Between Financiers and the Court: The Hidden Tax of Contractual Autonomy in Secured Financing

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1.0. Background

The best secured financing minimises credit risk during insolvency. Financiers[1] leverage contractual autonomy to negotiate hard-fought security packages that secure early credit recovery ahead of other creditors upon insolvency, thereby reducing overall credit risk. However, contractual autonomy suffers legal constraints. Courts may recharacterise 'hard-fought" contractual clauses that disguise security packages, exceed permissible legal scope or result in ambiguity. In practice, financiers push the boundaries of their autonomy to aggressively minimise insolvency risk, but end up contracting themselves into recharacterisation, invalidation, and adverse-construction risks arising from these legal constraints. This paper critically analyses party autonomy as the basis of secured financing, examines autonomy-induced risks, and offers risk mitigation strategies.

2.0. Nature of secured financing: interplay of party autonomy

In high value transactions, secured financing is a form of borrowing where the financier advances credit to a borrower supported by credit securities, that is, assets or rights the financier can claim upon borrower's default on payment. Credit securities have two main categories: security interest and credit support. Security interest refers to mechanisms under which the financier obtains recourse to borrower's assets upon default.[2] It includes title-based security where title to borrower's assets is transferred to the financier in lien or retention of title deeds; contract-based assets where financiers rely on contractual rights to control borrower's assets in charges or mortgages; and reverse security where the borrower limits its liability to a defined pool of assets through Special Purpose Vehicles.[3] On the other hand, credit support are additional personal undertakings by third parties that alter their legal position

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[1] Note, the use of financier(s) in this work include corporate lawyers negotiating on behalf the financier.
[2] Colin Bamford, 'Security Interests' in *Principles of International Financial Law* (3rd edn, Oxford University Press 2019) ch 10, 279–308.
[3] Bamford, Principles of International Financial Law.

or offer recourse to third party assets, enhancing borrower's payment obligations. It includes guarantees and indemnities.[4]

Contractual autonomy —one of the oldest legal vehicles— drives these secured transactions. Jessel MR echoed this principle over 100 years ago in the locus classicus case of *Printing and Numerical Registering Co v Sampson*[5] that:

"...men of full age and competent understanding shall have the utmost liberty of contracting and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by Courts of justice...[However,] there is no doubt public policy may say that a contract... is necessarily void."

The natural implication in secured transactions is that parties should be free to create a security interest of whatever type in other consenting parties if they want to do so. However, any contract that contrary to the social or economic interest of the public must be forbidden.[6] Courts have attempted to describe public policy to entail that contracts 'that run 'contrary to the general policy of the law',[7] 'that stipulate for iniquity' or 'is against the public good',[8] or which had arisen ex turpi causa.[9] As rightly articulated per Lord Wilberforce in *Esso Petroleum Co Ltd v Harper's Garage (Stourport) Ltd*[10] any attempt to classify the categories of contract that are prima facie void is hazardous in the extreme. Therefore, there is no accurate rubric under which they can be brought; the classification must remain fluid and the categories can never be closed.

Notably, of all the credit securities, floating and fixed charges, shaped heavily by party autonomy, are one of the most hotly contested. A classic fixed charge prevents the borrower from dealing with or disposing of charged assets while floating charge permits borrower's free use of charged assets including disposition thereof without reference to the chargee, until the

[4] Colin Bamford, 'Credit Support in Financial Markets' in *Principles of International Financial Law* (3rd edn, Oxford University Press 2019) ch 9, 247–278.
5 (1875) 19 Eq 46.

[6] M P Furmston, J W Carter, C Cheshire and E Fifoot, *Cheshire, Fifoot and Furmston's Law of Contract* (16th edn, OUP 2012).
[7] *Lowe v Peers* (1768) 4 Burr 2225 at 2233.
[8] *Collins v Blantern* (1767) 2 Wils 341 at 350.
[9] Holman v Johnson (1775) 1 Cowp 341 at 343.
[10] [1968] AC 269.

charge crystallises upon the occurrence of specified event.[11] Upon insolvency, fixed charge holders rank in priority over preferential creditors and all other creditors whereas unsecured creditor's carve-outs, preferential creditors and administrative expenses erode floating charge recoveries.[12] To expand charged assets while bypassing the condition-laden floating charges, financiers take fixed charge over the borrower's book debts while allowing the borrower to deal with or dispose of such receivables in normal course of business. The debate has been whether such arrangements created a fixed charge, or whether the charge should instead be categorised as a floating charge.[13]

The court settled this controversy in *re Spectrum Plus*[14]. The House of Lords held similar to decisions in *Illingworth v Houldsworth*[15] *and Agnew v Commissioner of Inland Revenue*[16] that the critical distinction between floating and fixed charges lies in the control exerted by the secured party over the property rather than the nature of the secured property per se. Therefore, any charge whereby the company is allowed to deal with the charged assets and remove them from the charge must be a floating charge and not a fixed charge.[17] The basis of this decision is the public policy concerns on protection of innocent third party rights. The court in *re Spectrum Plus* held that:

"The facilitation of the lender and creditor to structure their agreement in the way they so choose, could seriously compromise the third parties. Consequently, Parliament has

[11] Ccompanies Act 2006, Section 859D of cross-referencing Section 486(1) of the Companies Act 1985.
[12] Companies Act 2006, 754, 150ZA; Insolvency Act 1986, ss 175, 176, 245, 251, Sch B1; Enterprise Act 2002, ss 250–252.
[13] Ernest Owusu-Dapaa, 'An Assessment of Party Autonomy in the Evolution of Secured Credit in England and beyond - Lessons for Ghanaian Law' (2007-2008) 4 KNUST LJ 20; Dora Neo Swee Suan, 'Fixed and Floating Charges over Book Debts: A Post Mortem on the Debate' (2005) 17 Singapore Academy of Law Journal 617–647; Gerrard McCormack, *Secured Credit under English and American Law* (Cambridge University Press 2004) 12, cited in Ernest Owusu-Dapaa, 'An Assessment of Party Autonomy in the Evolution of Secured Credit in England and beyond – Lessons for Ghanaian Law' (2007–2008) 4 *KNUST LJ* 20.; Jennifer L. L. Gant, 'Floating Charges and Moral Hazard: Finding Fairness for Involuntary and Vulnerable Stakeholders' in Jonathan Hardman and Alistair MacPherson (eds), *The Floating Charge in Scotland: New Perspectives and Current Issues* (Edinburgh University Press 2022).
[14] [2005] 3 WLR 58.
[15] [1904] AC.
[16] [2001] 2 AC 710.
[17] The House of Lords in Spectrum Plus agreed with the Privy Council in Agnew that New Bullas was wrongly decided, hence overruled.

intervened to subordinate floating charge to preferential debts in priority contest...to mitigate the harsh consequence of party autonomy on third parties so to speak."

Some scholars argue that these decisions erode party autonomy in secured financing. Professor McCormack[18] has argued that security represents a fair exchange for the loan and consequently priority position conferred by such agreement should not be upset, since secured creditors have bargained for rights of proprietary nature over the debtor's property whereas general creditors have not done same. Owusu-Dappa[19] submits that the concern for weaker third parties should not be used as a justification to place too many fetters on autonomy of parties to secured transactions as the interest of third parties are best served by making information on what has been done readily available.

In my view, public policy is a core feature of party autonomy and not a bug. The combined provisions of the English company act, insolvency act and Enterprise Act 2002's show legislative intervation to protect the innocent public by preserving a certain percentage of realisations from assets subject to floating charge for preferential and involuntary creditors to prevent financiers from potentially taking every company assets including book debt out of their grasp, and in a case where the company's assets consist mainly of book debts, leave the preferential creditors with nothing at all. Dr Gant[20] offers a fresh perspective. She argues that the information asymmetries naturally present between the financiers and weak employees means that financiers are significantly better informed about the borrower's financial state whereas preferential creditors like regular employees depend on the company fully for livelihood and pension contributions and will not be privy to the same level of information; and even if they were, they were caught in the ubiquitous need for a job without any true risk mitigation tool than continuing to work for their current financially distressed employer.

Recent UK data, from a 2024 Insolvency Service research report on Creditors' Voluntary Liquidations (CVL), analyzing recoveries, shows that unsecured creditors received 0% in 90% of 2,697 cases; preferential creditors received 0% in 78% of 905 cases while floating charge

[18] McCormack, *Secured Credit under English and American Law* (n. 11).
[19] Owusu-Dapaa, 'Party Autonomy in the Evolution of Secured Credit' (n. 11).
[20] Gant, 'Floating Charges and Moral Hazard' (n. 11).

creditors received 0% in 80% of 250 cases.[21] A cursory glance at the statistics reveals a stark disparity in the volume of reported cases, which alone underscores the unfairness of permitting floating charge holders to capture more charged assets, thereby extinguishing any realistic prospect of recovery for other creditors.

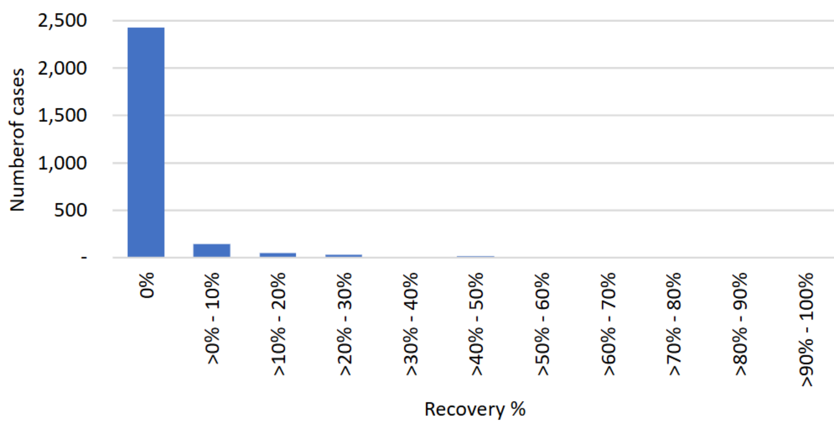

Fig 1: Recovery: Unsecured Creditors. Source: CVL research report.

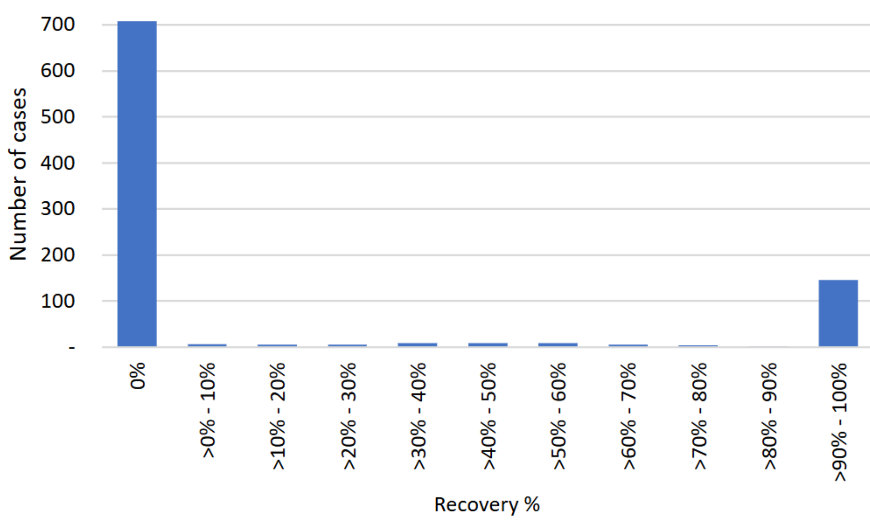

Fig 2: Recovery: Preferential Creditors. Source: CVL research report.

[21] Insolvency Service, *CVL Research Report for the Insolvency Service* (Corporate Report, 17 December 2024) https://www.gov.uk/government/publications/creditors-voluntary-liquidation-cvl-research-report-for-the-insolvency-service/cvl-research-report-for-the-insolvency-service accessed 18 December 2024.

Viewed from this perspective, it cannot really be said that the court relegated party autonomy in recharacterising mislabeled charges. To assume otherwise is to impute to party autonomy the improbable feature of absolutism, contrary to the spirit of law.

3.0. The Hidden Tax of Party Autonomy: Distortion of Risk Perception in Secured Financing

3.1. English Law Position

In practice, financiers push the boundaries of their autonomy to aggressively minimise insolvency risk. They disguise security packages, exceed permissible legal scope and draft ambiguous clauses distorting their risk perception of what is possible. They move from hedging against insolvency to contracting themselves into recharacterisation, invalidation, adverse-construction and other autonomy-induced risks. Party autonomy exists within set rules and public policy consideration, driving roughshod through it necessitates several risk exposures. I examine these risks in more detail below.

3.1.1. Recharacterization risk: Where parties mischaracterize security packages to alter non-consenting third-party position

The financier aims to reduce overall credit risk by maximizing full and early credit recovery upon insolvency, whereas insolvency law, like every other law, aims to protect the public interest by subordinating floating charge holders to preferential holders.

As discussed earlier, where parties mischaracterize securities the court will apply overriding public interest to recharacterise such securities and render them void for being unregistered floating charges in accordance with the provisions of the law.[22] The relevant guidance that can be distilled from *Siebe Gorman*, *Agnew* and *Spectrum Plus* cases is that neither labelling of charge as first fixed charge nor inclusion of negative pledge clause in the security agreement precluding unilateral assignment will suffice to characterise a charge as a fixed charge. If their intention, properly gathered from the language of the instrument and post-contractual behaviour, is to grant the company rights in respect of the charged assets which are inconsistent

[22] As Lord Walker observed in Spectrum Plus, "there is a public interest which overrides unrestrained freedom of contract".

with the nature of a fixed charge, then the charge cannot be a fixed charge however they may have chosen to describe it.[23]

The practical result of the developments in England could therefore be that debenture holders might have to contend themselves with a floating charge that is subject to the claims of preferential creditors and live with less protection than they thought they had before.[24]

3.1.2. Invalidation risk: where transactions are legally defective eg. parties abandon fundamental terms or negotiate beyond the scope of law and public policy

In contract law, not all agreements are fully effective. A security contractual clause may be classified as void, voidable, or unenforceable when it suffers from fundamental legal defects. A void contract is treated as if it never existed from the beginning (e.g., due to illegality or lack of consideration or ultra vires provisions), producing no legal rights or obligations. A voidable contract is valid and binding until one party exercises their right to rescind it (e.g., due to misrepresentation, duress, or undue influence). An unenforceable contract exists and may be valid in substance, but cannot be enforced in court due to technical or procedural failings (e.g., lack of required writing under statute or registration).[25]

Insolvency law generally requires equal (pari passu) distribution of assets among unsecured creditors under the anti-deprivative rules. In *British Eagle International Airlines Ltd v Compagnie Nationale Air France*,[26] the House of Lords held that private contracts which circumvent this mandatory principle are void. The IATA clearing arrangement, which effectively paid one creditor from an asset that should have been part of the general insolvency estate, was struck down. On the question of furnishing contractual consideration, in *Carillion Construction Ltd v Hussain*,[27] Carillion sought to enforce three "letters of support" issued by directors of the parent company it was in business with. The Court held that there was no contract as the letters had been addressed to the directors, in their personal capacity, and not as

[23] Owusu-Dapaa, 'Party Autonomy in the Evolution of Secured Credit'.
[24] Neo Swee Suan, 'Fixed and Floating Charges over Book Debts'.
[25] Cheshire, Fifoot and Furmston, *Law of Contract.*
[26] [1975] 1 WLR 758.
[27] [2013] EWHC 685 (Ch).

agent for the company. Further, there had been no new consideration flowing from Carillion to the parent company for the benefit of promise in the subsequent letter.[28]

3.1.3. adverse construction risk: where parties draft ambiguous terms into the clauses

Courts rely on objective rules to interpret the contractual terms.[29] The rule as laid out by Lord Hoffmann in *Investors Compensation Scheme v West Bromwich Building Society*[30] is that words should, as a matter of practical policy, be given their natural and ordinary which they would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract. It includes absolutely anything that would have affected the way in which the language of the document would have been understood by a reasonable man. Patten LJ in *Kookmin Bank v Rainy Sky SA*[31] and others explains that in a commercial contract (like any other contract) the parties have chosen to define the limits of the obligations which they have undertaken by the language they have used. The purpose of the contract is to provide an objective record of what they have agreed so as to regulate the legal relationship between them. The Court's function is to give effect to those obligations by respecting the terms in which they are cast. [32]

Where terms are vague and ambiguous, financiers risk adverse constructuction of security packages by court in favour of true intention of parties and reasonable man in the society. In the leading case of *Kleinwort Benson Ltd v Malaysian Mining Corp Bhd*,[33] a parent company which had given a comfort letter in respect of its subsidiary subject to the parent company's policy argued that it had not intended to create any binding obligation. The Court of Appeal held that the letter had honestly and correctly stated the policy of the parent company at the date when it was written. The letter had not said that the parent company's policy would not change in the future, if circumstances changed. There was no question that the parent company had misrepresented its own view at the time the letter was written. The only question was

[28] Bamford, 'Credit Support in Financial Markets'.
[29] Colin Bamford, 'The Construction of Financial Contract' in *Principles of International Financial Law* (3rd edn, Oxford University Press 2019) ch 11.
[30] [1998] 1 WLR 896.
[31] [2010] EWCA Civ 582.
[32] Bamford, 'The Construction of Financial Contract'.
[33] [1989] 1 WLR 379.

whether it had undertaken that it would not change its policy. In reaching the conclusion that it had made no such promise, the Court of Appeal was heavily influenced by the fact that, in negotiations, the parent company had refused repeatedly to give a guarantee. In other words, it had not been prepared to accept a continuing obligation of support, even though that support was in accordance with its policy at the time.[34]

3.2. Comparative analysis of Legal Position in Nigeria and England on Party Autonomy in Secured Financing

Nigeria operates under the common law system applicable in the England. Therefore, the principles of party autonomy in secured transactions has been recognised by courts in the Nigeria. For example, Sections 203 and 204 of the Nigeria Company Act[35] set out that fixed charges attach to specific assets and take priority over floating charges, which "float" over changing assets until they crystallise, establishing a clear hierarchy in enforcement and repayment that protects secured creditors' interests. However, unlike English laws, Section 222(13) of the Nigeria Companies Act provides a definition of hotly contested book debt. It stipulates that book debt means "a debt due or to become due to the company at some future date on account of or in connection with a profession, trade or business carried on by the company, whether entered in a book or not, and includes a reference to a charge on a future debt of the same nature although not incurred or owing at the time of the creation of the charge, but does not include a reference to a charge on a marketable security or on a negotiable instrument".

These statutory provisions in Nigeria appear to be equivalent to the English law contemplation, and similar legal analysis applicable in England will be relevant in Nigeria.[36]

4.0. Addressing Autonomy-induced Risk Distortions in Secured Financing: a Faustian Bargain or Calculated Gamble?

[34] Colin Bamford, 'Credit Support in Financial Markets'
[35] Companies and Allied Matters Act.
[36] Aaron Ologe, 'Examining the Legal and Economic Indices of Priority of Floating Charges: A Comprehensive Analysis' (2021) 1 *Western Delta University Law Journal*.

Financiers are highly creative — and indeed encouraged to be so — in crafting security arrangements, yet they must remain strictly within the ambits of the law. Any financier who attempts to outwit the law is effectively striking a Faustian bargain; they may gain short-term advantage through their ingenuity, but they risk an eventual loss when the court intervenes. No matter how well calculated their strategies, they are at best executing a calculated gamble and the very notion of such a gamble is inherently devoid of fair reason, for what begins as a deliberate strategy can spiral into consequences far exceeding any anticipated reward.

Financiers may expand their charged assets to capture the borrower's book debts through legitimate means depending on the financiers' business objectives. ***First***, they may hold floating charge on book debt to maximize control of borrower's company upon insolvency/ bankruptcy, by exercising their power to appoint an administrator out-of-court. This is suitable for financiers such as private equity firms investing in underperforming business with the aim of turning it around and realising value through operational improvements, asset optimisation, or eventual exit.[37] ***Second***, they may hold floating charge and adjust loan rate to reflect risk of low credit recovery upon insolvency. Each party must protect his own interest by studying the situation, examining the subject matter of the contract and the general market situation and assessing the future probabilities to alter the rates on their loan. ***Third***, flowing from the preceding strategy, where fixed charge appears insufficient, financiers should seek less risky businesses as an alternative to avoid overleveraging the borrower. ***Fourth***, they may opt for outright assignment of book debts known as debt factoring. The borrower assigns its book debts at a discount to the financier (factor) in exchange for immediate cash; this removes the book debts entirely from the borrower's balance sheet, provides non-recourse funding and allows the financier to collect directly from customers without relying on crystallisation or insolvency priorities, offering a more efficient way to capture book debts compared to security-based structures. ***Finally***, they may take a fixed charge over book debts by requiring them to be paid into a blocked account. This restricts business efficiency and undermines the debtor's ability to maximise returns and discharge liabilities as they fall due, thereby ultimately

[37] Extensive exposition by Adrian J Walters, 'Statutory Erosion of Secured Creditors' Rights: Some Insights from the United Kingdom' (2015) *University of Illinois Law Review* 544–570.

signalling to third parties that the business is over-leveraged and allowing the law to serve its true function of third-party protection.

Financiers must refresh their knowledge of basic principles of contract —offer, acceptance, consideration and consensus —to avoid defective securities. In practice, financiers who seek new securities to cover existing loans, will need to furnish new consideration for such securities, otherwise the securities will fail for past consideration. The most common and reliable solution is to formalise the promise as a deed rather than a simple contract as deeds do not require consideration to be binding, or in the alternative, integrate the prospects of future security into the transaction as part of the overall deal from the outset, where the lender's advancement of funds or forbearance is conditional on the new securities.

This underscores the importance of clear and all-encompassing drafting in secured financing.[38] In *Kleinwort Benson Ltd case* above which was unenforceable for limited use of the word "policy", the relevant sentence of the agreement was:

"*It is our policy to ensure that the business of [the subsidiary] is at all times in a position to meet its liabilities to you...*"

Other contractual and post-contractual elements being satisfied, a better draft could have included a carve-out or stronger promissory language to create enforceable obligations, such as:

"*...we hereby irrevocably and unconditionally undertake and agree that: ...*"

5.0. Conclusion

It appears the law circled back to where it took-off: contract law. In truth, the *spectrum case* made no new introductions, it mainly clarified existing law exposing many contracts resting

[38] Note, careful drafting does not guarantee that a security would be characterised as a fixed charge by the courts, the court in Agnew noted 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".

on distorted and fragile foundations of contractual principles. Financiers must understand that the spirit of the law particularly contract and insolvency laws driving their secured financing is anchored on protecting public interest including innocent third parties and punishing illegality. Armed with this understanding, their key question beyond credit risk maximization should be: will this position harm innocent third parties and if it does not will it be ultra vires under the law?

Financiers who consider this risk perspective will win with contractual autonomy and avoid being scapegoated whenever the court raises its gaze upon them. Ultimately, while party autonomy drives efficient credit markets, legal limits ensure resilience without undermining public good.