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The Fixed/Floating Distinction: Either Fixing a Fixed Charge or Seeing that the Floating Charge Floats, Not in Between

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A lender's decision between taking a fixed charge and taking a floating charge requires it to weigh a multitude of pros and cons. A fixed charge ranks ahead of an earlier floating charge that has not crystallized when the fixed charge was created, but with a floating charge, the chargor generally retains the liberty and flexibility to deal with the charged assets and thus can conduct business as usual. In this short passage, we do not intend to dive into whether a fixed charge or a floating charge should be preferred one over the other — irrespective of that choice, careful drafting of the security is crucial because the last thing the lender wishes is to be embroiled in a dispute over the nature of the security itself — whether it is a fixed charge or a floating charge.

In a recent case *Bei Ni Ltd v Cornwell (Hong Kong) Ltd* (13/07/2023, HCA923/2022) [2023] HKCFI 1799, the Hong Kong Court of First Instance (the "**CFI**") was invited to consider whether a charge over shares in a margin account was a fixed charge or a floating charge. The CFI held that the key issue was whether the chargee retained sufficient legal control over the charged shares. In this case, this hinged on whether the proceeds from any of the chargor's attempt to sell the charged shares were held for the benefit of the chargee, or whether the chargor could apply such proceeds for its own purposes.

The Bei Ni case: Summary of Facts

The case can be summarized as follows: in July 2022, the defendant opened a margin account with a financial institution (the "**FI**") and deposited certain shares in a Hong Kong-listed company into the margin account as collateral. The collateral was subject to a charge (the "**Charge**") created in favour of the FI pursuant to the terms and conditions of the margin account. Later in October 2022, the plaintiff obtained a charging order *nisi* (the "**Charging Order**") against the defendant over the same shares (the disputes between the plaintiff and the defendant are not relevant here). As the FI attempted to enforce the Charge and dispose of the shares to reduce the defendant's indebtedness owed to the FI, the plaintiff as judgment creditor served a stop notice to restrain any transfer of the shares. The plaintiff and the defendant also jointly applied for an injunction against the FI in December 2022 to restrain the FI from disposing of the shares. At issue was whether the Charge had priority over the Charging Order.

The Bei Ni case: Analysis and Rulings on priority of competing interests

The parties accepted that the Charge was created first in time, but the plaintiff alleged that the Charge was only a floating charge which crystallized after, and thus ranked behind, the Charging Order.

On the issue of classifying the Charge as a fixed charge or a floating charge, the CFI referred to the well-established two-stage process, arising from *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710: the first stage considers whether the interpretation of the terms of the contract gives rise to a fixed charge or a floating charge, and the second stage considers whether the Charge should be characterized as a fixed charge or a floating charge.

With regard to the first stage, the Charge labelled itself as a "first fixed charge" and the starting point was that the Charge was a fixed charge. With regard to the second stage, applying the classic statements in *Re Yorkshire Woolcombers Association Limited* [1903] 2 Ch 284, a floating charge has the following three characteristics:

1. It is a charge on a class of present and future assets of a company;

2. That class of assets is changing from time to time in the ordinary course of the business of the company; and

3. The charge contemplates that, until some future step is taken by or on behalf of the chargee to enforce it, the company may carry on its business in the usual way as far as the charged assets are concerned.

The gist is that, for a charge to be a fixed charge, the chargee must have sufficient legal control over the charged assets, namely the contractual right to prevent the chargor from withdrawing the charged assets from the scope of the security. To constitute sufficient legal control, the CFI considered it not necessary to prohibit the chargor from unilaterally disposing of the shares, but that it was sufficient that the chargor had to hold the sale proceeds for the benefit of the chargee.

Accordingly, the CFI found that in this case, the Charge was a fixed charge and thus had priority over the Charging Order for the following reasons:

1. Any disposal of the shares could only be effected out of the margin account, meaning that the FI would always learn of any attempt to dispose of the shares, and the FI was contractually entitled to refuse the withdrawal of shares from the margin account; and

2. The sale proceeds were automatically applied to reduce the defendant's indebtedness owed to the FI, as such, the proceeds never became available to the defendant.

***The Bei Ni* case: Takeaways**

The *Bei Ni* case is a useful reminder of the legal principles to bear in mind when drafting a fixed or, as the case may be, a floating charge: a charge that is intended to be a fixed charge should give sufficient legal control over the charged assets to the chargee, whereas a charge that is intended to be a floating charge should give sufficient discretion to the chargor.

In particular, to constitute a fixed charge, first and foremost all related agreements should refer to the charge as a fixed charge. The charge will also explicitly set out sufficient control arrangements, so that:

1. As against the chargee, no unilateral disposal of charged assets is permitted; and

2. Alternatively, such a disposal may be permitted but only with the chargee's prior knowledge and consent, and only if all sale proceeds are to be applied for the chargee's benefit (such as automatically applied to reduce the existing debt owed by the chargor to the chargee).

All in all, whether a charge is to be classified as a fixed charge or a floating charge is very much a fact-sensitive question. Legal advice should be sought when in doubt.

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