Charges Over Book Debts: 
What Security Do We Have?

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Book debts are debts arising out of the ordinary course of business, which are of the type normally entered in well-kept books of that business. For many small- and medium-sized trading firms in Hong Kong, book debts form an important, if not sole, asset of the business which can be offered as security to banks in obtaining financing. For decades, banks have happily accepted book debts as good security. In particular, both banks and borrowers have welcomed the English Court of Appeal’s decision in Re New Bullas Trading Limited for the flexibility which it afforded them, despite the many criticisms levied against the reasoning in that decision. However, all this came to a halt with the Privy Council’s decision in Agnew v Commissioner of Inland Revenue (more widely known as Brumark). Whilst Brumark clearly upheld the orthodox “control” test as the most important criterion in deciding whether a charge is fixed or floating, it leaves many issues unresolved.

Fixed Charge Versus Floating Charge

Distinguishing Features of a Floating Charge

In Illingworth v Houldsworth, Lord Macnaghten made a valiant attempt to distinguish a fixed charge from a floating charge: A fixed charge is

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1 For judicial pronouncements on what “book debts” are, see Shipley v Marshall (1863) 14 CB (NS) 566; Dawson v Isle [1906] 1 Ch 633, and Independent Automactic Sales Ltd v Knowles and Foster [1962] 3 All ER 27. In Re Brightlife [1986] BCLC 418, at p 421, Hoffmann J held that a credit balance in a bank account is not a book debt.
3 [2001] 2 AC 710.
one which “fastens on ascertained and definite property or property cap-

able of being ascertained and defined”. In contrast, a floating charge is "ambulatory and shifting in its nature, hovering over and so to speak floating with the property which it is entitled to affect until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp.”

The “ambulatory” nature of the floating charge is, however, only one of three characteristics of a typical floating charge described by Romer LJ. The three characteristics of a typical floating charge as identified by his Lordship are as follows: (1) the charge is over a class of assets, present and future; (2) the class of charged assets is one which in the chargor’s ordinary course of business would change from time to time; and (3) the chargor is free to carry on its business in the ordinary way until the char-

ggee intervenes. This third characteristic means the chargor is left at liberty to deal as it wishes with assets covered by the charge (that is, the chargor retains “control” over the charged assets), and may deal with those assets in a way which is inconsistent with the chargee’s security interest. For example, the chargor may dispose of an asset within the class of assets charged without the chargee’s consent.

Subsequent cases have shown that it is the “control” element, viz the third characteristic described by Romer LJ, which is the distinguishing mark of a floating charge.

Why is the Distinction Important?
The distinction is of crucial importance to financiers who have advanced money on the security of the charge, especially when default seems imminent. Whilst a fixed chargee will always have priority over other creditors to the extent of its security, a floating chargee will generally rank behind preferential creditors if the chargor should go into receiver-

ship or liquidation. Much to the consternation of financiers, the list of preferential creditors has become much longer in the last decade or so. Worse still, if the chargor should go into liquidation within 12 months

5 Ibid, at p 358.
6 Ibid
7 Re Yorkshire Woolcombers Association [1903] 2 Ch 284, at p 295.
8 Companies Ordinance (Cap 32), ss 79 and 266.
of granting a floating charge, then unless the chargor was solvent immediately after the charge was granted, the charge will be invalid except to the extent of cash paid to the chargor upon or after the creation of the charge. This invalidation provision, however, does not apply to fixed charges. Besides, whether the charge is fixed or floating becomes highly relevant when assets subject to the charge are disposed to third parties without the chargee's consent.

Leading Cases on Taking Security over Book Debts

*Siebe Gorman v Barclays Bank Limited*¹⁰

It was once believed that a fixed charge cannot be created over present and future book debts. As Romer LJ pointed out,¹¹ one of the typical characteristics of a floating charge is that it is created over a class of assets present and future. However, the fact that a floating charge is well-suited for present and future assets does not necessarily follow that a charge over a class of assets, present and future, must be a floating charge, or that a fixed charge cannot logically be created over such a class of assets. Indeed, in *Siebe Gorman v Barclays Bank Limited*, Slade J broke new ground by holding it possible to create a fixed charge over a company's present and future book debts. The crucial question to ask would be: whether the chargor is at liberty to dispose of the charged assets free from the charge.

The debenture in *Siebe Gorman* purported to create a fixed charge over the chargor's present and future book debts. It expressly prohibited the chargor from assigning or charging the debts without the chargee's consent. The chargor was permitted to collect the book debts but would have to do it for the chargee's benefit, and to pay the proceeds collected into an account maintained with the chargee. It is of interest to note that the debenture in this case did not in any way prohibit the chargor from drawing on the account.

¹⁰ [1979] 2 Lloyd's Rep 142
¹¹ See n 7 above.
Slade J held that the debenture was effective in creating a fixed charge over the book debts. He stressed that the test to apply was the "control" test. On the facts, his Lordship was satisfied that the chargor's freedom to deal with the charged assets had been removed. Whilst the book debts remained uncollected, the chargor was restricted by the negative pledge clause in the debenture from assigning or charging them. Upon collection, the chargor was obliged to pay the proceeds into an account maintained with the chargee. Despite the absence of any prohibition against the chargor drawing on the account, his Lordship found that, if it so chose to do, the chargee could have asserted "a lien under the charge on the proceeds of the book debts" had the account been in credit. That being so, Slade J was satisfied that the charge created by the debenture passed the "control" test and was thus a fixed charge.

Re Keenan Brothers

This decision of the Irish Supreme Court confirmed the "control" test as the determining factor in distinguishing a fixed charge over book debts from a mere floating charge. The debenture in Re Keenan Brothers was more stringent in its requirements regarding control over the charged assets than the Siebe Gorman debenture. Not only did it require the chargor to pay all proceeds of debts collected into a special account designated by the chargee, it also restricted the chargor from accessing those proceeds once they were paid into the designated account. The Irish Supreme Court had no difficulty in upholding this charge as a fixed charge. This decision was referred to and cited with approval by the Privy Council in Brumarfc.

Re Brightlife

The debenture in Re Brightlife also contained a restriction against the chargor selling, factoring or discounting the debts. However, it differed from the ones in Siebe Gorman and Re Keenan Brothers in that it allowed...

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12 See n 10 above, at p 159.
14 See n 3 above, at p 722.
15 See n 1 above.
the chargor to get in the debts for its own benefit and pay the proceeds into its own account (maintained with a bank other than the chargee) where they remained at the free disposal of the chargor. Hoffmann J had no hesitation in holding that this debenture merely created a floating charge over the book debts, notwithstanding the restriction against alienation. By permitting the chargor to collect the debts for its own use and benefit, the debenture in Re Brightlife failed the “control” test required of a fixed charge over book debts.

Re New Bullas Trading Limited

Cases like Siebe Gorman, Re Keenan Brothers and Re Brightlife have clearly established that, to effectively create a fixed charge over book debts, the charge in question must satisfy the “control” test mentioned by Romer LJ. The chargee must restrict the chargor’s freedom in alienating the uncollected book debts, as well as its ability to utilize the collected proceeds. This means that, in ascertaining the nature of a charge over book debts, one would have to consider the treatment of uncollected debts, as well as the handling of the proceeds of collection.

Such a requirement appealed to neither chargors nor chargees. Whilst chargees were keen to have the security offered by a fixed charge, they were quite happy to forgo the administrative hassle of monitoring the account into which the proceeds had to be paid. Chargors complained bitterly, because they were denied access to the proceeds which, in many cases, constituted their main source of cashflow and upon which they depended for continuing their normal business operations. To alleviate their misery, ingenious and commercially-minded lawyers came up with this brilliant idea of segregating the book debts from their proceeds. This innovative device came under the scrutiny of the English Court of Appeal in Re New Bullas Trading Limited.

In this case, the charge in question was granted to 3i Plc, which was the second chargee of the book debts concerned. A first charge had already been granted in favour of Lloyds Bank Plc. 3i’s debenture purported to create a fixed charge over the chargor’s uncollected book debts. The debenture contained the usual prohibition against alienation of the debts.

16 See n 2 above.
The chargor was permitted to collect the debts but was required to pay the proceeds into an account designated by 3i (bearing in mind that a first charge already existed in favour of Lloyd's, 3i designated the account with Lloyd's for this purpose). 3i was empowered by the debenture to give direction to the chargor on the operation of the designated account, but if no such direction was given, then the proceeds would be released from the fixed charge and become subject to a floating charge. 3i never gave any such direction. Question arose as to whether the law allows book debts to be subject to a fixed charge whilst they remain uncollected and to a floating charge upon their collection.

Nourse LJ, giving the leading judgment in the Court of Appeal, upheld the freedom of the contracting parties to provide for whatever their intention was. In holding that the parties were free to provide for a fixed charge over uncollected book debts and a floating charge over their realised proceeds, the Court of Appeal implied that for a fixed charge to subsist over book debts, the chargor need not be denied access to their realised proceeds. This was clearly good news for chargors.

Brumark\textsuperscript{17}

This case involved an appeal from New Zealand. The debenture purported to create a \textit{New Bullas}-type split charge over book debts and their proceeds, and the material facts were indistinguishable from those of \textit{Re New Bullas}.

In \textit{Brumark}, the Privy Council adopted a two-stage enquiry. First, the court would construe the charge document, with a view to ascertaining the nature of the parties' respective rights and obligations, as intended by the parties. Then the court would proceed to categorise the charge, which would be done according to established legal principles. In this second phase, the parties' intention would be irrelevant.

Having gone through the two-stage enquiry, Lord Millett (who delivered the Privy Council's advice) concluded that the charge over book debts created by the debenture in \textit{Brumark} was a mere floating charge. By permitting the chargor to collect and get in the debts and turn them

\textsuperscript{17} See n 3 above.
into proceeds (which the chargor was given the liberty to use for its own benefit), the debenture enabled the chargor to extinguish the charged assets by collection and effectively remove them from the charge without the chargee's consent and without having to account to the chargee for them. In the Privy Council's view, such an arrangement fell short of the control required to establish a fixed charge. For an effective fixed charge to be created over present and future book debts, the chargee must control the uncollected debts (by a negative pledge in the charge document), the collection process (the chargor must be collecting as the chargee's agent and not for its own use and benefit), as well as the collected proceeds (by adopting a blocked account arrangement so that the chargor cannot draw on the proceeds except with the chargee's consent). Lord Millett added that it would not be sufficient for the charge document to provide for a blocked account; the blocked account must also in fact be operated as such.18

Unresolved Issues

Brumark clearly marked a return to the orthodox view, adopted in a long line of cases including Siebe Gorman, that "control" is the mark which distinguishes a fixed charge from a floating charge. It is likely to be followed in both England and other common law jurisdictions.19

Whilst there are good reasons to applaud the decision in Brumark, it is unfortunate that a number of issues still remain unresolved.

1. Is a Debt Divisible From its Proceeds?

Some academic writers have argued that a debt is indivisible from its proceeds. A forceful proponent of this theory is Goode20 who advocates the idea of a "single continuous security interest" flowing from a book debt through its proceeds. Berg,21 on the other hand, argues that a book

18 See n 3 above, at p 730.
19 Brumark was cited with approval by Lord Hoffmann who delivered the leading speech of the House of Lords in Re Cosslett (Contractors) [2002] 1 AC 336, at p 352.
debt and its proceeds are two entirely distinct assets, each capable of forming the subject matter of a charge. A “half-way house” approach was suggested by Armstrong:

“An uncollected book debt and its proceeds are technically different assets, but economically they are so intrinsically linked that it would be unrealistic and impossible to regard them as separate assets.”

The Privy Council in *Brumark* dodged the issue of whether a book debt and its proceeds are legally divisible or otherwise. However, Lord Millett’s speech echoed the pragmatic approach suggested by Armstrong. Whilst acknowledging the conceptual possibility to separate a book debt from its proceeds, Lord Millett said that “it makes no commercial sense” to do so. Hence, one must examine the way the collected proceeds are dealt with in determining whether the charge created over the book debts is fixed or floating.

2. Is it Possible to Have a Floating Charge Over Uncollected Book Debts and a Fixed Charge Over Proceeds of Collected Debts?

According to Goode’s theory of a “single continuous security”, the answer would appear to be in the negative. Worthington, however, took a different view. Whilst agreeing that control over the collected proceeds is essential to the existence of a fixed charge over book debts, Worthington argued that the converse is not true, and that it should be possible to create a floating charge over uncollected book debts and a fixed charge over the proceeds.

Worthington’s argument appears to be supported by practice. It is not uncommon for debentures to provide for a floating charge over a company’s present and future book debts, as well as a fixed charge over the company’s bank account into which its income (including proceeds

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23 See n 3 above, at p 729.

24 S Worthington, “Fixed Charges Over Book Debts And Other Receivables” (1997) 113 LQR 562
of collected book debts) must be paid. It is hoped that the courts will not seek to extend *Brumark* in a way which will render this practice impossible, as it is quite unnecessary to do so.

3. *What if the Charge is Expressly Limited to Uncollected Book Debts?*

In *Brumark*, Lord Millett seemed to take the view that the value of a debt lies solely in its realisation. Hence, control over the proceeds is crucial to the existence of a fixed charge over book debts. However, it has been cogently argued that the value of a book debt does not lie solely in its collection. For example, an uncollected book debt may be assigned for value before its maturity. Taking a charge over a subject matter is also commonly used as a means to prevent the unauthorised disposal of the same to a third party. Therefore, with due respect to their Lordships, the debts have economic value in their own right and there do exist good reasons for treating book debts and their proceeds separately.

That being so, is there any policy reason why the law should prevent a chargor and a chargee from agreeing to confine the fixed charge to be created to only those debts which remain uncollected? Taking this argument one step further, why should the law prevent a company from creating a fixed charge over its uncollected book debts in favour of one creditor, and another fixed charge over the collected proceeds of its debts (perhaps in the form of a charge over the company’s bank account) in favour of another creditor? So long as the two creditors are happy with the sufficiency of their respective securities, there appears to be no good reason why the law should intervene to forbid it. However, after *Brumark*, it would appear that this kind of security arrangement is no longer available as an option to the parties. Because of the way the proceeds are released and become subject to another charge, *Brumark* dictates that the first-mentioned creditor cannot in law have the security of a fixed charge over the uncollected debts.

4. *What is the Extent of “Control” Needed for a Fixed Charge?*

In the light of Lord Millett’s speech in *Brumark*, is it sufficient for a fixed chargee to merely have the *ability* to control rather than exercising

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actual control over the proceeds? This issue brings into question the continued authority of Siebe Gorman.

In Siebe Gorman, the debenture contained no restriction against the chargor drawing on the account into which the proceeds of debts collected must be paid. Slade J, however, found as a fact that there was an implied restriction, because the chargee had the ability to refuse withdrawal by the chargor. The chargee, as the account-holding bank, could, if it so chose, assert a lien over the proceeds standing to the credit of the account. One commentator has forcefully argued that the so-called "implied restriction" is no more than a power on the part of the chargee to intervene when the need arises. That being the case, the charge created by the debenture in Siebe Gorman appears to be more in line with a floating charge than a fixed charge, it being one of the characteristics of a floating charge that the chargor remains at liberty to deal with the assets concerned unless and until the chargee intervenes.

Though Brumark appears to endorse Slade J's approach in Siebe Gorman, it is difficult to see how the charge in Siebe Gorman can be effective nowadays in creating a fixed charge over book debts after Brumark. This is particularly so in the light of Lord Millett's comment that a blocked account arrangement must not only be provided for in the charge document, but must also be observed by the parties in practice.

5. Is Re Atlantic Computer Systems Still Good Law? Re Atlantic Computer Systems concerns the nature of a charge created over certain existing sub-leases of chattels and their rental income. In that case, the English Court of Appeal focused on the ambulatory characteristic of the floating charge and held that the charge in question was a fixed charge, since it covered only existing but not future assets. Nicholls LJ did not consider the chargor's freedom in that case to use the rental income collected to be inconsistent with the existence of a fixed charge. In so holding, his Lordship drew an analogy from the mortgagor's entitlement to retain income generated from the mortgaged land.

26 At time of going to press, Philip Smart's article "Fixed or Floating? Siebe Gorman post-Brumark" is unpublished. A working copy is available with the author of this paper.

Re Atlantic Computer Systems was one of the cases referred to the Privy Council in Brumark. Unfortunately, Lord Millett, who delivered the advice of their Lordships, made no reference to this case at all. It is therefore unclear as to the authority of this case after Brumark. Is Re Atlantic Computer Systems still good authority for the proposition that a fixed charge may be created over specific revenue-producing contracts even if the chargor is still allowed access to the revenue for its own use and benefit, the rationale for distinguishing it from Brumark being that a book debt is necessarily extinguished by collection whilst collection of certain types of revenue may not in any way prejudice the continued existence and validity of the contractual obligation which generates the revenue? If Re Atlantic Computer Systems is still good law, then is the theoretical basis for drawing such a distinction a sound one?

6. Relevance of Post-Contract Conduct of the Parties?
In Brumark, Lord Millett stressed that “it is not enough to provide in the debenture that the account is a blocked account if it is not operated as one in fact”. This would suggest that the courts would look at the parties’ post-contract conduct in determining the nature of the charge created by the contract. His Lordship’s observation has raised many an eyebrow, for it appears to deviate significantly from the rule of document interpretation laid down by the House of Lords in Whitworth Street Estates v Miller. In general, a court would not normally concern itself with the post-contract conduct of the parties when interpreting a contract. It would only look at the post-contract conduct of the parties to determine whether the same constitutes a variation of the terms of the contract or has otherwise given rise to an estoppel, in the absence of allegation that the contractual provisions were a sham. This is a rule which has been widely accepted and has worked well in practice. Therefore, Lord Millett’s observation in Brumark has understandably caused concern amongst both practitioners and academics.

In the specific instance of a charge over book debts, Lord Millett’s requirement that the parties’ post-contract conduct be taken into

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28 See n 3 above, at p 730. Emphasis added
account would create much uncertainty. This can be shown by a simple illustration: Chargor and chargee purported to create a fixed charge over the chargor's book debts. The debenture stipulated for a blocked account arrangement for the proceeds of the debts. The charge over book debts was duly registered as such at the Companies Registry. The parties diligently adhered to the blocked account arrangement for some six months before the chargee decided, at the chargor's request, to suspend the restriction against withdrawal from the account, “subject to review of the chargor's financial and other conditions from time to time by the chargee”. Bearing in mind Lord Millett's requirement, has the charge over book debts now been “converted” into a floating charge by virtue of the chargee's relaxation of the restriction against withdrawal? If that is so, presumably this charge started off as a fixed charge and only became a floating charge upon the relaxation of the withdrawal restriction. That being so, this charge is, strictly speaking, not “a charge which, when created, was a floating charge” and therefore should not be subject to invalidation under section 267 of the Companies Ordinance (CO). It would appear that this would create a major inroad into the operation of section 267. Conversion of the initial fixed charge into a floating charge would also raise the question as to whether the floating charge would require a new registration under section 80 of the CO. Unfortunately, none of these issues was addressed in Brumark.

7. Is it Now Practicable for a Second or Non-bank Chargee to Take a Fixed Charge Over Book Debts?
3i, the chargee in Re New Bullas, was a second chargee, and it had already done everything it possibly could to control the book debts. 3i designated the account with Lloyds (the first chargee) as the account into which all proceeds of the debts must be paid. Until the discharge of Lloyds' prior charge, it would have been pointless for 3i to issue any direction to the chargor on the operation of that account. Yet, the absence of control on the part of the chargee would render the charge created a mere floating charge post-Brumark. The practical difficulty presented by Brumark to financiers is this: in view of the stringent control requirement laid down by Lord Millett, is it still practicable for a second or non-bank chargee to take a fixed charge over book debts as
security for its advances? How (if at all) will a second or non-bank chargee be able to exercise the requisite control over the collected proceeds?

The important economic implications which *Brumark* has on the many small- and medium-sized enterprises in Hong Kong should not be under-estimated. In most cases, these enterprises can offer little more than their cashflow as security. More often than not, many such enterprises do not have sufficiently good standing or track record to enable them to obtain loans from banks. When they turn to non-bank financial institutions and offer their book debts as security, the financial institutions may find it utterly impracticable to secure a fixed charge over those debts, since the blocked account would inevitably have to be maintained with a bank. The practical difficulties and costs involved in putting in place a blocked account arrangement in such a situation are daunting. Hence, it is not unlikely that Hong Kong will witness a gradual shift away from overdraft or working capital loan financing to debt factoring, as far as such small- and medium-sized enterprises are concerned.

**Conclusion**

Whilst *Brumark* has been hailed for its return to the orthodox "control" test for distinguishing a fixed charge from a floating charge over book debts, it has left behind a wake of question marks and unresolved issues. In some ways, the decision has possibly caused more problems for practitioners than it has solved. In particular, the emphasis which Lord Millett put on the parties' post-contract conduct has caused grave concern among practitioners and much uncertainty in the law. In the United Kingdom, many insolvency practitioners involved in company liquidation or receivership are now sitting on huge amount of receipts from book debts but dare not pay them out to creditors of the companies concerned, lest they should incur personal liability for having wrongfully paid out the dividends. Such a situation is, of course, far from ideal, and clarification by the courts is eagerly and urgently awaited.