AUTOMATIC CRYSTALLISATION
OF A FLOATING CHARGE

Author: Dr Robert Dean
Date: 1984

© Copyright 1984
This work is copyright. Apart from any permitted use under the Copyright Act 1968, no part may be reproduced or copied in any form without the permission of the Author.

This paper was published in the Law Institute Journal (July, 1984)

Requests and inquiries concerning reproduction and rights should be addressed to the author c/- annabolger@foleys.com.au or T 613-9225 6387.
Automatic crystallisation of a floating charge
by Robert L. Dean

Robert L. Dean is a member of the Victorian Bar.

In an earlier article which examined the many contradictions and problems that arise with respect to the theory of the floating charge and the cases concerned with crystallisation it was noted that Australian courts had not yet squarely tackled the effectiveness of automatic crystallisation clauses. It was concluded that when the question arose it would be necessary to determine whether a floating charge is a product of the "draftsmen's skill, as tempered by negotiation"; or whether a floating charge should be seen as "a creature of the courts". The latter conclusion introduces the need to answer a further question, namely whether the courts will regard the cessation of business, or some positive action by the debenture holders, as a pre-condition to crystallisation.

It appeared that Jenkinson J. in Re B investigated the view that the courts should maintain control of automatic crystallisation clauses. In that case the debenture deed stated that: "The right of the company to deal with the mortgage property shall forthwith cease on the happening of any one or more of the following events . . . ." A clearer indication that the parties proposed automatic crystallisation on the happening of the specified events could not be imagined. Yet His Honour held that on the basis of Government Stocks and Other Securities Investment Company v. Manila Railways Co., such clauses postponed crystallisation until the debenture holder exercised his "option ... to bring about that result". The right of the company to deal with the mortgage property did not cease, but continued "by the sufferance of the debenture holders and at their mercy".

Strong arguments for adopting his view are found in precedent, in theory and in policy considerations.

However, in a decision in April 1983, Mr. Justice Murphy, in Deputy Commissioner of Taxation v. Horsburgh, held that the floating charge before him crystallised automatically on either of two events, default by the charger or the creation of a prior fixed charge. Those events were specified in the charge as events upon which the charge "shall become fixed". The learned judge rejected submissions based on the view that regardless of the words used in the debenture, the charge would not crystallise until the intervention by the debenture holders. His Honour stated: "I have read the authorities on this matter and it is my opinion that as a matter of law there is nothing to prevent an agreement being made where a floating charge crystallises on the happening of specified events . . . . I am not able to accept that as a matter of legal theory that (such) a contract is ineffectual to achieve that purpose."

I find that the intention of the parties to the original floating charge as expressed in the deed, was that it would convert from a floating charge to a fixed charge on the happening of certain events. However, His Honour appears to contemplate the possibility that the debenture did not crystallise on default because he held that if it did not crystallise at that time, then it crystallised upon the creation of a subsequent prior ranking charge; and if not then, "even the defendant concedes that it crystallised on appointment of Receivers".

The learned judge appears to take the view that the floating charge is purely and simply a contract, and that its character is to be interpreted largely, if not solely, by reference to contractual principles of construction. In so doing His Honour accepts the principle espoused by Speight J. in the case of In re Manurewa Transport which, it is submitted, is the only strong authority for such a proposition. Speight J. said: "A floating charge is not a work of art; it is a creation, particularly with respect to the theory of the floating charge because . . . ." The right of the company to deal with the mortgage property did not cease, but continued "by the sufferance of the debenture holders and at their mercy".

To adopt this view is to ignore the view that a floating charge is a creation of the court. A debenture does more than create an interest affecting the rights of third parties. As with other proprietary interests created by the courts, such as the "use" or the "restrictive convenant", the courts have in the past controlled the effect of their creation, particularly with respect to priorities and innocent third parties who played no part in the negotiations of the rights created. This was the view of Fletcher Moulton L.J. in Evans v. Rial Granite Quarries Ltd., a case which has consistently been reaffirmed. Fletcher Moulton L.J. stated: "I do not deny that in the earlier cases the actual words of the particular documents may have influenced the courts and enabled them to come to the conclusions which they did. But at an early period it became clear to judges that this conclusion did not depend upon the special language used in particular documents but upon the essence and nature of the security of this kind."

In the earlier case Lord Macneile included as part of the "essence" of a floating charge, that it would not crystallise until the undertaking ceased to be a going concern or until the debenture holders intervened.

The question which was clearly raised in the Horsburgh case was, would the courts take a further step and allow the debenture holder on the one hand, to encourage the debenture holder to maintain priority at all times by the use of automatic crystallisation. A further question linked to the first is, would the courts allow the intervention of the debenture holder to maintain their priority, and then allow a "de-fixing" of the charge without loss of priority and without forever freezing the business of the company. The answers to these questions were awaited by the profession with much interest.

In Horsburgh's case Mr. Justice Murphy answered "yes" to the first question, and by viewing the floating charges as a product of the draftsmen's skill rather than a creature of the court, impliely answered "yes" to the second. Given the copious and wide-ranging debate by legal commentators on these questions and the unsatisfactory nature of the authorities, it is disappointing that His Honour did little more than state his opinion, offering a cursory reference to the authority. It is respectfully submitted that insofar as His Honourcountenanced automatic crystallisation he may well be correct, but insofar as the decision paved the way for the courts releasing control over the floating charge he was not correct.

Inherent nature of a floating charge

(a) Development

A brief look at the history of the floating charge demonstrates that the courts did not feel obliged to abide by the terms decided upon by the parties. The floating charge is a relatively recent judicial creation born through commercial necessity and shaped to meet the pressing needs of joint stock companies to obtain finance. As late as 1850 the courts refused to recognise the floating charge because it was unfair to third parties. However, progressively, the courts allowed the barriers to the creation of a floating charge at all, to be overcome. Firstly, equity overcame the need for an act confirming the transferee's prior intention to create an interest in future acquired goods. This was done by the courts' willingness to grant specific performance. Secondly, the courts interpreted a mortgage of a company's "undertaking" as a charge with the characteristic which allowed the company the right to continue trading, and hence to deal with its stock unencumbered.

(b) Theory

If the floating charge is more than a contractual agreement the question of its inherent characteristics must arise. Much depends on whether the theory underlying
the floating charge is seen to be the licence theory or the mortgage of future assets theory (the hovering charge theory). In the former case the charge fixes to the company's hands, and due to an implied licence the company may trade with these assets until the licence is removed. The licence can be removed on the basis that the chargee acts in breach of the licence. Until then the charge "defixes" as the stock is disposed of. Under the latter theory the charge does not become fixed to the stock-in-trade until crystallisation. Prior to that time it is "ambulatory and shifting in its nature, hovering over and so to speak floating with the property".

Both commentators and the judiciary exhibit a wide variation of views as to which is the correct theory, and these differences of opinion extend to which of the theories best supports automatic crystallisation. Unfortunately: "The difference of judicial opinion as to whether there is an implied licence given to the company is not a merely metaphysical one. It can result in different answers to problems concerning the rights of debenture holders.

"These theories are not merely of academic interest; they can produce different practical consequences." 23

The licence theory is the simplest theory. It was undoubtedly the original theory and it is submitted that it is the only one which can explain the puzzling group of cases known as the "Sheriff cases". 24 It is supported by Wickham J. in Landall Holdings v. Cavalli, who undertook an extensive review of the authorities and came to the conclusion that a debenture created an "immediate equitable charge upon the assets of the company", and surprisingly, this is supported also by Buckley L. J. in Cretanor Maritime Company Ltd. v. Irish Marine Management Ltd. 25 It was also the basis of the recent case of Reynolds Bros. (Motors) Ltd. v. Esanda Ltd. 26

If the licence theory is the correct theory, it is submitted that following a breach of conditions by the charger, equity would require some act by the chargee to remove the licence. This view supports those who argue against automatic crystallisation. 27

Irrespective of the language used in a debenture deed, certain characteristics in a floating charge can be isolated. "It is plain that when you start with your floating security, the whole basis of that arrangement is that the business is going on and should go on until the debenture holders according to the terms of the deed intervene." 28

All the descriptions of a floating charge take the ratio dividendi the proposition that the charge remains floating, or otherwise ineffective only so long as the undertaking is a going concern. In Plyer v. Crompton 29 efforts by the draftsman to prevent the charge crystallising on the reconstruction of the company failed because, as part of the reconstruction process, the "business ceased to be a going concern".

There is support for the proposition that action outside the ordinary course of business will create grounds for crystallisation. 30

Some of the terms used by Glass J. A. in Reynolds Bros. (Motors) to describe the company's right to carry on were "so long as the company is a going concern", "until the undertaking charged ceases to be a going concern" and until the company "has closed its doors".

Glass J. A. adopted the description of a floating charge found in Wallace v. Everstall 31 based on the right of the charger to continue trading in the ordinary course of business. The learned judge stated: "The Deed of Equitable Mortgage and floating charge does not itself define the nature of the licence vested in the mortgagor..."

In determining whether a company acts within the ordinary course of business all three judges undertook an enquiring into whether the charger's actions were the result of an intention to carry on business.

Mahoney J. A. emphasised that the breach of a "crystallising" term prohibiting the creation of prior interests did not crystallise the charge but rather, that priorities are determined by the nature of the floating charge together with the use of equitable principles (supra).

It is unclear whether the crystallisation that takes place on the appointment of a receiver or liquidator is due to the appointment or to the cessation of business. On a winding up the former must necessarily cause the latter (s. 368(1) Companies Act 1981). On the appointment of a receiver the business is effectively anaesthetised. From the few examples where the two have not coincided it would seem that the courts have treated them as separate crystallising events. 32

Remedies available for enforcing a fixed charge are also available for enforcing a floating charge. Hence seizure, foreclosure 33 and grant of power of sale 34 are all available, and somewhere between the institution of the remedy and the enforcement of the rights the charge must have crystallised. The availability of these remedies is not dependent on such remedies being expressly mentioned in the deed.

There is support for the proposition that action outside the ordinary course of business will create grounds for crystallisation. 35

Despite the decision in Industrial Development Bank v. Valley Dairy Ltd. and McDonald, 36 it is submitted that the charge will not crystallise on the issue of a writ in a debenture holder's action.

Automatic crystallisation

Academics disagree over whether automatic crystallisation is a characteristic compatible with the nature of a floating charge. Laing and Boyle 37 and Gough 38 both accept, with various conditions and riders, that automatic crystallisation is possible. Pennington, 39 Allan and Sher, 40 Farrar, 41 Gower 42 and Ford 43 refuse to commit themselves, Sykes 44 and Halsbury's Laws of England 45 are both against automatic crystallisation.

The difficulty with the cases relied on by those who reject automatic crystallisation is to determine to what extent particular decisions rely on the inherent nature of a floating charge, as distinct from the implied intentions of the contracting party.

In the Manitoba Railway case, Lord Halsbury L. C., in deciding that the charge would not automatically crystallise, was content to rely on the intention of the parties. Lord Naughten agreed that a debenture holder's right to intervene might be suspended by agreement. But in relation to crystallisation, His Lordship felt it was in the nature of the agreement that it continue to float until a cessation of business or until the debenture holders intervened. Lord Shand said: "I should have great difficulty in any case, even upon the construction of the instrument which has been presented, in holding that if the creditors in these debentures lay by and took no step whatever to arrest the business, or to put a receiver in charge of the business, they could affect anyone in the transaction of business with the company."

The Evans case is not directly concerned with an automatic crystallisation clause. However, Their Lordships made certain statements concerning the nature of a floating charge. Vaughan Williams L. J. based his judgment on the licence theory. In the learned judge's opinion: "Unless something has occurred entitling the debenture holders to make such an application and the application has in fact been made for the appointment of a receiver or an action brought by them or on their behalf to realise their security, or unless something has happened which entitles the debenture holders to determine their licence to the company to carry on their business and they have actually done so the company is entitled to do all the things which the licence entitles them to do." (Emphasis added)

The learned judge refers to earlier authorities concerning the rights of debenture holders, which he said were given on the basis that the debenture holders had in some form to determine the licence to carry on business. 41 His Lordship adopted these principles to prevent "any further extension of the evil results from the admitted power of the debenture holders". Fletcher Moulton L. J. said: "The effect of these floating securities has been frequently considered. Many years back the attention of the courts was drawn to their particular nature. In all the decisions to date the courts realised that the nature of a security of this nature it was impossible to come to any other conclusion than that it was intended to leave the company free to carry on its business until the time arrived when the debenture holders enforced their security. It is of the essence of such a charge that it remains dormant until the undertaking charged ceases or until the
The Council for Christian Education in Schools

★ has the major responsibility for the Religious Education of pupils in Victorian State Schools.

★ recruits, trains and accredits Voluntary Instructors for whom syllabus materials are produced. (There are at present 3,380 Voluntary Instructors).

★ appoints full-time Chaplains to High and Technical Schools for which there are 32 established appointments.

★ will spend over $850,000 on these services in 1983.

★ invites support for its work through Bequests which are free of Probate and Donations which are Tax deductible.

Enquiries to:
The Secretary Manager,
The Council for Christian Education in Schools, 55 Exhibition Street, Melbourne 3000
Telephone: 63 4105
notice was not in issue. On more than one occasion Murphy J. drew attention to the fact that in the circumstance of the Horsburgh case the chargee second in time had actual notice of the automatic crystallisation clauses.60

If the courts hold that registration is constructive notice of the contents of the debenture, then the debenture holder's powers may go further. In that case it is possible that legal interests obtained by bona fide purchasers without actual notice of the terms of the debenture where they had knowledge that the event which caused crystallisation had occurred, would be postponed to the crystallised charge. Whether the notice of the crystallisation clause without actual knowledge of the event would be enough to constitute notice is arguable. In Reynolds (Bros.) (Motors) the significance of notice of a floating charge and of its contents is discussed. Mahoney J.A. says at p. 427:

"It may be that, in this area of judge made law, whilst notice of the existence of a floating charge will not be sufficient to burden legal interests, notice that the acquisition of it involves contravention of such a restriction is."

His Honour suggests that the same outcome may occur as between competing equities.

The practical effect of such a situation in the normal environment of daily trading is ineradicable. The legal complications of an unnoticed crystallisation which lies undetected for weeks, months or even years do not bear contemplation. Such a situation, though rare, highlights the conflict between the automatic character of the business may continue unhindered and the power of the debenture draftsman.

(b) Secured creditors

Those dealing with the company who choose to use the subject property to secure their loans will, in the case of a prior unregistered charge or debt secured prior to the Act, find that automatic crystallisation triggered by the creation of prior ranking charges denies them the priority they expected. In the Horsburgh case it was only because the Commissioner of Taxation is in a particular position that he was able to collect the taxes on behalf of the community.

Where there is a failure to lodge a restrictive provision under s. 204 Schedule 5 of the Act, sub-section 204(3) postpones that charge to a later registered fixed charge to the crystallised charge. Whether a charge to a later registered fixed charge will give the chargee the right to freeze parts of the business while maintaining priority and control. The court has expressly stated this to be unacceptable.65

One can foresee a situation where, because of an unregistered charge or debt secured prior to the Act, an automatic crystallisation may occur in the company, which may be trivial, and so structured as to force the company to undertake policies which the debenture holders wish the company to pursue. The nature of such events is limited only by the imagination of the draftsman. If we combine this with the ability to structure a floating charge to reflect all the losses and developments of the business, then it is clear that the control of the debenture holders is further increased. Whether or not a charge can be refloated without loss of priority, it seems likely that partial crystallisation is possible.67 This means that a charge structured to crystallise only in part on those assets the subject of a subsequent fixed charge will give the debenture holder the right to freeze parts of the business while maintaining priority and control. The court has expressly stated this to be unacceptable.65

Undoubtedly the best way to resolve the problems associated with automatic crystallisation clauses is to introduce legislation which limits the powers of the debenture holder. However, in the meantime both the legal considerations and policy considerations which the court must take into account when dealing with such clauses are considerable. To date these matters have not been squarely faced and as a consequence the matter has not yet been laid to rest. The legal issues are made more complex by the introduction of the hovering charge theory. There is no reason why the original theory, based on a licence to use the subject goods, should be discarded.

The prospect that the debenture holder can interfere with the running of the company is rejected, even by those judges who are said to support automatic crystallisation.

"It is inconsistent with the nature of a floating security that the holder should be able to pounce down on particular assets and to interfere with a company's business while still keeping his security a floating security; he cannot at once give freedom and insist on servitude."66

The possibility that a debenture holder who failed to take action at the time of the crystallisation event would have waived his right to proceed may well be the correct analysis. It is just as circular to say that an acceptance of implied waiver is an acceptance of the invalidity of automatic crystallisation as to say the reverse. It is in the nature of a floating charge that intervention coupled with notice must take place before crystallisation. The necessity of these pre-requisites to occur will result in the debenture holders having waived their rights to later rely on that crystallisation event. Where a debenture holder creates a situation where third parties are lulled into a position to their detriment, the courts have had no trouble in depriving the debenture holder priority.68 Is not this same failure in relation to floating charges with automatic crystallisation clauses?

Mason says:

"The draftsman puts into shape, judges define and harmonise, Parliament gives its imprimatur, but it is mercantile custom and mercantile convenience which makes the law. This is the secret of a living law."69

However, in 1984 it is necessary to maintain a balance between financial strength and the requirements of the broader commercial community. Greater power for debenture holders does not ipse facto mean greater mercantile convenience.