

THE FLOATING LIEN AND THE PREFERENCE CHALLENGE: SOME GUIDANCE FROM THE ENGLISH FLOATING CHARGE

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I. INTRODUCTION

England has been wrestling with floating charge problems for ninety-seven years, and this experience may be helpful in dealing with the developing conflict between the U.S. Bankruptcy Act¹ and the floating lien provisions of the Uniform Commercial Code. The English floating charge and the American floating lien have nearly identical characteristics. Both security clauses may encompass all or any part of the debtor's assets, including assets acquired after the date the security is created. The collateral may be used as security for past, present, and future advances by the creditor. The debtor can pass good title to the encumbered assets to a bona fide purchaser for value in the ordinary course of business prior to the commencement of insolvency proceedings.

An examination of both the English and American treatment of the problem makes it obvious that there can be no assurance that a floating charge or lien will provide satisfactory collateral. In England, the courts and Parliament have imposed so many restrictive preference and priority rules that the floating charge has been substantially emasculated. In the United States, there have not been enough authoritative decisions to reach any conclusions as to the interaction of the Bankruptcy Act and the Code. Articles on this subject vary greatly in their suggestions and offer no real solution to the confused lender.²

The central issue in the Bankruptcy Act-Commercial Code conflict is whether the floating lien is prejudicial to the interests of unsecured creditors. At the time of bankruptcy, there is an irreconcilable conflict between the floating lien creditor and the general creditor, but it is submitted that this is not the proper time to recognize the existence of a conflict. The appropriate time is the date of the creation and perfection of the floating lien. Most credit men are very pessimistic about the position of the general creditor in bankruptcy and this pessimism is supported by experience. Therefore, even assuming that a debtor

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¹ 30 Stat. 544 (1898), as amended, 11 U.S.C. §§ 1-1103 (1964).

² See Comment, *The Code in the Bankruptcy Courts: Some Significant Conflicts of Policy*, 8 B.C. Ind. & Com. L. Rev. 101 n.3 (1966), for a compilation of some of these articles. It should be noted that although there are still no authoritative decisions, there has been a referee's decision which has caused a great deal of concern. In *re Portland Newspaper Publishing Co.*, 2 Bankr. L. Rep. (4th ed.) ¶ 61722 (D. Ore. Feb. 9, 1966).

was insolvent or in serious business difficulty, it would be reasonable to believe that general creditors would not be opposed to allowing a floating lien at least to the extent of any new funds given and legitimately used by the debtor. It may even be argued that the general creditors would be willing to consent to a floating lien for an amount in excess of new value given, if the floating lien was part of a bona fide effort to keep the business going and avoid bankruptcy.

No general creditor, however, would consent to a floating lien designed to give a fraudulent preference to a creditor. For example, let us assume a fairly common situation. The principal supplier of a company burdened with a large unsecured account discovers that the debtor company is hopelessly insolvent. In order to obtain security and continue profitable operations, the supplier agrees to extend further credit to the debtor upon receipt of adequate security, *i.e.*, a blanket floating lien. The principal supplier should not have to furnish much additional capital to keep the debtor's business going beyond the four-month preference period.³ After that time has passed, the debtor company is thrown into bankruptcy, and the principal supplier receives payment for the bulk of his account from the realization of the collateral. Similar situations can be manipulated by insiders of the insolvent company. These practices constitute blatant fraud. Regardless of the four-month preference period, the lien should be held invalid, and the lien creditor held personally liable to other secured and unsecured creditors for damages resulting from his fraudulent continuation of the business. It is submitted that recognition of this cause of action as a part of the common law tort of fraud⁴ would go a long way toward properly solving the floating lien problem.

Moreover, the economic effect of floating liens must be carefully evaluated in any rational determination of their validity. When a debtor obtains a loan, this usually results in the creation of additional credit. For example, laborers will work, tax liability will accrue, utilities, services, and goods will be supplied, all as a result of the debtor's apparent solvency. A large portion of this credit may be classified as nonconsensual; that is, the extension of credit was not a conscious extension of credit. No system of recording or notice will protect this class of creditors, and it is at least arguable that this class of creditors, which is in effect created or enlarged by the floating lien creditor, is entitled to some protection. Obviously, additional credit is created

³ The four-month preference period refers to the statutory provision that one of the prerequisites for a creditor to achieve "preferred" status is that the transfer be "made or suffered . . . within four months before the filing by or against [the debtor] . . . of the petition initiating a proceeding [in bankruptcy] . . ." Bankruptcy Act § 60(a)(1), as amended, 64 Stat. 25 (1950), 11 U.S.C. § 96(a)(1) (1964).

⁴ See pp. 254-55 *infra*.

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by a secured loan, but it would appear that a floating lien would create the greatest possible additional credit. It would create more credit than a pledge, because the floating lien debtor would have both the collateral and the loan to use in his business, whereas the pledge debtor would have only the loan. A floating lien would create more credit than a security interest in the nature of a chattel mortgage or similar device because of the right of the floating lien debtor to freely dispose of the collateral. Furthermore, the floating lien, while creating the greatest credit, makes it most unlikely that the nonconsensual creditors will be paid in the event of insolvency, because the floating lien creditor will take all of the debtor's assets as collateral.

Certainty in commercial law is itself a virtue, and it is essential that the problem of the validity of the floating lien be resolved. Public policy, however, may well dictate the necessity of some definite limitation on the scope of the floating lien.

II. THE AMERICAN FLOATING LIEN

A. *The Bankruptcy Act*

The most basic problem arising with respect to the floating lien involves the preference provisions of Section 60(a) of the Bankruptcy Act.⁵ The act provides that if the trustee in bankruptcy can carry his burden of proof on the following elements, the preference is voidable: (1) a transfer of the debtor's property; (2) to or for the benefit of a creditor; (3) for an antecedent debt; (4) by an insolvent debtor, the creditor having reasonable cause to believe the debtor is insolvent; (5) within four months of bankruptcy; (6) having the result of giving the creditor a greater percentage of his claim than another creditor of his class.

The controversy over the validity of the floating lien focuses on whether after-acquired collateral is given for an antecedent debt. The Bankruptcy Act does not define antecedent debt, but it could be argued that any collateral acquired more than twenty-one days after creation of the lien can be considered to have been given for an antecedent debt.⁶ If *In re Portland Newspaper Publishing Co.*⁷ is not followed by the federal courts, or if section 60 is amended to allow the floating lien, then section 9-108 of the Code can be given effect and the floating lien will survive the voidable preference provisions. In the

⁵ 64 Stat. 25 (1950), 11 U.S.C. § 96(a)(1) (1964).

⁶ Bankruptcy Act § 60(a)(7)(1), as amended, 64 Stat. 26 (1950), 11 U.S.C. § 96(a)(7)(1) (1964).

⁷ 2 Bankr. L. Rep. (4th ed.) ¶ 61722 (D. Ore. Feb. 9, 1966). In this case, the first to find the Code in conflict with the Federal Bankruptcy Act, the referee refused to apply § 9-108 of the Code, and thus the floating lien in question was defeated by the preference provisions of the Bankruptcy Act.

past, however, courts have favored an interpretation of the Bankruptcy Act which provided the most equal distribution among creditors, even if it was necessary to strain the proper literal meaning of the act.⁸ So far, there have not been any authoritative appellate court cases to resolve this problem, and only four recent decisions appear to bear any relation to the subject.⁹ There were a number of pre-Code cases in which liens containing after-acquired property clauses were upheld in bankruptcy.¹⁰ However, the floating lien provisions of the Code have substantially diluted the applicability of these cases.

The Bankruptcy Act also sets forth a policy opposed to equitable liens.¹¹ Section 9-204 of the Code, however, states that a floating lien is not merely an equitable interest, because, as official comment 2 explains, the secured party is not required to take any further action, "such as the taking of a supplemental agreement covering the new collateral"

B. *Uniform Commercial Code Provisions*

The valid use of after-acquired property clauses and future advance clauses is made possible by three sections of the Code—9-108, 9-204, and 9-205. Section 9-108 provides that after-acquired property taken in the ordinary course of business shall be deemed to be taken for new value if new value was given when the lien was created. Furthermore, under section 9-205 it is no longer necessary to police the collateral in order to have a valid security interest.¹² There may, however, be some difficulty in bankruptcy if the assets are not policed. In striking down section 9-108, the referee in *Portland* said that the problem would have been avoided if the accounts in question had been policed.¹³ It is too early to predict whether this opinion will be accepted in the federal courts, but if it is, policing will again become the most overrated detail of commercial law.

⁸ See, e.g., *Moore v. Bay*, 284 U.S. 4 (1931); *Constance v. Harvey*, 215 F.2d 571 (2d Cir. 1954).

⁹ In re *Portland Newspaper Publishing Co.*, supra note 7; *Howarth v. Universal C.I.T. Credit Corp.*, 203 F. Supp. 279 (W.D. Pa. 1962); In re *Newkirk Mining Co.*, 1 U.C.C. Rep. 468 (E.D. Pa. 1962); *Erb v. Stoner*, 19 Pa. D. & C.2d 25 (1959).

¹⁰ See, e.g., *Union Trust Co. v. Bulkeley*, 150 Fed. 510 (6th Cir. 1907); *Matter of Hayes*, 140 F. Supp. 444 (D. Alaska 1956); In re *Comet Textile Co.*, 15 F. Supp. 963 (S.D.N.Y. 1936); In re *Alabama Braid Corp.*, 13 F. Supp. 336 (N.D. Ala. 1935). But see *Corn Exchange Nat'l Bank & Trust Co. v. Klauder*, 318 U.S. 434 (1943). For further discussion, see Friedman, *The Bankruptcy Preference Challenge to After-Acquired Property Clauses Under the Code*, 108 U. Pa. L. Rev. 194 (1959).

¹¹ Bankruptcy Act § 60(a)(6), as amended, 64 Stat. 25 (1950), 11 U.S.C. § 96(a)(6) (1964).

¹² According to official comment 1, U.C.C. § 9-205 specifically "repeals the rule of *Benedict v. Ratner*, 268 U.S. 353 (1925) . . . and other cases which held such arrangements void as a matter of law because the debtor was given unfettered dominion or control over the collateral."

¹³ In re *Portland Newspaper Publishing Co.*, supra note 7, at 71136.

Section 9-204 contains key provisions involved in the preference problem. In order to have a security interest which will be recognized in an insolvency proceeding, the security interest must be perfected,¹⁴ and before it can be perfected, it must "attach."¹⁵ "A security interest cannot attach until there is agreement . . . that it attach and value is given and the debtor has rights in the collateral."¹⁶ This last requirement makes it appear that all collateral received after the lien is perfected becomes security for an antecedent debt. This requirement also makes it difficult to argue that the collateral relates back to the date the lien was created, or that the debtor was assigning an expectancy in the collateral at the time of the original security agreement, or that the collateral, although constantly changing, is really a single res.¹⁷

Section 9-108 provides:

Where a secured party makes an advance, incurs an obligation, releases a perfected security interest, or otherwise gives new value which is to be secured in whole or in part by after-acquired property his security interest in the after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt if the debtor acquires his rights in such collateral either in the ordinary course of his business or under a contract of purchase made pursuant to the security agreement within a reasonable time after new value is given.

This section was obviously drafted for the sole purpose of avoiding the preference provisions of Section 60(a) of the Bankruptcy Act. If section 9-108 were interpreted to mean that if any new value is given initially, the entire floating lien will be upheld, it will conflict directly with section 60(a) and the entire floating lien can be struck down.¹⁸ If, however, it were interpreted to save security interests only to the extent that new value was actually given at the time of creation and thereafter, there could be no reasonable objection to the validity of section 9-108.

III. THE ENGLISH FLOATING CHARGE

*A. General Nature of the Floating Charge*¹⁹

The first English case upholding a floating charge was decided in 1870,²⁰ and, in the ninety-seven years since that decision, the En-

¹⁴ U.C.C. § 9-301.

¹⁵ U.C.C. § 9-303.

¹⁶ U.C.C. § 9-204(1).

¹⁷ See *Manchester Nat'l Bank v. Roche*, 186 F.2d 827 (1st Cir. 1951).

¹⁸ See *In re Portland Newspaper Publishing Co.*, supra note 7.

¹⁹ For a more complete discussion of the general nature of a floating charge, see Gower, *Modern Company Law* 73-75, 389-93 (2d ed. 1957); Palmer, *Company Law* 399-405 (20th ed. 1959).

²⁰ *In re Panama, New Zealand & Australian Royal Mail Co.*, L.R. 5 Ch. 318 (1870).

glish courts and Parliament have considered many of the problems which have now been raised in the United States by the Uniform Commercial Code's floating lien. A floating charge is a security device covering either all or a specific part of the property and assets of the debtor both presently owned and thereafter acquired. The charge may be given to secure past indebtedness, current loans, and future advances. All types of tangible and intangible personal property may be validly included as collateral, although when real estate is made a part of a floating charge, land registry laws must be complied with. Thus, it can be seen that the floating charge is basically very much like the American floating lien.

The floating charge, of course, constitutes a radical departure from the possessory pledge and its progeny, which require specific existing collateral and detailed description.²¹ It is therefore not surprising to discover that the floating charge was developed in equity. In one case, Lord Macnaghten declared:

A floating security is an equitable charge on the assets for the time being of a going concern. It attaches to the subject charged in the varying condition in which it happens to be from time to time. It is of the essence of such a charge that it remains dormant until the undertaking charged ceases to be a going concern, or until the person in whose favour the charge is created intervenes.²²

The historical source of the floating charge, and the dormant nature of a floating security before it becomes fixed, may be extremely relevant considerations in determining whether a floating lien would be treated as an unattached equitable lien under the Bankruptcy Act. There can be no doubt that a floating lien is dormant in the sense that the debtor is free to deal with the collateral in the ordinary course of his business until he defaults and the secured party takes action.

The English floating charge is available only to incorporated companies²³ and farmers.²⁴ An individual debtor may not give a floating charge on personal property, because personal property security devices are controlled by the Bills of Sale Act which requires specific description of collateral, thereby excluding any after-acquired property clauses.²⁵ However, the issuance of debentures by incorporated companies is excepted from the Bills of Sale Act,²⁶ and the Agricul-

²¹ See, e.g., Bills of Sale Act, 1878, 41 & 42 Vict. c. 31.

²² *Government Stock & Other Sec. Inv. Co. v. Manila Ry.*, [1897] A.C. 81, 86.

²³ Bills of Sale Act, 1878, Amendment Act, 1882, 45 & 46 Vict. c. 43, § 17.

²⁴ Agricultural Credits Act, 1928, 18 & 19 Geo. 5, c. 43, § 5.

²⁵ Bills of Sale Act, 1878, Amendment Act, 1882, 45 & 46 Vict. c. 43, § 4. Compare U.C.C. § 9-204(4)(b).

²⁶ Bills of Sale Act, 1878, Amendment Act, 1882, 45 & 46 Vict. c. 43, § 17.

tural Credits Act of 1928 provides that an agricultural charge shall be effective notwithstanding anything in the Bills of Sale Act.²⁷ The justification for excepting debentures of incorporated companies from the Bills of Sale Act has been based on the requirement that all debentures be publicly registered.²⁸ The exception for incorporated companies is very strictly construed, and, therefore, associations incorporated under the Industrial and Provident Societies Act of 1893 are not excluded from the Bills of Sale Act and may not create a valid floating charge on their assets.²⁹ An industrial or provident society may, however, be able to create a valid floating charge on its assets other than personal property, although this does not seem a very important concession.³⁰ It is therefore clear that the English floating charge is available to a rather limited class of debtors. This limitation may be in part due to the historical equitable development of the charge, but it seems more reasonable to attribute the limitation to a policy decision that floating charges should be restricted.

The English courts of equity have been very liberal in their rulings regarding the detail required in the description of collateral in order to create a valid floating charge. In the first floating charge case, it was held that the word "undertaking" constituted a sufficient description.³¹ Subsequent cases supported the proposition that a very general description of collateral was sufficient.³²

The floating charge must be registered with the registrar of companies.³³ This is a "lien" type of filing, requiring particulars of the charge, together with the instrument creating the charge, rather than the "notice" type of filing provided for by the Code.³⁴ Furthermore, the floating charge, if not registered within twenty-one days after its creation, will be completely void and of no effect, even against a subsequent charging creditor who has actual knowledge of the previous floating charge.³⁵ The courts have been liberal in granting extensions of time to complete registration, but they will usually impose the condition that the extension be without prejudice to rights acquired prior to the time when the debentures are actually registered.³⁶ This

²⁷ Agricultural Credits Act, 1928, 18 & 19 Geo. 5, c. 43, § 8(1).

²⁸ *In re Standard Mfg. Co.*, [1891] 1 Ch. 627; Companies Act, 1948, 11 & 12 Geo. 6, c. 38.

²⁹ *Great No. Ry. v. Coal Co-operative Soc'y*, [1896] 1 Ch. 187; Industrial and Provident Societies Act, 1893, 56 & 57 Vict. c. 39.

³⁰ *In re North Wales Produce & Supply Soc'y, Ltd.*, [1922] 2 Ch. 340.

³¹ *In re Panama, New Zealand & Australian Royal Mail Co.*, *supra* note 20.

³² See, e.g., *In re Colonial Trusts Corp.*, 15 Ch. D. 465 (1880); *In re Florence Land & Pub. Works Co.*, 10 Ch. D. 530 (1879).

³³ Companies Act, 1948, 11 & 12 Geo. 6, c. 38, § 95(1).

³⁴ U.C.C. § 9-402, Comment 2.

³⁵ *In re Monolithic Bldg. Co.*, [1915] 1 Ch. 643.

³⁶ *In re Joplin Brewery Co.*, [1902] 1 Ch. 79.

proviso in an extension order apparently benefits only subsequent secured creditors and not general creditors.³⁷ However, if liquidation takes place during the extension period and prior to registration, general creditors will prevail, and holders of the unregistered floating charge will not be treated as secured creditors.³⁸ Registration of a floating charge gives constructive notice of its existence, but not of restrictions on the creation of subsequent charges which may be contained in the registered floating charge.³⁹ Furthermore, actual knowledge of the existence of the floating charge does not constitute notice of any restrictions on the creation of subsequent charges.⁴⁰ It is, therefore, obvious that the registration and notice provisions restrict and weaken the efficacy of the floating charge, and thus further support the policy of limiting the scope and effectiveness of floating charges.

B. *Bankruptcy*

In addition to the restrictions contained in the Bills of Sale Act, a provision of the English Bankruptcy Act of 1914 makes the floating charge totally ineffective in the event of bankruptcy. Section 38 of the English Bankruptcy Act provides, in part, that the property of the bankrupt which is divisible among his creditors shall include:

(c) All goods being, at the commencement of the bankruptcy, in the possession, order or disposition of the bankrupt, in his trade or business, by the consent and permission of the true owner, under such circumstances that he is the reputed owner thereof; provided that things in action other than debts due or growing due to the bankrupt in the course of his trade or business shall not be deemed goods within the meaning of this section.⁴¹

The reputed ownership requirement would, if not rendered inapplicable, eliminate the effectiveness of floating charges in all insolvency situations.

The reason that the reputed ownership provisions of the English Bankruptcy Act do not emasculate floating charges created by incorporated companies is that insolvent limited companies are not liquidated pursuant to the act, but instead are subject to the winding up provisions of the Companies Act.⁴² The respective rights of secured and unsecured creditors in the winding up of an incorporated com-

³⁷ *In re Kris Cruisers Ltd.*, [1949] 1 Ch. 138.

³⁸ *In re Anglo-Oriental Carpet Mfg. Co.*, [1903] 1 Ch. 914; *In re S. Abrahams & Sons*, [1902] 1 Ch. 695.

³⁹ *Wilson v. Kelland*, [1910] 2 Ch. 306.

⁴⁰ *English & Scottish Mercantile Inv. Co. v. Brunton*, [1892] 2 Q.B. 700.

⁴¹ Bankruptcy Act, 1914, 4 & 5 Geo. 5, c. 59, § 38(c).

⁴² Companies Act, 1948, 11 & 12 Geo. 6, c. 38, §§ 211-365.

pany are controlled by the rules and laws of bankruptcy;⁴³ however, it has been held that the reputed ownership rules of Section 38 of the Bankruptcy Act do not apply to the winding up of a limited company.⁴⁴

The reputed ownership provisions do not apply to agricultural floating charges by virtue of the Agricultural Credit Act of 1928, which provides:

Farming stock subject to an agricultural charge shall not, for the purposes of section thirty-eight of the Bankruptcy Act, 1914, be deemed to be goods in the possession, order, or disposition of the farmer, in his trade or business, by the consent and permission of the true owner thereof, under such circumstances that he is the reputed owner thereof.⁴⁵

The purpose and drafting of the foregoing section are very similar to that of Section 9-108 of the Uniform Commercial Code. The effectiveness of the two sections, however, may well be quite different. The subsection from the Agricultural Credits Act is a subsequent enactment by the same legislative body that enacted the Bankruptcy Act, and there can be no question that it would effectively modify the Bankruptcy Act. On the other hand, section 9-108, enacted by state legislatures, will probably have little effect on federal bankruptcy law, especially in the light of the supremacy doctrine. Of course, this problem could be resolved by a specific congressional action, either affirming or rejecting the rule contained in section 9-108.

C. Preferences

The English bankruptcy rules and laws support the apparent policy of restricting and limiting floating charges. Further evidence of this policy of limitation can be found in the provisions relating to preferences and priorities with respect to floating charges created by incorporated companies. Section 322 of the Companies Act of 1948, for example, limits the creation of floating charges and affords some protection to the general creditor:

When a company is being wound up, a floating charge on the undertaking or property of the company created within twelve months of the commencement of the winding up shall, unless it is proved that the company immediately after the creation of the charge was solvent, be invalid, except to

⁴³ Companies Act, 1948, 11 & 12 Geo. 6, c. 38, § 317.

⁴⁴ *Gorringe v. Irwell India Rubber & Gutta Percha Works*, 34 Ch. D. 128 (1887).

⁴⁵ Agricultural Credits Act, 1928, 18 & 19 Geo. 5, c. 43, § 8(4).

the amount of any cash paid to the company at the time of or subsequently to the creation of, and in consideration for, the charge, together with interest on that amount at the rate of five per cent per annum or such other rate as may for the time being be prescribed by order of the Treasury. . . .⁴⁶

This section differs from Section 60(a) of the American Bankruptcy Act in several respects. For one thing, the relevant period of time preceding insolvency proceedings is one year in section 322 compared to four months in section 60(a). It should be noted that the English act originally provided for a period of three months prior to winding up, later expanded to six months, and then, in 1948, extended to one year.⁴⁷ The reason for the increases was obviously to combat the fraudulent practice of creating the charge and then keeping the business alive for the preference period. In addition, the English courts define insolvency as the inability to pay one's debts as they become due,⁴⁸ rather than an excess of liabilities over assets. Furthermore, the burden of proof on the solvency issue rests on different parties. In England, the burden rests on the floating charge creditor to prove the company solvent at the time the charge was created, whereas in the United States the burden would rest on the trustee in bankruptcy to prove insolvency at the time the preferential transfer occurred.

It should also be noted that in the United States a transfer is either wholly void or wholly valid insofar as the preference section is concerned. There is no provision like Section 322 of the English Companies Act, which permits a court to find part of a floating charge invalid as a preference, while at the same time upholding the charge to the extent of new consideration actually given at the time of the creation of the charge and thereafter. The same unitary approach is taken by section 9-108 of the Code as is taken by the American Bankruptcy Act. Section 9-108 provides that if any new value is given at the time of the creation of the floating lien, then the lien shall be treated as entirely valid and construed as though new value had been given for any after-acquired property. The section does not limit the validity of the lien on after-acquired property to the amount of the new value given.

The result reached through Section 322 of the English Companies Act seems infinitely superior to the results reached either by those who advocate treating floating liens as preferences or by those who, by virtue of section 9-108, would treat all floating liens as valid *in toto* if any new value were given. The real purpose of the preference sec-

⁴⁶ Companies Act, 1948, 11 & 12 Geo. 6, c. 38, § 322.

⁴⁷ See Gower, *op. cit.* *supra* note 19, at 393.

⁴⁸ *In re Patrick & Lyon, Ltd.*, [1933] 1 Ch. 786.

tions is to prevent a creditor from improperly obtaining a secured position, after insolvency, for an antecedent debt. There is justifiable animosity among general creditors to insolvency proceedings, because they rarely acquire much in bankruptcy.⁴⁹ If, however, the floating lien is given effect, under the Bankruptcy Act, only to the extent of new value actually given, the general creditors should have no legitimate objection to this. On the other hand, the general creditors have a perfectly valid objection to a system which favors a lien to the extent it is given to secure antecedent indebtedness. It certainly seems reasonable to assume that most general creditors would have given their consent to a lien to the extent of new value advanced if they had been asked at the time the lien was perfected, which seems to be the relevant time for inquiry.

Since insiders and large creditors are in positions to effectuate the continued operation of an insolvent company, the longer English preference period of one year seems more desirable. Furthermore, placing the burden of proof of solvency on the charging creditor seems to conform more with reality and with the policy of the preference provisions, which is certainly a desirable policy. While section 322 does not provide a complete answer to the problem, it is a step in the right direction.

The exclusion from the English preference section of the amount of any cash paid at the time of, or subsequent to, the creation of the charge raises the familiar problems of when payment is in fact made and when value is given. The English floating charge cases apply the Rule in Clayton's Case, to wit, the doctrine of "first in, first out."⁵⁰ Thus, if a creditor advances money against a floating charge to a debtor who already owes the creditor money for an antecedent debt, and the debtor then repays the creditor a portion of the total amount owed, the antecedent debt would be the first repaid because of the doctrine of "first in, first out." This is so even if the subsequent advances by the creditor did not equal or exceed payments made by the debtor. In this situation, section 322 would be satisfied even though the basic amount of the antecedent debt was constantly maintained because of the subsequent advances. Although the "first in, first out" rule conforms with business practices, the application of the rule could be abused, and should, therefore, be circumscribed by a requirement that the floating charge be a legitimate transaction entered into in good faith. Thus, in *In re Yeovil Glove Co.*,⁵¹ the court properly applied the "first in, first out" rule to a situation in which the creditor bank was

⁴⁹ See Comment, *supra* note 2, at 112 n.71.

⁵⁰ See, e.g., *In re Yeovil Glove Co.*, [1965] 1 Ch. 148; *In re Primrose (Builders) Ltd.*, [1950] Ch. 561.

⁵¹ [1965] 1 Ch. 148.

making legitimate advances to the debtor. However, the facts of the case illustrate how a fraudulent charging creditor could avoid Section 322 of the Companies Act if there were not a good-faith limitation. In *Yeovil Glove*, the creditor bank received £1,000 more in payments from the debtor than it advanced after creation of the floating charge. To reduce this to its simplest form, assume that an insolvent debtor owes a creditor one hundred pounds prior to the creation of a floating charge. When the floating charge is created, creditor pays debtor one hundred pounds in cash, and debtor immediately pays creditor for the antecedent debt. One well-reasoned English decision has indicated that such a transaction would not constitute cash payment, because the cash was not paid in good faith for the benefit of the debtor.⁵²

The preference provisions, however, may not be sufficient to combat all of the possible abusive and fraudulent uses of floating security devices. It may be possible for an insider or major creditor to maintain company operations for a period longer than that provided in the applicable preference section. This is especially true in the United States where the preference period is only four months. In *In re Patrick & Lyon, Ltd.*,⁵³ the applicants sought a declaration that the charging creditor, an insider, was personally liable for all of the debts of the corporation on the theory that he fraudulently created floating charges for the purpose of continuing the operation of an insolvent business, to the detriment of the creditors. The fraud theory was based in large part on provisions of the English Companies Act,⁵⁴ and the court ruled that actual fraud or intent to defraud had to be proven in order to hold the defendant personally liable. Nevertheless, if all the elements of fraud or misrepresentation could be shown in a case in which a defendant improperly continued the operation of an insolvent business, or improperly and in bad faith created a floating charge or floating lien, it would be perfectly reasonable to declare the floating security invalid, no matter how long it had been in existence, and hold the fraudulent creditor personally liable for the debts of the insolvent debtor. Such a cause of action would serve as an excel-

⁵² *In re Destone Fabrics, Ltd.*, [1941] 1 Ch. 319. But see *In re Mathew Ellis, Ltd.*, [1933] 1 Ch. 458.

⁵³ [1933] 1 Ch. 786.

⁵⁴ Companies Act, 1948, 11 & 12 Geo. 6, c. 38, § 332(1) provides in part:

If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the court, on the application of the official receiver, or the liquidator or any creditor or contributory of the company, may, if it thinks proper so to do, declare that any persons who were knowingly parties to the carrying on of the business in the manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct.

lent complement to a well-drafted preference provision, and would constitute a real deterrent to the fraudulent use of floating charges and floating liens. Thereafter, if an insider or major creditor of an insolvent company created a floating security in order to secure his antecedent debt, and then assisted or permitted the company to continue operations until the preference period was past (resulting in all likelihood in the extension of substantial additional credit by the general creditors) the floating security would be ruled invalid, and the insider or major creditor held personally liable for the debts of the insolvent firm. It would seem that this common law tort cause of action would exist in the United States without any statutory enactment. The recognition of such a cause of action would have a salutary effect on the use of floating liens, and this, coupled with an amended preference section, would provide adequate control of the floating lien, which could then be upheld and given full validity for all its legitimate business purposes.

D. *Priorities*

A study of the English priority rules relating to floating charges is useful for purposes of comparison with the priority rules of the Code,⁵⁵ and also to illustrate another example of the limitations that the English place on floating charges.

In considering priorities on floating charges, it is important to determine when the charge becomes fixed or "crystallized," because it is crucial in answering the question of whether the claim competing with the floating charge attached before or after crystallization. Ordinarily, no claim attaching after the floating charge has become fixed can gain priority over the floating charge. Crystallization occurs, and the floating charge ceases to float and becomes attached to specific assets of the debtor company, when winding up proceedings are begun, when the company stops doing business, or when a receiver is appointed for the debtor company.⁵⁶ Normally, winding up is the event which fixes the floating charge.⁵⁷ Mere demand for payment by the charging creditor, or a notice sent to the debtor's bank, is not enough to crystallize the floating charge.⁵⁸

The floating charge, like the floating lien, permits the debtor company to continue to operate its business in the usual way, using the assets as though they were completely unencumbered. A purchaser in the ordinary course of business takes the assets free and clear of the floating charge. Thus the rules governing the rights of a good-faith

⁵⁵ The Code's priority rules are in §§ 9-307, -308, -309, -310, -312.

⁵⁶ *Edward Nelson & Co. v. Faber & Co.*, [1903] 2 K.B. 367.

⁵⁷ *Wallace v. Universal Automatic Machs. Co.*, [1894] 2 Ch. 547.

⁵⁸ *Evans v. Rival Granite Quarries, Ltd.*, [1910] 2 K.B. 979.

purchaser for value in England and in the United States are very similar.⁵⁹

By statutory enactment, certain taxes and wage claims are given preferred status in winding up proceedings, and such claims, "so far as the assets of the company available for payment of general creditors are insufficient to meet them, have priority over the claims of holders of debentures under any floating charge created by the company. . . ."⁶⁰ This statute expressly recognizes that there are at least two classes of creditors whose interests and rights are in conflict with holders of floating charges, and who should be given priority over the charges.⁶¹ These creditors would not ordinarily examine registrations, and they, together with other suppliers of goods and services, would be induced to give more credit as a result of the funds furnished pursuant to the floating charge which permits continuation of the business. It seems to be a perfectly legitimate approach to the floating charge or floating lien problem, especially in light of the special characteristics of such security devices, to determine if the rights of any class of persons are being destroyed by the creation of the floating security. Certain classes of creditors may be given priority as a matter of public policy. It would be desirable at least to consider whether floating liens do in fact thwart the legitimate rights or expectations of anyone.

Neither the "first to file" rule of priority,⁶² nor the "first to perfect" rule,⁶³ is applicable in England when a conflict arises as to priority between a floating charge and a subsequent charge placed on the assets of the debtor company. Ordinarily a subsequent specific charge will take priority over a general floating charge.⁶⁴ This is true even though the subsequent creditor had knowledge of the existence of the floating charge,⁶⁵ and even though the debtor company is in default in its payments on the loan secured by the general floating charge.⁶⁶ The basis for this rule of priority seems to be that the owner-debtor has the right to use the assets as though they were unencumbered prior to the time the floating charge becomes crystallized. In other words, the right of the debtor to sell and absolutely dispose of his assets in the ordinary course of business must include the lesser right to use the assets as collateral in the ordinary course of business. It is

⁵⁹ See U.C.C. § 9-307.

⁶⁰ Companies Act, 1948, 11 & 12 Geo. 6, c. 38, § 319(5)(b).

⁶¹ Companies Act, 1948, 11 & 12 Geo. 6, c. 38, §§ 319(4), (5).

⁶² U.C.C. § 9-312(5)(a).

⁶³ U.C.C. § 9-312(5)(b).

⁶⁴ *English & Scottish Mercantile Inv. Co. v. Brunton*, supra note 40; *Wilson v. Kelland*, supra note 39.

⁶⁵ *In re Hamilton's Windsor Ironworks*, 12 Ch. D. 707 (1879).

⁶⁶ *Government Stock & Other Sec. Inv. Co. v. Manila Ry.*, supra note 22.

even true that a subsequent specific floating charge will take priority over a prior general floating charge.⁶⁷ A prior general floating charge does, of course, have priority over a subsequent general floating charge.⁶⁸

Apparently, it is proper to insert in the instrument creating a floating charge a provision restricting the debtor's right to impose subsequent charges upon the assets. However, in order for the restriction to be effective, the subsequent charging creditor must have actual knowledge of the restriction. Although registration of a floating charge gives subsequent creditors constructive notice of the existence of the charge, registration does not constitute constructive notice of restrictions on subsequent charges contained in the registered instrument creating the charge.⁶⁹ Not even actual knowledge of the existence of the floating charge will serve as sufficient notice of the existence of restrictions. If the holder of a floating charge does not take possession of the title deed, the holder of a subsequent specific charge who has possession of the title deed will be given priority over the floating charge, notwithstanding the existence of restrictions.⁷⁰ As a matter of fact, in one case the bank which took the subsequent specific charge and received possession of the title deeds knew of the floating charge and had in its possession, on behalf of some of its customers, copies of the debentures issued under the floating charge, containing restrictions on subsequent charges. Nevertheless, the court held that the bank had priority over the prior floating charge.⁷¹ The mechanics and rules relating to registration are also quite often relevant in priority problems, and improper or delayed registration may completely eliminate all the priority rights of the floating charge.

Floating charges will also lose their priority to the following types of creditors and situations: A garnishee takes priority over a non-crystallized floating charge if the garnishment order is final and the garnishee paid;⁷² a distraint for rent levied prior to winding up takes priority over a prior floating charge;⁷³ and the possessory lien of a solicitor takes priority over a floating charge.⁷⁴ A floating charge will take priority over an execution creditor who has levied execution prior to the commencement of the winding up proceedings,⁷⁵ over service of a garnishment order prior to appointment of a receiver in a wind-

⁶⁷ *In re Automatic Bottle Makers Ltd.*, [1926] 1 Ch. 412.

⁶⁸ *In re Benjamin Cope & Sons*, [1914] 1 Ch. 800.

⁶⁹ *Wilson v. Kelland*, *supra* note 39.

⁷⁰ *In re Castell & Brown Ltd.*, [1898] 1 Ch. 315.

⁷¹ *In re Valletort Sanitary Steam Laundry Co.*, [1903] 2 Ch. 654.

⁷² *Robson v. Smith*, [1895] 2 Ch. 118.

⁷³ *In re Roundwood Colliery Co.*, [1897] 1 Ch. 373.

⁷⁴ *Brunton v. Electrical Eng'r Corp.*, [1892] 1 Ch. 434.

⁷⁵ *In re Standard Mfg. Co.*, [1891] 1 Ch. 627.

ing up,⁷⁶ and over a distress levied after a receiver was appointed.⁷⁷ A debtor whose debt is subject to a floating charge created by his creditor may set off against the debt all claims which he has against the creditor that arose prior to the time the floating charge became crystallized.⁷⁸ These English priority rules greatly restrict the effectiveness of the floating charge and indicate further the English policy of limiting such charges.

IV. CONCLUSIONS

The following modifications in the American law relevant to floating liens are recommended:

First. It seems very unlikely that section 9-108 will be given effect in bankruptcy,⁷⁹ and consequently, after-acquired property will continue to be considered as given for an antecedent debt. This would be unfortunate, because it is unnecessary that any decision go that far. It would be much more reasonable to uphold section 9-108, but limit the lien's validity to the amount of new value actually given at the creation of the lien and thereafter. If this result cannot be achieved by statutory interpretation, then section 9-108 should be amended accordingly.

Second. The best method of resolving the present uncertainty is by federal legislation. This could be accomplished by amending the preference provisions of the Bankruptcy Act to do the following: (1) extend the preference period from four months to one year; (2) place the burden of proving the debtor's solvency on the lien creditor; and, (3) uphold a floating lien to the extent of new value given at the time of and after the creation of the lien, together with reasonable interest on such amount.

Third. A cause of action should be recognized against a lien creditor who fraudulently obtains a preferential security interest. This lien creditor would be held personally liable for claims against the insolvent debtor resulting from the creditor's fraud.

Fourth. Legislation should be enacted granting priority in bankruptcy to tax claims and laborers' claims over the floating lien. Consideration should also be given to the possibility that there may be other classes of creditors who should have priority over floating liens.

⁷⁶ Norton v. Yates, [1906] 1 K.B. 112.

⁷⁷ In re Oak Pits Colliery Co., 21 Ch. D. 322 (1882).

⁷⁸ Biggerstaff v. Rowatt's Wharf, Ltd., [1896] 2 Ch. 93.

⁷⁹ See, e.g., In re Portland Newspaper Publishing Co., 2 Bankr. L. Rep. (4th ed.) ¶ 61722 (D. Ore. Feb. 9, 1966); Comment, The Code in the Bankruptcy Courts: Some Significant Conflicts of Policy, 8 B.C. Ind. & Com. L. Rev. 101 (1966).

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