Agnew v CIR* [2001] UKPC 28; [2001] 2 AC 710 at [29]-[35]; Worthington (1997).

[39] [2001] 2 AC 710.

[40] [1987] Ch 200, 210.

[41] Insolvency Act 1986 s 176A; Insolvency Act (Prescribed Part) Order 2003, SI 2003/2097. The precise amount is 50 per cent of the first £10,000 of 'net property' (that is, assets otherwise available to satisfy a floating charge holder, net of preferential claims), then 20 per cent of the rest, up to a global maximum payment of £600,000. This maximum would be achieved for net property worth a total of just under £3m.

[42] The *quid pro quo* is not, however, immediate. Owing to concerns about the application of the Human Rights Act 1998, the operation of the 'prescribed part' and the abolition of receivership are purely prospective: that is, they apply only to floating charges created after 15 September 2003. The abolition of Crown preference, however, applies in respect of all floating charges. Thus lenders with security taken before the commencement date stand to receive a windfall.

[43] Insolvency Act 1986 s 72A. Administrative receivership will, however, remain open to creditors with floating charges created prior to 15 September 2003. Even for subsequent charges, there are a number of 'carve-outs' from the prohibition, relating to amongst other things to capital market arrangements, public-private partnerships and project finance structures: *ibid*, ss 72B-72H. See generally Armour and Mokal (2005).

[44] Insolvency Act 1986, Sch B1, para 14.

[45] *Ibid*, paras 3, 4, 70, 99.

[46] [2004] UKHL 9; [2004] 2 AC 298.

[47] Company Law Reform Bill 2005, cl 868.

[48] Whilst the prescribed part is taken from *part of* the secured creditor's recoveries, as opposed to coming *in advance of* them (as the Crown preference formerly did), it is clearly anticipated that the impact on banks of the change will be neutral. The amount of the prescribed part will be adjusted, if necessary, to ensure this: see Insolvency Service (2005: 10-11).

[49] See Insolvency Act 1986, Sch B1 para 14; *Re Croftbell Ltd* [1990] BCLC 844.

[50] Insolvency Act 1986 s 251. The fact that a lender is exercising control in order to protect its interests as such is not sufficient, without more, to constitute it as a shadow director (*Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch) at [1267]); the question will depend on whether the cumulative pattern of conduct (*ibid* at [1609]) is such that the lender has become the 'locus of effective

[corporate] decision making': *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340 at 354.

[51] The line is very fine indeed where the 'sale' is effected on a recourse basis: see *Re George Inglefield Ltd* [1933] Ch 1, 12, 22-23, 24-26, 27-28.

[52] On the use of this terminology, see the website of the Factors and Discounters Association: http://www.factors.org.uk/public/faq.asp.

[53] The line of least resistance for an overdraft lender wishing to convert their arrangement to 'invoice discounting' would be to use documentation providing for a global assignment of receivables, as opposed to more onerous individualised approval of receivables. This would, however, run a real risk of being characterized as a charge: see *Motor Trade Finance Ltd v HE Motors Ltd* (HL, unreported, discussed in *Re George Inglefield* [1933] Ch 1, 20-21); *Re Kent and Sussex Sawmills Ltd* [1947] 1 Ch 177, 179-180; *Orion Finance v Crown Financial Management* [1996] 2 BCLC 78, 84-85.

[54] Such as the moratorium on the enforcement of security imposed in administration proceedings: Insolvency Act 1986 Sch B1, para 43.

[55] Were the existing lender not granted priority, the new lender would be able to poach, as its cushion against default, part of the 'cushion' of assets which protected the earlier lender against the risk of default. The competitive interest rate required for the second loan would therefore be commensurately lower. In effect, the firm would have been able to secure finance at less than the competitive rate by expropriating the earlier creditor.

[56] The impact on debt capacity could be interpreted either as an interest rate reduction from the secured creditor, or, in a market characterised by credit rationing owing to adverse selection problems (Stiglitz and Weiss, 1981), an increase in the amount of credit offered.

[57] One of the reasons such arrangements are employed is to avoid difficulties that might be encountered with negative pledges granted to banks, were 'traditional' security to be taken by asset financiers.

[58] Strictly speaking, of course, title retention involves a retention of outright ownership, rather than a grant of an interest by way of security: see, eg, *Armour v Thyssen* [1991] 2 AC 339, 352-354.

[59] The circumstances under which the moratorium in administration proceedings will not be lifted approximate to the situations in which such synergies exist. See, eg, *Re Atlantic Computer Systems plc* [1990] BCC 859, 880-882.

[60] This provides a rationalisation of the courts' approach to the characterization of extended retention of title clauses, which, in England and Wales at least, have universally been held to create charges rather than outright beneficial ownership.

In practical terms this limits the trade creditor's priority to the original goods.

[61] Tort victims are also often said to constitute a class of 'non-adjusting' creditor. However, their interests are well-protected in the UK through systems of mandatory insurance for the most empirically significant categories of tort claim, coupled with the Third Parties (Rights Against Insurers) Act 1930, which transfers to the injured party an insolvent company's claim against the insurer. Moreover, the author conducted interviews with approximately 20 Insolvency Practitioners during 1999-2000 (Armour and Frisby, 2001: 102), amongst other things asking subjects whether they had ever had to deal with significant tort liabilities in relation to a case they had conducted. No subject was able to remember a single case where this had occurred.

[62] Mokal claims that the low level of recoveries for preferential creditors, which in turn imply even lower recoveries for the floating charge holder, is evidence of the floating charge's lack of utility in protecting the interests of the secured creditor. In contrast, this paper's argument is that this pattern of recoveries is rather evidence of banks' success in structuring their lending so as to have as few assets as possible within the floating charge and therefore liable to redistribution. Moreover, the pattern of recoveries can tell us little about the floating charge's *potential* usefulness in protecting the chargee's interests in a world where it is not subjected to such redistribution.

[63] *Wheatley v Silkstone & Haigh Moor Coal Co* (1885) 29 Ch D 715, 724; *English and Scottish Mercantile Investment Co v Brunton* [1892] 2 QB 700, 711.

[64] From the financier's point of view, 'quality' here means the probability that payment will be made by the receivable debtor.

[65] This monitoring might occur in the context of an arrangement whereby the debtor must request approval of finance against individual receivables, or batches of receivables. Alternatively, there might be a single general agreement to fund the borrower's sale ledger, in which case the financier's specialist knowledge will have been used at the outset in scrutinising the quality of the borrower's sales book, and will continue to be used in ongoing monitoring of the quality of the debts.

[66] To be sure, a basic floating charge would permit a debtor to use the charged assets 'in the ordinary course of business', words which have been interpreted to include unusual transactions designed to save the business from failure (see *Ashborder BV v Green Gas Power Ltd* [2004] EWHC 1517 (Ch); [2005] 1 BCLC 623 at [192]-[227]). However, additional restrictions—for example on sale or assignment of book debts—can of course be drafted into the security agreement, as can provisions for automatic crystallisation on specified conduct (see *Fire Nymph Products Ltd v Heating Centre Pty Ltd* (1992) 7 ACSR 365).

The most powerful control, however, comes from the lender's threat—where the finance is coupled with an overdraft—to terminate, on demand, the company's power to deal.

[67] This combination is preferred to a general ('entire undertaking') floating charge by itself, because the latter would not offer the relationship lender sufficient protection from the possibility of having its priority subsequently downgraded by the subsequent grant of fixed charges over specific assets to other lenders.

[68] A second floating charge over the same assets will rank behind the earlier one: *Re Benjamin Cope & Sons Ltd* [1914] 1 Ch 800, 806-807; *Re Automatic Bottlemakers Ltd* [1926] Ch 412, 423.

[69] This is not to say that relationship lenders such as banks will not take floating charges. On the contrary, it is likely to continue to be worthwhile for them to take a 'lightweight' charge in order to be able to control the appointment of an administrator. Rather, the prediction is that they will not *lend significant sums on the security of such charges*, because of liability to fund statutory redistribution. Their unwillingness to do so, coupled with their inability to take fixed security over book debts, will lead to companies turning to invoice discounting instead.

[70] As between the two, it seems appropriate that asset-based financiers should take priority (as they generally do): in focusing their attention on particular assets, it is more fundamental to their lending strategy than is general priority for relationship lenders: see Picker (1999).

[71] It is well-known that for larger firms, more heterogeneous capital structures are associated with a lower probability of successful workouts: see, eg, Chatterjee *et al* (1996).

[72] Insolvency Proceedings (Monetary Limits) Order 1986, SI 1986/1996, art 4.

[73] Part XII (ss 182-190).

[74] The amount is £280 per week, up to a maximum of 8 weeks: that is, £2240 per employee: Employment Rights Act 1996 s 186(1)(a), as amended by Employment Rights (Increase of Limits) Order 2004, SI 2004/2989, art 3.

[75] *Ibid*, s 189.

[76] A desire on the part of the judiciary to avoid this outcome under the previous version of the rules lead to considerable complexity in the law: see *Re MC Bacon Ltd (No 2)* [1991] Ch 127; Armour and Walters (2006).

[77] Insolvency (Amendment) (No 2) Rules 2002, SI 2002/2712, modifying Insolvency Rules 1986 r 4.218(1)(a).

[78] [1970] Ch 465, 475-476.

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