CORPORATE LEGAL UPDATE

April 2007 to April 2008

"From boom to bust?"

Introduction

1. Much has happened in corporate insolvency law over the past year. The economy in April 2007 appeared to be relatively rosy, a continuation of the credit "boom" with independent forecasters projecting strong growth. The business climate is now much more challenging, though it may be too early to predict a general "bust". The headlines generated by and possible consequences of the credit crunch will be considered by other speakers[1], as will developments in cross-border insolvency issues[2]. The impact of the change in business climate and some of the litigation generated as a result is beginning to feed into mainstream practices. We intend to examine here corporate case law and legislative developments in the last 12 months in the following areas:

   - Part 1: The administration regime
   - Part 2: Directors' liability
   - Part 3: Prescribed part issues
   - Part 4: Employees of insolvent companies
   - Part 5: Insolvent tenants
   - Part 6: Miscellaneous; distribution issues and other matters

2. We also hope to consider in these notes, and in the seminar itself, how market practice has and should adapt in these areas, as well as to suggest some possible practical solutions to commonly experienced difficulties.

Part 1: The administration regime

Introduction

3. The administration regime is now firmly entrenched as the most popular form of insolvency procedure, with significant advantages over other insolvency procedures. The streamlined administration procedure introduced by the Enterprise Act and Schedule B1 has now had some time to bed down. During this year there have been some significant decisions which assist in interpreting material parts of Schedule B1, some of which we discuss further in Parts 3 and 5 below. There remain, however, a number of gaps in the legislation and practical difficulties or challenges which practitioners have to deal with, and we consider it useful to start by considering the same:

Pre-appointment costs

4. The question of recovery of pre-administration expenses, and in particular fees incurred during that period, remains an ongoing problem for practitioners. Any outstanding fees and expenses at the date of the administration are prima facie to be treated as an unsecured claim (see Dear IP letter in September 2005). As noted in last year's seminar, this problem in relation to pre-administration costs is particularly acute in relation to pre-packs where almost all the work is carried out pre-administration.

5. It is understood that the new insolvency rules (the implementation date for which keeps getting pushed back; they are unlikely to be laid and brought into force until 2009) will bring in a new regime in relation to pre-administration costs. It is proposed to give creditors (or the "paying

---

[1] See "After the credit crunch", Justin Bickle & Stephen Davies QC

[2] See "Solutions to common cross-border insolvency issues", Graham McPhie & Stefan Ramel

party") an opportunity to approve the recovery of pre-appointment expenses after the administration order has been made.

6. In addition, a new SIP16 is now in the pipeline, which, when released, will deal with pre-pack administrations. There is still concern that practitioners are improperly taking pre-appointment remuneration and until the new rules are brought in the safest option remains to make sure that separate provision is made for payment of pre-administration work, with an appropriate client engagement letter identifying who will be responsible for the prospective administrators' fees during the pre-pack period and to whom they accept that they owe a duty of care. In most cases the prospective administrators will be advising the company. Two important issues flow from this. First, it is always prudent expressly to explain that the prospective administrators are not advising the directors personally and that they should seek independent legal advice. Trading, particularly for an extended pre-pack period, can be fraught with risks. Secondly, the prospective administrators, when finally accepting appointment, should remember to disclose, on Form 2.2B, their prior professional relationship with the company. All too often, administrators consider pre-appointment time and post-appointment time as "one job". Regulatory professional bodies are now insistent upon pre-appointment time being kept entirely separate from post-appointment time. By creating separate files for the pre and post appointment work, the change in identity of client and the parties to whom a duty of care is owed is highlighted. Furthermore, there is less risk of practitioners viewing the recoverability of pre and post appointment time "as a whole".

Paragraph 52(1)(b) cases

7. Under paragraph 52(1)(b) of Schedule B1, the administrator may dispense with the need for an initial creditors' meeting if s/he thinks that the company has insufficient property to enable a distribution to be made to unsecured creditors other than by virtue of section 176A(2)(a) (the prescribed part provision). Rule 2.33(5) provides for the administrators' proposals to be deemed to have been approved unless a meeting of creditors is requisitioned under paragraph 52(2).

8. A common mistake made by firms is to forget that they still have to get their remuneration approved; business which would ordinarily be dealt with at the initial creditors' meeting. IR 2.106(5A) provides that in paragraph 52(1)(b) cases, if there is no creditors' committee or the committee does not make the requisite determination in relation to fees, remuneration may be fixed by the approval of each secured creditor (subsection (a)) or, in cases where a distribution to preferential creditors is anticipated, each secured creditor and preferential creditors whose debts amount to more than 50% of the preferential debts, disregarding the debts of any creditor who does not respond to the invitation to give or withhold approval. The default option is to have remuneration fixed by the court (subsection (6)). The most common difficulty to arise in relation to paragraph 52(1)(b) cases is in relation to obtaining the consent of a charge holder who is "out of the money" but, for reasons often best known to themselves, sometimes not prepared to provide the requisite consent. Practitioners should bear in mind that consent must only be sought in relation to the *basis* of remuneration: time charges or percentage of realisations (although, of course, full disclosure should be given regarding the charge out rates for each grade of staff and anticipated disbursement in accordance with SIP9. However, once the appropriate consent to the basis of remuneration has been given, the administrator is allowed to draw his fees, complying at all times with the disclosure obligations of SIP9. Where an IP anticipates that he may have difficulty obtaining the requisite consent from an "out of the money" charge holder, the sooner he seeks to agree the basis of his fees, the better. Once time charges have been incurred, it is difficult to avoid lengthy discussions regarding quantum and the amount of evidence that will be required to be prepared for an application to court will simply increase over time.

9. Further difficulties can arise in this area as a result of the potentially wide meaning of "secured creditor". The administrator requires the approval of "each secured creditor". Schedule B1 does not provide a definition of "secured creditor"; instead it falls to be defined by section 248: "a creditor of the company who holds in respect of his debt a security over property of the company". In perhaps one of the most inadequate and circular definitions contained within

statute, section 248(b) tells us that "security means in relation to England and Wales, any mortgage, charge, lien or other security". An administrator is not required to obtain approval to the proposed basis of his remuneration from the holders of floating charges; he is required to obtain the approval of "each secured creditor". Should this really include the holders of fixed charge security? And what about the local warehousemen with liens over the company's chattels? Most practitioners adopt a purposive approach and only seek the approval of floating charge holders but even then, they must be careful to examine the full terms of each type of security granted by the company. One must not overlook the possibility of a "lightweight" floating charge, often used by property lenders and even by some landlords who take fixed charges to secure rent deposits. Arguably, since as far back as most practitioners can remember, and more certainly since the introduction of the Financial Collateral (No.2) Regulations, charges created over rent deposits need not even be registered.

10. Where administrators' approvals have not been obtained at an initial creditors' meeting, there is no prescribed mechanism for dealing with modifications to the administrator's proposals. Paragraph 54 and 68(1) do not apply as there was no initial creditors' meeting. The mechanism is therefore uncertain. If the modifications required are substantial (e.g. a change to the exit route, or if there will now be a distribution to unsecured creditors) the only safe option would appear to be to make an application to court for directions under paragraph 68(2) (relying on paragraph 68(3)(a)). However, on the basis that in several smaller cases, the costs of such an application could prove to be prohibitive, where the substantial modification is good news and unsecured creditors will now receive a distribution, most practitioners are likely to "risk it" and on the basis that no party is likely to be prejudiced, notify creditors of the change of plan by letter and proceed to distribute as swiftly as possible.

11. It is perhaps a sign of the marvelous work achieved by administrators that several instances have arisen where, at the outset of a case, the administrators make a statement under paragraph 52(1)(b) (on the basis that they do not anticipate there will be a distribution to unsecured creditors) only to find, during the course of the administration, that sufficient assets will be realised to enable the payment of such a distribution. Having obtained the consent of secured and preferential creditors to the basis on which they are to be remunerated, are the administrators now required to obtain a resolution of the general body of creditors? Several advisers suggest that they are, but it is submitted that this cannot be right. Approval is given not to the actual quantum of remuneration to be paid, but to the basis of remuneration. SIP9 requires that the amount to be drawn is disclosed to all creditors, and they have the right to object if they consider the remuneration to be excessive. However there is no requirement to obtain the approval of all creditors concerned, even though the general body of creditors has fortuitously become the "paying party". It is notable that this approach has been adopted in the latest Insolvency (Amendment) Rules 2008 aka the Leyland Daf "fix" where a liquidator is obliged to seek the consent of the "paying party/ies" to proposed expenditure on litigation.

Invalid appointments

12. Paragraph 25 of Schedule B1 provides that an administrator of a company may not be appointed under paragraph 22 (out of court appointment by the company or directors) if either (a) a petition for winding up has been presented and has not been disposed of or (b) an administration application has been made and is not yet disposed of or (c) an administrative receiver of the company is in office.

13. There appear to have been a number of cases in practice where administrators have taken appointments and carried out substantial work under those appointments only to discover that either (a) a petition has been presented, but for whatever reason (due to court inefficiency, changes in addresses or other delays) it has not come to their notice or (b) unknown to them, another person has made an administration application. Difficult issues arise in this respect as to (1) how to regularise the position as regards ensuring a valid insolvency procedure is commenced, (2) the validity of acts done so far by the administrator and (3) who is to pay for the administrator's time costs prior to any regularisation of the position.

14. Some of these issues arose for determination in the case of *Re Blights Builders Limited* [2008] 1 BCLC 245; [2007] All ER (D) 147 (Jan) (Ch D) (Birmingham)(Judge Norris QC). In that case the administrators applied for directions regarding the validity of their appointment in relation to an administration petition presented after the presentation of a winding-up petition. The judge held that a petition is presented as soon as it is filed or delivered to court, notwithstanding that this date could be well in advance of the date when it was sealed and issued. As a result, a petition had been presented and not disposed of at the time the company purported to make an out of court appointment of the administrators, and accordingly the appointment was invalid under para 25. The appointment position was regularised moving forward since the petitioning creditor was willing for the court to treat his application as an application for an administration order, and the court appointed the administrator on that application. In other circumstances, the administrator will need to find a qualifying floating charge holder or secure the fresh efforts of the directors or the company or one or more creditors to make an administration application under para 12.

15. As regards the validity of the acts done, the court noted that the failure to satisfy the statutory criteria under paragraph 25 was a fundamental flaw which could not be remedied under any regularisation provision (following the decision in *Re Awan* [2000] BPIR 241). The court was willing, however, to grant the administrators an indemnity in respect of the actions taken by them under paragraph 34 of Schedule B1.

16. That did not provide a solution in relation to their remuneration, however, because that was not a "liability" which arose by reason of the invalidity of the appointment. The judge noted that the issue was whether the administrators should be entitled to look to the assets collected in for payment of their costs and remuneration. In the *Blights Builders* case that issue was stood over for further consideration in the event that no satisfactory arrangement could be reached with the creditors. Should the matter come before the court, however, it is considered likely that the court would be well disposed to an argument that some recovery out of assets realised and administered would be appropriate, based on *Berkeley Applegate* type principles.

Absence of ability to distribute prescribed part to unsecured creditors

17. To date paragraph 65 has been commonly interpreted as requiring an application to court even where the only proposed distribution to unsecured creditors is under the prescribed part provisions. This is dealt with in Part 3 (Prescribed part issues) below.

Part 2: Directors' liability

18. Most concentration and debate in the last year has concerned the effect of the Companies Act 2006. In last year's seminar, in the context of pre-packs, two headline changes to the duties and liabilities of directors were considered:

- Substantial property transactions with directors: Sections 320 to 322 of the Companies Act 1985 ("the CA 85") require the approval of members to transactions between the company and a director or person connected with the director concerning the acquisition of non-cash assets above certain prescribed values. An exception for liquidations was made, but no similar exception for administrations and receiverships (see the decision in *Demite v Protech Health Limited*). Section 193 of the CA 2006 extends the exemption to administrations. The commencement date is due to be October 2008

- Codification of directors' duties: Section 171 et seq. of the 2006 Act introduced a new codification of directors' duties to members (i.e. setting out in legislation the principles settled in cases, the common law) and a new derivative claims procedure. That legislation was brought into force in 2007. To date there have been no significant reported decisions in relation to the same.

19. One area where directors can expect an improvement in their position relates to the prospective replacement of section 349 of the Companies Act 1985. Section 349 is the section which requires the company's name to appear on correspondence and other documentation. As well as providing for criminal liability for the company and its officers in default it imposes personal liability on office holders in the following terms:

"(4) If an officer of a company or a person on its behalf signs or authorises to be signed on behalf of the company any bill of exchange, promissory note, endorsement, cheque or order for money or goods in which the company's name is not mentioned as required by subsection (1), he is liable to a fine; and he is further personally liable to the holder of the bill of exchange, promissory note, cheque or order for money or goods for the amount of it (unless it is duly paid by the company)."

20. Section 349(4) is due to be replaced in October 2008 when sections 82 to 85 of the CA 2006 are intended to be brought into force. In particular section 83 limits the civil consequences of failure to make the required disclosures to the ability of a defendant to take the point as a defensive measure to proceedings issued by the company. If the defendant can show that he has a claim against the company which he has been unable to pursue by reason of a breach or that he has suffered some loss by reason of the breach, the court may dismiss the proceedings unless satisfied that it is just and equitable to permit them to continue. The office holder is no longer personally liable.

21. Until 1 October 2008, however, section 349(4) remains in force. Furthermore, the width of section 349(4) has been widened by the Companies Act 2006 (Registrar, Languages and Trading Disclosures) Regulations 2006, to include order forms, and all electronic documentation falling within the definition of section 349, including websites.

22. Probably the most significant case law decision concerning directors' liability in the context of corporate insolvency in 2008 is the decision of the Court of Appeal in *Contex Drouzhba Ltd v Wiseman* [2007] EWCA Civ 1202 (20 November 2007). This case concerned whether or not the director in question, Mr Wiseman, could be held liable in the tort of deceit for impliedly representing, by signing an agreement with the claimant company containing specific payment terms, that the company had the capacity to meet its payment obligations in the event that it ordered the goods which were the subject of the agreement.

23. The insolvency profession are familiar with those parts of the Insolvency Act which provide for recovery against directors who have engaged in wrongful (section 214) and fraudulent trading (section 213). However both of those remedies are statutory remedies which may only be commenced on the application of a liquidator. Furthermore, even where one creditor may have been the only or principal subject of the fraud in question, any recoveries are paid back to the company for general distribution (under pari passu principles) to all the creditors rateably (see *Morphitis v Bernasconi* [2002] EWCA Civ 289).

24. It was with these provisions in mind that the Court of Appeal considered in *Contex v Wiseman* above whether a director signing for a company may be making an implied representation that the company had the capacity to meet the payment terms set out in the relevant document. The judge at first instance held that he did. He also found that at that time the company was insolvent, that Mr Wiseman knew it was insolvent, and that Mr Wiseman knew that the company did not, and would not, have the capacity to comply with any payment terms.

25. In the Court of Appeal the Court held that signature of the document on behalf of the company was sufficient for the purpose of section 6 Statute of Frauds (Amendment) Act 1828, which requires the representation to be in writing and signed by the person to be charged. The Court of Appeal rejected the suggestion that the implied representation was by conduct; they found that the representation was implied in the document signed by the director.

26. In short, this case provides a significant avenue for disgruntled creditors to pursue where:

- The directors are considered to have substantial assets; and

- The directors have committed the company to obligations which they knew at the time the company would be unable to meet; and

- They wish to recover their complete loss against the directors, rather than have to share it rateably with other creditors.

Part 3: Prescribed part issues

Introduction

27. The reader is now familiar with the flagship policy of the Enterprise Act 2002 to improve the lot of the unsecured creditors. A key aspect of this, and said to be the quid pro quo for the abolition of the crown preference, was the introduction of the prescribed part provisions in section 176A of the Insolvency Act 1986. There has been some debate and much uncertainty as to how, precisely, the prescribed part would work, and who would be entitled to share in it. Because these provisions only apply to debentures created post Enterprise Act we have to wait some time for any judicial pronouncements on the subject. Much of the debate concerning who may share in the prescribed part is now said to be settled by the decisions in *Re Permacell Finesse Limited (in liquidation)* and in *Re Airbase Services (UK) Limited (in administration)*. We propose to consider whether those cases have settled all the major questions and to consider some remaining practical issues. We shall do so in the context of answering two key questions, namely:

    - Who is entitled to share in the prescribed part?
    - How can the prescribed part be distributed?

28. First, however, it is useful to consider the relevant primary and secondary legislation.

Section 176A & the 2003 Order

29. Section 176A provides as follows:

176A Share of assets for unsecured creditors

(1) This section applies where a floating charge relates to property of a company-

(a) which has gone into liquidation,
(b) which is in administration,
(c) of which there is a provisional liquidator, or
(d) of which there is a receiver.

(2) The liquidator, administrator or receiver-

(a) shall make a prescribed part of the company's net property available for the satisfaction of unsecured debts, and
(b) shall not distribute that part to the proprietor of a floating charge except in so far as it exceeds the amount required for the satisfaction of unsecured debts.

(3) Subsection (2) shall not apply to a company if-

(a) the company's net property is less than the prescribed minimum, and
(b) the liquidator, administrator or receiver thinks that the cost of making a distribution to unsecured creditors would be disproportionate to the benefits.

(4) Subsection (2) shall also not apply to a company if or in so far as it is disapplied by-

(a) a voluntary arrangement in respect of the company, or

(b) a compromise or arrangement agreed under section 425 of the Companies Act (compromise with creditors and members).

(5) Subsection (2) shall also not apply to a company if-

(a) the liquidator, administrator or receiver applies to the court for an order under this subsection on the ground that the cost of making a distribution to unsecured creditors would be disproportionate to the benefits, and

(b) the court orders that subsection (2) shall not apply.

(6) In subsections (2) and (3) a company's net property is the amount of its property which would, but for this section, be available for satisfaction of claims of holders of debentures secured by, or holders of, any floating charge created by the company.

(7) An order under subsection (2) prescribing part of a company's net property may, in particular, provide for its calculation-

(a) as a percentage of the company's net property, or

(b) as an aggregate of different percentages of different parts of the company's net property.

(8) An order under this section-

(a) must be made by statutory instrument, and

(b) shall be subject to annulment pursuant to a resolution of either House of Parliament.

(9) In this section-

"floating charge" means a charge which is a floating charge on its creation and which is created after the first order under subsection (2)(a) comes into force, and

"prescribed" means prescribed by order by the Secretary of State.

(10) An order under this section may include transitional or incidental provision."

30. In short, the 'net property', which part is known as the 'prescribed part', which would have been available for the satisfaction of claims of floating charge holders, is to be made available for distribution to unsecured creditors.

31. The method of calculating the prescribed part is set out in the Insolvency Act 1986 (Prescribed Part) Order 2003[3]. The prescribed part is to be calculated in the following way:

- 50% of the first £10,000 of the net property;
- 20% of any net property in excess of £10,000, but subject to the fact that the maximum value of the top-slice fund for unsecured creditors is £600,000.

32. The secondary legislation has been designed so as to try and ensure the unsecured creditors obtain at least a modest dividend even where realisations are small. In the medium sized insolvency the return is still significant. For example with unsecured creditors of £1 million, bank lending of £2 million, and net floating charge realisations of £1 million, the top-slice would be £203,000. That would represent a dividend of approximately 20p in the £1 assuming that the floating charge holder is not able to participate in the top-slice as regards any shortfall under the charge. On the other hand, if the floating charge holder was able to participate in the top-slice as regards a shortfall, the dividend would be reduced, in the above example, to approximately 10p in the £1. It can be seen therefore, that the question of whether or not floating charge holders may participate in the fund for unsecured creditors in respect of any shortfalls will have a big impact on any distribution. What is the correct position in this respect?

Re Permacell Finesse Limited (in liquidation)[4]

[3] SI 2003 No. 2097

33. In *Permacell* the liquidators applied for a direction as to whether the floating charge holder, Synseal Holdings Limited, was permitted to participate in the prescribed part in respect of the shortfall under its floating charge. In *Permacell* the prescribed part was £379,000. Synseal was owed £2,307,000, and with realisations to Synseal only totalling £1,188,150, it had a shortfall of £918,950. Unsecured creditors other than Synseal totalled £3,104,000.

34. His Honour Judge Purle QC, sitting as a Judge of the High Court in Birmingham, ruled that Synseal was not entitled to participate in relation to its shortfall. The reasons for him doing so were two-fold:

- First, he considered it would be surprising if a floating chargeholder should be compelled by statute to accept the setting aside of a prescribed part of its assets only for it then to be allowed to claw some of it back as an unsecured creditor. In his view that could have the potential to substantially undermine the statutory purpose behind the prescribed part, namely to provide for the unsecured creditors;
- Secondly, he considered the plain wording of section 175(2)(b), which prohibits distribution to the holder of a floating charge holder "except in so far as it exceeds the amount required for satisfaction of unsecured debts", was a strong indication that a floating charge holder could not participate in respect of a shortfall.

35. Synseal did not attend to argue the matter before the Judge, so the robustness of the decision was considered by some to be uncertain. They did not have to wait too long for a further decision:

Re Airbase Services (UK) Limited (in administration)[5]

36. In *Airbase* the administrators of two companies (Services and International) applied for directions to determine the same question as had been decided in *Permacell*, though the argument at the hearing proceeded in ignorance of the decision in *Permacell*[6].

37. The sums involved in *Airbase* were as follows: The floating charge holder, Harris, held fixed and floating charges over the assets of both companies and was owed £6.35m. Unsecured creditors (including HM Revenue & Customs) were owed £1.7m odd. The net recoveries from the sale of fixed charge assets amounted to £243k and floating charge realisations totalled £1.312m (net). The prescribed part was calculated to be £265k, leaving £1.074m to meet the liabilities under the floating charge. So there was a fixed charge security shortfall of some £6.107m and an unsecured shortfall as a whole of £5.06m. If Harris was entitled to participate in the prescribed part in relation to it shortfall, the dividend from the same would have been c. 4p in the £. On other hand, if Harris was not entitled to participate in the shortfall, the dividend would be c. 15p in the £.

38. Mr Justice Patten decided that Harris was not entitled to participate, and as such his decision follows the decision in *Re Permacell* (albeit the decision was reached independently). He did so on substantially the same grounds as HHJ Purle QC did in *Re Permacell*, though his decision goes two steps further in that:

- He concluded that it made no difference whether the shortfall in security cover was for indebtedness under a fixed charge or a floating charge for a floating charge holder to be excluded from participation;
- He went on to state that on his interpretation of the statute the prescribed part was for the benefit of unsecured creditors alone and both floating charge holders and fixed charge holders are excluded in respect of their unsecured claims.

---

[4] Unreported, 30 November 2007
[5] Unreported, 5 February 2008
[6] The Judge was provided with a copy of the decision in *Permacell* after the hearing but before judgment

39. The first step was a necessary part of his decision given that Harris enjoyed both fixed and floating charges and had shortfalls in relation to both.

40. The second step was not necessary and should be viewed as "obiter dicta" and not binding.

Comment

The fact that the judges in *Permacell* and *Airbase* independently concluded that the statute did not permit a floating charge holder to participate in the prescribed part in relation to any floating charge shortfall suffered by that holder, should mark the end of that particular debate. It might have been thought that this was the only possible conclusion given the terms of section 176A(2)(b)[7]. The doubt may have arisen as a result of assurances given to the British Bankers' Association when the legislation was in draft form, that they would be entitled to share in the prescribed part to the extent of their shortfall. Nevertheless, even if that were the intention, it is not the effect of the words ultimately used in section 176A(2)(b).

41. Since the secured creditors in question in *Permacell* and *Airbase* were holders of a floating charge, neither can be said to be determinative of the question of whether a secured creditor who is not the holder of a floating charge may participate in relation to a shortfall. The comments of Patten J in *Airbase* suggest that he thought his reasoning also applied to a fixed charge holder who sought to prove in respect of a shortfall. It is suggested here, however, that the reasoning of Patten J is not conclusive in that respect[8]. Indeed there are a number of strong arguments which would point to the opposite conclusion, including the following points[9]:

- In other parts of the Insolvency Act 1986 ("the IA 1986") secured creditors are allowed to prove alongside unsecured creditors in respect of any shortfalls which may have occurred[10]. As such, absent a clear statutory steer to the contrary, section 176A should be interpreted to be consistent with those provisions;
- We have been reminded by the House of Lords in *Leyland DAF* that clear statutory language is required to deprive secured creditors of their proprietary rights. Similarly, it might be argued that nothing short of the express language (along the lines of section 176A(2)(b)) would be required to prevent unsecured creditors from proving in relation to a shortfall;
- Last, but by no means least, the policy behind the Enterprise Act was, in broad terms, that floating charge holders, who would be the main beneficiaries of the abolition of Crown preference, should in turn share some of that bounty with unsecured creditors. However the position of fixed charge creditors was unchanged by the abolition of Crown preference. So whilst there is some policy justification in concluding that holders of floating charges should not be entitled to participate, that justification would not equally apply to fixed charge holders.

42. Finally, neither of the above decisions say anything about the position of the secured creditor who abandons or surrenders their security. The wording of section 176A(2)(b) might suggest that if a floating charge holder abandons their security then there would be no bar to their participation (note this would only be applicable where they were the second or subsequent

[7] So said the authors of Insolvency and the Enterprise Act 2002, Edited by Stephen Davies QC, Jordans, 2003, pp57. There is currently a debate within the Insolvency Team of Guildhall Chambers as to who should take credit for stating the same in para 5.24.

[8] See the three different scenarios considered in Insolvency and the Enterprise Act 2002 above @ para 5.23

[9] See para 5.25 in Insolvency and the Enterprise Act 2002 above, where the authors suggest that section 176A would be interpreted in this way. There is currently a debate within the Insolvency Team of Guildhall Chambers as to whether para 5.25 was drafted by the same person who drafted para 5.24

[10] *Whitehead v Household Mortgage Corporation Plc* [2003] 1 WLR 1173. This case does not appear to have been considered in either Permacell or Airbase

charge holder)[11]. The comments of Patten J in *Airbase* may be said to have thrown some doubt on that reasoning however.

Distribution issues

43. In the case of administrations, the power of distribution is contained in paragraph 65 of Schedule B1. In particular paragraph 65(3) states that "A payment may not be made by way of distribution under this paragraph to a creditor of the company who is neither secured nor preferential unless the court gives permission." The conventional wisdom is that this even applies where the only distribution to be made to unsecured creditors is under the prescribed part provisions. It is not immediately apparent why this should be so and a rule change in this respect would be welcome.

44. Other practical issues which have concerned practitioners relate to the circumstances in which they can decide not to distribute the prescribed part. First, office holders can decide not to distribute when the net property (the property available for satisfaction of claims of holders of debentures secured by any floating charge) is less than £10,000 (the prescribed minimum under SI 2003/2097/para 2) and they think the cost of distribution would be disproportionate to the benefits (section 176A(3)). There is as yet no case law on how the office holder judges proportionality. That is an easy task when the cost would swallow up all the net property, but what of the situation where, for example, the cost would swallow up half of that sum? Does the answer to that question depend on the size of the dividend? It is likely that some guidance will emerge on these questions when there is a reported case falling within the second category.

45. The second category is where the office holder thinks the cost of distribution would be disproportionate to the benefit, yet the net property is greater than £10,000. In these circumstances s/he must apply to court for an order that the prescribed part provisions should not apply (section 176A(5)). There have been several such applications to court, all of which to the authors' knowledge, have been successful. However, as yet, there has been no reported decision which provides an indication of whether, on such an application, the court would be prepared to permit the fund which would otherwise be distributed to the general body of creditors, to be used for an alternative purpose – perhaps to fund litigation which, if successful, might significantly swell the company's assets. This appears to have been contemplated in the early days of the Enterprise Bill but no express provision has been made.

46. Should the fund be viewed as some form of specific purpose trust? If so, and that purpose cannot be achieved (for example because the costs of distribution are prohibitive) is there any scope for the purpose to be amended or must the trust simply fail? The notion of the prescribed part appears to have several elements of a trust, and yet there is no provision for the time at which funds should be ring-fenced and no provision for interest to accrue on the funds so set aside. The rules provide for the prescribed part to comprise a maximum amount. At what time should the fund be set aside? If only when making a distribution then there should be no question of interest accruing, but the Act and rules are silent on the issue.

Part 4: Employees of insolvent companies

47. In the 2006 seminar, consideration was given to claims by employees of insolvent companies that certain payments due to them should qualify for "super-priority" status under paragraph 99 of Schedule B1 as administration expenses. In particular consideration was given to the decisions in *Allders* and *Granville Technology*.

48. In *Allders Departments Stores Ltd (in administration)* [2005] BCC 289 the High Court confirmed that where an administrator terminates a contract of employment, sums due to employees in respect of redundancy and unfair dismissal are not administration expenses.

[11] See the discussion in Insolvency and the Enterprise Act 2002 above @ para 5.24

49. In *Re Huddersfield Fine Worsteds Ltd and Re Ferrotech Ltd & Granville Technology Ltd* [2005] EWCA Civ 1072 the Court of Appeal was asked to determine whether liabilities for protective awards and payments in lieu of notice were included within the words "wages or salary" for the purpose of paragraphs 99(4)-(6) of Schedule B1. The Court of Appeal held they were not and did not have super-priority (with the exception of "garden leave" payments in lieu of notice).

50. The question of protective awards again arose for consideration in *Day v Haine* [2007] EWHC 2691 (Ch) (16 October 2007), though in this case the principal argument was whether protective awards were provable debts in the liquidation. If they were then at least in part they would constitute preferential debts by virtue of paragraph 9 of Schedule 6 to the 1986 Act.

51. The protective award in *Day v Haine* arose under section 189 of the Trade Union Labour Relations (Consolidation) Act 1992 ("the 1992 Act"). Under section 188 of the 1992 Act (as amended by the 1999 Regulations) an employer who is proposing to dismiss as redundant 20 or more employees within a period of 90 days or less is obliged to consult before dismissal. The "consultation period" where the employer proposes to dismiss 100 or more employees is at least 90 days; otherwise it is at least 30 days. Whilst this provision can be avoided in certain special circumstances, insolvency on its own does not constitute a special circumstance. If section 188 is breached an employee may complain to the Employment Tribunal. Section 189 provides that if the tribunal finds a complaint is well founded it shall make a declaration to that effect and may also make a protective award based on a "protected period" of up to 90 days. In short, the question of whether a protective award is made by an Employment Tribunal is a matter of discretion on the part of the tribunal. In the case of *Day v Haine* that discretion was not exercised until after the commencement of liquidation.

52. Insolvency Rule 12.3(1) provides that (under the heading "what is provable") "Subject as follows, in administration, winding up and bankruptcy, all claims by creditors are provable as debts against the company or, as the case may be, the bankrupt, whether they are present or future, certain or contingent, ascertained or sounding only in damages". Further Rule 13.12(1)(b) provides that "debt" includes any debt or liability to which the company may become subject after the date of liquidation by reason of any obligation before that date and 13.12(3) provides that references to a debt or liability includes future or contingent debts.

53. Sir Donald Rattee observed that as at the date when the company entered liquidation the employees had no certain debt or claim against the company. The question was whether it could be said they had a contingent debt within the meaning of Rule 12.3(1) and 13.12(3). He concluded they did not, because whilst the breach of the obligation to consult gave rise to an entitlement to apply for an award, whether such an award would be made was discretionary. He concluded reference to an obligation incurred in Rule 13.12(1)(b) meant an enforceable obligation (such as for example a contractual obligation). In arriving at those conclusions the judge largely followed the decisions and reasoning in *Steele* [2005] EWCA Civ 1824 (liability for determinations by the Secretary of State of overpayment of job seeker's allowance not provable) and *Glenister v Rowe* [2000] Ch 76 (liability for costs order made after bankruptcy not provable)

54. He also dismissed the "fall back" argument that the company's liability under the protective award made after the commencement of liquidation is a necessary disbursement by the liquidator in the course of his administration under Insolvency Rule 4.218.

55. It is understood that this decision has been appealed to the Court of Appeal (permission to appeal having been granted by the judge at first instance), though the outcome of that appeal was not known at the time this paper was drafted.

56. Assuming the decision in *Day v Haine* is not reversed on appeal it has mitigated the possible adverse consequences of two recent decisions in relation to protective awards:

57. In *UK Coal Mining Ltd v NUM* (UK/EAT/0397) the President of the Employment Appeals Tribunal held that protective awards of the maximum 90 days were correct and would be upheld, noting that the measures introduced were principally intended to be penal.

58. In a more recent decision, the Employment Appeals Tribunal confirmed that the maximum 90 day protective period should be starting point for awards, even where consultation period was 30 days or less (because the number of employees was less than 100); see *P Hutchins v Permacell Finesse Ltd* (in administration) (23 October 2007). On appeal the protective award was increased in relation to the employee in question from £2742 to £8,226.

Part 5: Insolvent tenants

Introduction

59. There have been three developments this year which have an impact on the landlord and tenant relationship in the context of insolvency/pending insolvency. They are:

- The Non-Domestic Rating (Unoccupied Property) (England) 2008 Regulations ("the 2008 Regulations"), which ameliorates part of the decision in Re Trident Fashions plc, which was the subject of much discussion last year. We propose to reconsider *Re Trident*, one year on, having regard to the 2008 Regulations;
- The abolition of the common law right of distress by Part 3 of Tribunals, Courts and Enforcement Act 2007 and a more limited statutory replacement known as the Commercial Rent Arrears Recovery procedure or "CRAR";
- The impact of the decision in *Re Cheyne Finance plc* on the "cash flow" or "commercial" insolvency test, and its knock on effect on lease clauses.

60. We shall consider each in turn here as follows:

Re Trident – one year on

61. In *Re Trident Fashions plc (Exeter City Council v Bairstow)* [2007] EWHC 400 (Ch) Mr Justice David Richards held that rule 2.67 (administration expenses) is to be approached in the same way as rule 4.218 (liquidation expenses) so that the question of whether an expense qualifies as an administration expense falls to be decided as a matter of statutory construction, not as a matter of discretion (sweeping away the discretionary approach following *Re Atlantic Computer Systems plc*). As a result, he concluded that non-domestic rates are an expense of administration within rule 2.67(1)(f) (namely "any necessary disbursements by the administrator during the administration") and that there was no basis for distinguishing between business rates falling due on occupied or unoccupied property. This meant that rates ranked above the remuneration of the administrator. This decision was not well received by recovery professionals. It was considered that the effect of the decision would be to undermine the rescue culture which new style administrations were intended to promote.

62. The government appears to have listened to the lobbying from R3 and like bodies. Following a period of consultation, at the end of December 2007 it confirmed that it would introduce fresh legislation to ensure that companies in administration would get a permanent exemption from empty property rates. The Non-Domestic Rating (Unoccupied Property) (England) Regulations 2008, which will come into force on 1 April 2008, make good that promise. In particular regulation 4(l) provides an exemption in relation to any property:

"whose owner is a company in administration within the meaning of paragraph 1 of Schedule B1 to the Insolvency Act 1986 or is subject to an administration order made under the former administration provisions within the meaning of article 3 of the Enterprise Act 2002 (Commencement No. 4 and Transitional Provisions and Savings) Order 2003"

63. As such, from 1 April 2008 relief from payment of any further rates on unoccupied property is provided to new style administrations and, for those rare ones that remain, continuing old style administrations.

64. It should also be noted that the reasoning adopted by David Richards J in *Re Trident Fashions plc* has general application, and it is understood it is being tested (or may be tested) in the following areas:

65. Rent accrual after administration: following the observations of Lord Hoffmann in *Re Toshuku* that "debts arising out of pre-liquidation contracts, such as leases, whether they accrue before or after the liquidation, can and prima facie should be proved in the liquidation. In this respect they are crucially different from normal liquidation expenses which are incurred after the liquidation date and cannot be proved for" it was generally considered that rent accruals would not, at least not automatically[12], be treated as an administration expense (under rule 2.67(1)(a) or otherwise). It is understood however that this logic is being tested, using the reasoning in *Re Trident Plc*, in *Re Musiczone* (in administration), which has not yet been decided. It is understood the argument may centre on the situation where an administrator wishes to retain a property but refuses to pay rent and where an administrator wishes to surrender (having no power to disclaim). See further the discussion in Estates Gazette, 16 February 2008 "Something that is worth taking on", p125.

66. Rent arising in the context of finance leases: the position has long been considered to be unsatisfactory from the point of view of the finance company. In 9 out of 10 cases the lessor does not want to repossess the premises or the goods. What the lessor wants is to be paid, in full, for the continued use of the lessor's property. Historically, its only option has been to apply for an order for delivery up in the full knowledge that this was not the relief desired, but instead a conditional refusal order (along *Re Atlantic Computer Systems plc* and *Re Salmet* lines). The decision in *Re Trident* provides the opportunity to revisit these issues for the finance company.

Part 3 of Tribunals, Courts and Enforcement Act 2007 and CRAR

67. Part 3 of the Tribunals, Courts and Enforcement Act 2007 provides for the abolition of the common law right of the landlord to "distrain" for arrears of rent. In its place it introduces a new statutory procedure for the recovery of commercial rent arrears (known as "CRAR"). There is no new replacement statutory remedy for residential properties.

68. Under CRAR the landlord is permitted to enter the let premises in order to take goods belonging to the tenant, sell those goods and recover the rent arrears from the proceeds of sale. The remedy is only available through the use of a certificated enforcement agent and, significantly, must be done on notice to the tenant. The precise period and form of notice has yet to be laid down in secondary legislation. It has been commented that the requirement for notice substantially weakens the usefulness of the new procedure, since the tenant will be able to move equipment when provided with notice.

69. At the time of writing the commencement date for CRAR is not yet known.

Impact of Re Cheyne Finance plc

70. In *Re Cheyne Finance plc (in receivership)* [2007] EWHC 2402 (Ch) the receivers sought the court's directions as to how they should consider future and/or contingent debts when looking at the cash flow test in the context of an insolvency event as defined in a security trust deed. As a result the court considered, for the first time, whether the commercial, or cash flow insolvency test, in section 123(1)(e) of the Insolvency Act 1986 included consideration of the ability to pay debts as they fall due in the future.

71. Briggs J concluded that the wording of section 123(1)(e), namely [A company is unable to pay its debts] "if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due", and in particular the words "as they fall due", allowed for a consideration of whether a debtor would be able to meet debts as they became due in the future notwithstanding that the predominant view amongst practitioners prior to this decision

[12] Cf. *Re Salmet International Ltd* [2001] BCC 798

was that for the purposes of (e), contingent and prospective liabilities were not to be taken into account[13]. Moreover, the court confirmed that the standard of proof in this respect would be on the balance of probabilities.

72. There has been some discussion in the insolvency profession as to whether this decision is right. It has been noted that the judge did not need to decide the case on the basis of a construction of section 123(1)(e), because he could have decided it on narrower grounds relating to the particular words used in the security trust deed. The circumstances of the case were unusual. The company was no longer trading and was effectively in "run off". There would be no new assets, no new liabilities and no scope, in the future, to borrow against current or yet to be acquired assets.

73. There therefore appears to be considerable scope to distinguish the decision from ordinary, trading companies. If the essence of the decision were to be applied in wider circumstances, it might readily become the approach of choice for landlords of insolvent tenants: even though a company may be paying its way at present, it is more likely than not it will be unable to do so in the future. Could this really be grounds to wind up a company? It seems unlikely, but any party seeking to rely upon an event of default, based upon the statutory cash flow test in section 123(1)(e), is likely to be tracking the case and the circumstances in which it is cited, with particular interest.

Part 6: Miscellaneous

Distribution issues

(1) Liquidators' duties when declaring and making distributions

74. The nature and extent of a liquidator's duties to make distributions once a dividend has been declared has been the subject of judicial consideration in *Re Lomax Leisure Limited (in liquidation)* [2007] EWHC 2508 (Ch).

75. The background circumstances are somewhat unusual. The two defendants (Miller and Bramston) were appointed as joint administrators on 22 April 1999. They effected an asset sale which was thought to have generated a surplus for creditors. The chosen exit route was therefore an MVL and on 23 August 1999 they were appointed joint liquidators. They subsequently gave notice of their intention to make a first and final dividend pursuant to IR 11.2(1) within 4 months of the last date for proving. One creditor, Marpaul South Limited ("Marpaul"), submitted a proof which was rejected by the liquidators. They issued an application appealing that decision just in time, but due to delay in that application being issued and/or served on them, they believed that no challenge had been made, and pursuant to IR 11.5(1) they resolved to pay a dividend of 100p in the £1 and the necessary letters and cheques were sent out to all creditors whose proofs had been admitted. The cheques were drawn on an account in their joint names. They subsequently became aware of the appeal to court by Marpaul and contacted the bank to stop the cheques. The appeal by Marpaul was ultimately successful in that a substantial award was made in their favour, with the result that Lomax had insufficient funds to pay creditors in full. The liquidation was therefore converted into a creditors' voluntary liquidation and Stephen Hunt was appointed as liquidator. Mr Hunt procured the assignment of creditors claims to Lomax and the claim against the defendants (Miller and Bramston) was brought by Lomax at his direction as assignee of the creditors.

76. The claim was two-fold: first, that, once declared, the liquidators came under a personal duty to ensure the dividend was paid, and, secondly, in any event they were liable on the dishonoured cheques. Importantly, no misfeasance was alleged against the defendants.

77. Sitting as a Deputy High Court Judge Mark Cawson QC dismissed the claims. First, in relation to IR 11.5, he concluded that this did not impose a personal liability on the liquidator to

[13] See for example the commentary in Sealy & Milman on section 123(1)(e) @ p152, 10th Edn

make a payment of any dividend declared. In the event that a dividend was declared and not paid the creditors' sole remedy was a statutory one under IR 4.182(3). Secondly, he concluded that there was no consideration in support of the cheques so as to provide that the creditors could pursue an action on the cheques. He considered the liquidators were not liable to make the payment, and in any event they had a complete answer to the claim since the cheques were raised on the basis of an honest mistake of fact or law.

78. It is understood this decision is currently the subject of an appeal to the court of appeal.

(2) Group insolvencies and mixed assets and liabilities

79. It is not uncommon for practitioners to have to deal with group insolvencies where the assets and creditors are well and truly mixed. In some circumstances the best pragmatic solution is to pool them, and treat the group as if it were one company. In limited, and exceptional, circumstances the court may authorise the liquidator to implement a pooling of assets and liabilities and a rateable distribution out of that common pool; see *Bank of Credit and Commerce International SA* [1992] BCC 715 (see also the Australasian cases, *Windsor Mortgage Nominees Pty Ltd v Cardwell* (1979) CLC 32, 197; *Re Australian Home Finance Pty Ltd* [1956] VLR 1; *Re Landbase Nominee Co Ltd* (1989) 4 NZCLC 65, 093; and *Re Registered Securities Ltd* [1991] 1 NZLR 545). Ordinarily, however, the court will require an application to be made for a scheme of arrangement or a CVA or even for the points to be argued out and determined. All those options can be very costly. It is interesting to note that in Australia there are legislative proposals to provide a cost effective solution to these difficulties which will enable pooling to occur without the need to apply for schemes of arrangement or CVAs. The proposals have also been considered recently during the deliberations of the UNCITRAL Working Party on Cross Border Group Insolvencies where consensus was reached for provision to be made by local laws to permit pooling only in circumstances where (i) assets have been so intermingled that it is now impossible to distinguish which assets belong to which company or the costs of disentangling them would be so high as to render the exercise not worthwhile; or (ii) where corporate vehicles and the illusion of separate legal entities had been used to perpetrate a fraud. Generally those nations represented on the Working Party were resistant to any wider circumstances being contemplated, not least because of the risk of creating uncertainty in the lending community.

Reversal of Leyland DAF

80. Last but not least, it should not be forgotten that from 6 April 2008 the effect of the decision in Leyland DAF will be reversed, in part, by section 176ZA of the Insolvency Act 1986 (introduced by the Companies Act 2006), and ordinary liquidation expenses will become payable out of floating charge realisations in relation to liquidations commencing after that date (even in relation to charges granted before that date). However expenses incurred or anticipated to be incurred in relation to litigation are not (ordinarily) to be paid out unless the consent of the relevant floating charge holder or preferential creditor has been obtained.

Hugh Sims, Guildhall Chambers
Catherine Burton, Begbies Traynor

April 2008