

TECH 5/99

**INSOLVENCY GUIDANCE NOTE
STATEMENT OF INSOLVENCY PRACTICE 14 (E & W):
A RECEIVER'S RESPONSIBILITY TO PREFERENTIAL CREDITORS**

Reproducing the revised Statements of Insolvency Practice 14 issued in April 1999 by the Council of the Society of Practitioners of Insolvency.

Insolvency guidance notes as to the best practice to be adopted by licensed insolvency practitioners are persuasive rather than mandatory. Members are advised that a Court of Law may, when considering the adequacy of the work of an insolvency practitioner, take into account any pronouncements or publications which it thinks may be indicative of good practice. Statements of Insolvency Practice are likely to be so regarded. Members are also reminded that, by virtue of the ICAEW Bye-laws, 'in determining whether or not a formal complaint has been proved, the Disciplinary Committee may have regard to any code of practice, ethical or technical, and to any regulations affecting member firms'.

SMT/sm
T:0036
29.06.99

STATEMENT OF INSOLVENCY PRACTICE 14 (E & W)

A RECEIVER'S RESPONSIBILITY TO PREFERENTIAL CREDITORS

ENGLAND AND WALES

1. INTRODUCTION

- 1.1 This statement of insolvency practice is one of a series issued by the Council of the Society with a view to harmonising the approach of members to questions of insolvency practice. It should be read in conjunction with the Explanatory Foreword to the Statements of Insolvency Practice and Insolvency Technical Reminders issued in June 1996. The statement has been prepared for the sole use of members in dealing with receiverships where any assets of the company are subject to a floating charge. Members are reminded that SPI Statements of Insolvency Practice are for the purpose of guidance only and may not be relied on as definitive statements. No liability attaches to the Council or anyone involved in the preparation or publication of Statements of Insolvency Practice. This statement applies to England and Wales only.
- 1.2 This statement has been prepared to summarise what is considered to be the best practice to be adopted by receivers of the assets of companies where any of those assets are subject to a floating charge so that the office holder has legal obligations to creditors whose debts are preferential. Its purpose is to:
- ensure that members are familiar with the statutory provisions;
 - set out best practice with regard to the application of the statutory provisions;
 - set out best practice with regard to the provision of information to creditors whose debts are preferential and to responses to enquiries by such creditors.

Whilst this statement does not specifically address the treatment of preferential claims in liquidations, members acting as liquidators (or in any other relevant capacity) should have due regard to the principles which it contains.

- 1.3 The statement has been produced in recognition of the likelihood that creditors whose debts are preferential may be concerned about the categorisation of assets as between fixed and floating charges and the manner in which costs incurred during a receivership are charged against the different categories of assets.
- 1.4 The statement is divided into the following sections:
- the statutory provisions
 - the categorisation of assets and allocation of proceeds as between fixed and floating charges
 - the apportionment of costs incurred in the course of the receivership
 - the determination of claims for preferential debts
 - the payment of preferential debts
 - disclosure of information and responses to queries raised by creditors whose debts are preferential
 - other matters

2. THE STATUTORY PROVISIONS

- 2.1 The rights of creditors whose debts are preferential in a receivership derive from section 40 of the Insolvency Act 1986 ('the Act').

Where a receiver is appointed on behalf of the holders of any debentures of a company secured by a charge which, as created, was a floating charge and the company is not at the time in the course of being wound up, its preferential debts shall be paid out of the assets coming into the hands of the receiver in priority to any claims for principal or interest in respect of the debentures. Where the receiver is appointed under both fixed and floating charges, this requirement does not extend to assets coming into the receiver's hands pursuant to the fixed charge(s).

Preferential debts are defined in section 386 of the Act and are set out in Schedule 6 to the Act (as amended from time to time), which is to be read in conjunction with Schedule 4 to the Pensions Schemes Act 1993. The date at which they are to be ascertained is the date of the appointment of the receiver (section 387(4) of the Act).

- 2.2 Members should note that the statutory provisions give a right to creditors whose debts are preferential to be paid those debts in priority to the claims of floating charge holders, and the corollary of this right is the obligation of the receiver to pay them. Failure by a receiver to pay preferential debts out of available assets is a breach of statutory duty. However it is recognised that circumstances may arise when it is administratively convenient or cost-effective to cooperate with a company's liquidator and arrange for him to pay the receivership preferential debts, and guidance on such arrangements is given in paragraph 6.2 below. It should be noted that such arrangements do not exonerate the receiver from his obligations.

- 2.3 There are no statutory provisions requiring creditors with preferential debts in a receivership to prove those debts in any formal manner and no statutory obligation is imposed on a receiver to advertise for claims.

3. CATEGORISATION OF ASSETS AND ALLOCATION OF PROCEEDS

- 3.1 In order to ascertain what assets are subject to the statutory rights of creditors whose debts are preferential, it is necessary to distinguish, on a proper interpretation of the charging document(s), which assets are subject to a fixed charge and which are subject to a floating charge. In this statement this process is referred to as 'categorisation'.

- 3.2 The overriding principle, as laid down by the courts, is that it is not of itself sufficient for the charging document to state that an asset is subject to a fixed charge for it to be subject to such a charge. There have been cases where the courts have struck down charges that purported to be fixed and held that they were floating.

- 3.3 It is the duty of a receiver to effect the right categorisation and legal advice should be taken in cases of doubt. In some instances where there is doubt as to the correct categorisation it may be possible to consult preferential creditors and reach agreement with them and the chargeholder. However, if this is not possible and the receiver, in conjunction with his legal advisers, cannot determine the correct categorisation, it may be necessary to apply to the court for directions.

- 3.4 Members are reminded that:

- it is the type of charge at the time of its creation which determines whether the assets are available to meet preferential debts. Crystallisation of a floating charge into a fixed charge prior to or upon the appointment of a receiver does not affect the rights of creditors with preferential debts to be paid out of assets subject to a crystallised floating charge;
- the conversion, during receivership, of assets (for example, stock) subject at the date of appointment of the receiver to a floating charge into assets (for example, book debts) subject to a fixed charge, will not remove them from the pool of assets which is available to pay preferential debts.

- 3.5 Section 40 of the Act requires that the preferential debts 'shall be paid out of the [floating charge] assets coming to the hands of the receiver in priority to' the debenture holder. The effect is that a receiver is under a liability in tort to the preferential creditors if, having had available assets in hand, he fails to apply them in payment of the preferential debts. Where any action which he proposes to take could result in a diminution in the amount available to meet preferential debts the receiver should give the most serious consideration to the risks of such action.

3.6 When assets are sold as part of a going concern (or otherwise in parcels comprising both fixed and floating charge assets) the apportionment of the total consideration suggested by the purchaser (for example for his own financial reasons) may not properly reflect the financial interests of the different classes of creditors in the individual assets or categories of assets. In these circumstances the receiver should ensure that he will be able properly to discharge his obligations to account to holders of fixed charges on the one hand and creditors interested in assets subject to floating charges on the other.

4. APPORTIONMENT OF COSTS

4.1 The amount available to meet preferential debts is the funds realised from the disposal of assets subject to a floating charge net of the costs of realisation. It is dependent, therefore, not only on the correct categorisation of the assets but also on the appropriate allocation of costs incurred in effecting realisations.

4.2 These costs will normally fall into one of three categories:

- liabilities incurred by the company (the receiver being its agent until winding up supervenes) and costs incurred by the receiver and recoverable by him out of the company's assets under his statutory indemnity (other than those referred to below);
- the costs of the receiver in discharging his statutory duties;
- the remuneration and disbursements of the receiver.

4.3 Liabilities incurred by the company and the receiver's reasonable costs are sometimes readily identifiable as applicable to either the fixed charge or floating charge assets, but in other cases may not be so easily allocated between the two categories of assets.

Where costs are clearly identifiable as having been incurred in the realisation or collecting in of one or other of the two categories they should be recorded as such in the receiver's records so that they can be deducted from realisation proceeds in ascertaining the amount available for each class of creditors.

4.4 It is in the nature of receiverships, and particularly receiverships where trading is continued, that there will be continuation of employment of the company's directors and staff, ongoing occupation of its premises, purchase of supplies for manufacturing and other purposes and much of the other expenditure normally associated with a company's operations. In these circumstances it may be difficult to arrive at an appropriate allocation of costs. Many of the activities in a trading receivership will enhance the realisations of assets in both of the categories identified above. They may of necessity be incurred before full categorisation has been completed.

These factors do not affect the duty of a receiver to allocate costs appropriately but that allocation will involve the exercise of professional judgement undertaken with a full appreciation that it must be made with independence of mind and with integrity.

4.5 The key principles for a receiver in his consideration of the allocation of costs (including any trading losses) are:

- the statutory rights of preferential creditors as set out in the Insolvency Act 1986 and the decisions of the courts in cases under that Act and predecessor legislation;
- the provisions of the charging document(s);
- the maintenance of a proper balance as between the classes of creditors with whose interests he is required to deal in the light of their legal rights.

In order to enable a receiver to allocate costs on an appropriate basis, contemporaneous records of the dominant reasons for incurring costs should be maintained. These will also assist him in providing explanations as to how he arrived at what he considers to be an appropriate allocation and provide evidence should that allocation be challenged by any of the parties involved.

4.6 In allocating costs a receiver should have regard to:

- the objectives for which costs were incurred, it being recognised that certain types of costs may, properly, be allocated to the fixed charge assets in one case and to the floating charge assets in another.¹ In another case such costs may enhance realisations in both categories.
- the benefits actually obtained for those financially interested in one or other category of asset in terms of protection of those assets or their value and any augmentation of that value.
- whether the benefits to those interested in assets subject to a fixed charge has been enhanced by action which proves to be detrimental to those interested in floating charge assets (for example where trading losses are incurred to protect or enhance the value of property or book debts subject to a fixed charge).
- whether the realisation of the undertaking and assets by means of a going concern sale has resulted in a reduction in the quantum of debts which are preferential due to the transfer of employment contracts.

4.7 A receiver will incur costs in complying with his statutory duties. The extent of those duties depends upon the nature of his appointment and they are more onerous in the case of administrative receivers.

An administrative receivership arises only when there is a floating charge and the charges under which the receiver is appointed are over the whole or substantially

the whole of the company's assets. There are no decided cases as to how the additional costs incurred by an administrative receiver (as opposed to a receiver not so designated) should be allocated.

¹ For example the payment of rent on a leasehold property may be to preserve the value of the lease or to enable manufacturing to continue and work in progress to be completed.

In apportioning the costs of fulfilling their statutory duties and in the absence of any guidance from the courts, members should have regard to the general principle referred to in paragraph 4.5 above of maintaining a proper balance.

4.8 The allocation of a receiver's remuneration and disbursements should be undertaken adopting the same principles as those applicable to costs and he should ensure that he maintains contemporaneous records which will enable him to make an appropriate division of his remuneration and disbursements between the different categories of assets.

5. DETERMINATION OF PREFERENTIAL DEBTS

5.1 As stated in paragraphs 2.2 and 2.3 of this statement it is a receiver's obligation to pay preferential debts out of assets available for that purpose and no proof of debt or advertisement for creditors is required.

5.2 Following initial notification to potential preferential creditors of his appointment and before beginning the process of determining preferential debts, a receiver should assess whether there are likely to be sufficient floating charge realisations to pay a distribution. Where no payment will be made, it is not necessary to agree preferential claims. However, in such circumstances the receiver should write to creditors whose claims are preferential explaining why he is unable to make a payment to them.

5.3 Where there will be a distribution to preferential creditors, the receiver should assist those creditors, where possible, by providing adequate information to enable them to calculate their claims. In the case of all preferential creditors other than employees, the receiver is entitled to assume they have full knowledge of their legal entitlements under the Insolvency Act and should invite them to submit their claims. The receiver should then check those claims, and accept or reject them as appropriate.

5.4 In determining the preferential claims of employees, the receiver is not entitled to regard an individual employee as having full knowledge of his rights and entitlements. Accordingly, the receiver should obtain information from either the company's records or from the employee before calculating the claim (other than one which is payable to the Secretary of State by way of subrogation). The employee should be provided with details of the calculation of his claim and any further explanation that he may reasonably require.

- 5.5 Members are reminded that Schedule 6 (paragraph 11) of the Act provides that anyone who has advanced money for the purpose of paying wages, salaries or accrued holiday remuneration of any employee is a preferential creditor to the extent that the preferential claim of the employee is reduced by such advance.
- 5.6 When an employee's preferential debt has been paid out of the National Insurance Fund under the provisions of the Employment Rights Act 1996, the Secretary of State is entitled, by virtue of section 189 of that Act to the benefit of the employee's preferential debt, in priority to any residual claim of the employee himself. Members are reminded that a receiver is not obliged to accept the preferential claim of the Secretary of State without satisfying himself that it is correct. If a member is not able to accept the Secretary of State's claim he should contact the Redundancy Payments Service to explain why and attempt to reach agreement on the amount to be admitted.

6. PAYMENT OF PREFERENTIAL DEBTS

- 6.1 As soon as practicable after funds become available and the amount of the preferential debts has been ascertained, members should take steps to pay them. Under the statutory provisions preferential debts do not attract interest and payments to creditors should not be unnecessarily delayed. A receiver who does not comply timeously with his obligations under section 40 and against whom judgment is obtained may find himself ordered to pay interest by the court. While members cannot be expected to bear any financial risk by paying some preferential debts before all such debts are agreed, there are often circumstances when it is possible to make payment either in full or on account before all claims have been agreed and this course of action should be adopted whenever it is practicable to do so.
- 6.2 Situations may arise where, notwithstanding a receiver's statutory duty to pay preferential debts, it may (exceptionally) be administratively convenient or cost-effective for a receiver to make arrangements for the liquidator to make payment of the preferential debts arising in the receivership. Such arrangements are made at the receiver's risk, and should not be on any basis which could result in payment of an amount less than that which would have been available to meet those debts if the receiver had himself paid them, or which would cause delay in paying them.
- 6.3 The receiver should provide preferential creditors with details of any such arrangements and the reason for making them.

7. DISCLOSURE TO CREDITORS WITH PREFERENTIAL DEBTS

- 7.1 When the funds realised from assets subject to a floating charge are inadequate to pay the preferential debts in full, the receiver should (unless he has already written to them as suggested in paragraph 5.2) send those creditors a statement setting out:

- the assets which have, in accordance with the charging document, been categorised as subject to the floating charge;
- the costs charged against the proceeds of the realisation of those assets.

7.2 Any further information which a creditor with a preferential debt reasonably requires should be provided promptly.

8. OTHER MATTERS

8.1 Difficulties may arise in determining the rights of creditors to have debts paid preferentially in priority to a prior floating charge holder when the receiver has been appointed under a second or subsequent charge. The law in this area is complex and members should seek legal advice (and if necessary apply to the court for directions) when appointed under such a charge.

8.2 Situations will arise where payments sent out are not encashed and the payee cannot readily be located. The insolvency legislation does not make provision for this eventuality and there have been no reported cases where the courts have decided the matter. Where a receiver decides to account to the next person entitled to such monies he should bear in mind his overriding obligation to pay preferential debts. He should make such arrangements as he considers appropriate to enable him to recover the funds from the party to whom he has paid them so that he will be able to discharge his obligation to any preferential creditor who subsequently asserts his claim to payment.

Issued June 1999