

Secured Creditors: No Access to Prescribed Part

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Editor's Note: Formal insolvency processes might be coming back into fashion in the UK. After several years in which financing solutions have been readily available to distressed businesses (both good and bad), the seizure within the credit markets has limited those solutions to the more deserving and left the others often with no alternative to a formal filing.

Understanding the detailed workings of formal insolvency processes is therefore becoming increasingly pertinent, even in larger corporate restructurings. The "prescribed part" was introduced via legislation in 2003 as a limited upside for unsecured creditors who rarely otherwise saw any return in a formal insolvency. This came at the expense of the secured creditor via a carve-out from its floating charge realisations.

In last month's European Update column, we covered the decision of the Birmingham High Court in *Re Permacell Finesse Ltd.* (in liquidation), which held that a floating charge-holder is not entitled to participate at all in the prescribed part, not even as an unsecured creditor in respect of any shortfall under its floating charge. The High Court in London recently reached the same conclusion in *Re Airbase* and clarified that the prescribed part is also unavailable to meet any shortfall under a creditor's fixed charge. We look at this decision in this article.

It is often lamented by some lawyers that the preparatory stages to making legislation, such as white papers, consultation reports, discussion papers, Parliamentary speeches, etc. (i.e., the legislative history), are ignored once the legislation is enacted. However, the *Airbase* decision goes to show why too much reliance on such materials would be unwise as they are not necessarily conclusive. While they may serve as a useful "crutch" in times of need, a good case should be able to stand on its own two feet without them.

The administrators of two companies—Airbase Services (UK) Limited and Airbase Services International Limited—asked the court for directions as to whether the

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prescribed part of the companies' net property was available to satisfy a secured creditor's shortfall under its fixed and floating charge. In particular, the question was whether "unsecured debts" in §176A(2) included the unsecured balance of the debts due to the floating charge-holder or other secured creditor.

Section 176A(2) of the Act provides that the liquidator, administrator or receiver shall:

- (a) set aside the prescribed part for the satisfaction of "unsecured debts"; and
- (b) shall not distribute that part to the floating charge holder unless it exceeds the amount required for the satisfaction of "unsecured debts."

The prescribed part is (a) 50 percent of the first £10,000 of net floating charge

realisations, plus (b) 20 percent thereafter, subject to an aggregate maximum prescribed part of £600,000.



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This case differs slightly from *Re Permacell* (on which we reported in last month's column) in that there was a shortfall not only under the secured creditor's floating charge (as in *Permacell*) but also

under its fixed charge. The shortfall as a whole came to £5.06m.

Looking Behind the Legislation

Mr. Justice Patten of the Chancery Division of the High Court (Patten J) was made aware of the decision by Purle QC in *Re Permacell* following the hearing and the preparation of his judgment. He reached the same conclusion that a secured creditor—whether floating or fixed—is not entitled to participate in the prescribed part in respect of a claim based on any shortfall in its security.

In his judgment, Patten J underlined that the intention behind the Enterprise Act 2002, as clear from the White Paper published in July 2001, was that the prescribed part should benefit unsecured creditors. He also referred to statements made in the House of Lords to this effect.



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Relying on such statements, HM Revenue & Customs (the largest unsecured creditor) argued that it was clear that §176A should be read as excluding secured creditors who have unsecured debts due to a shortfall in

the value of their security. Patten J was clear that the benefits of the prescribed part to the unsecured creditors would be "considerably reduced" if a secured creditor could participate.

Unlike in *Re Permacell*, Patten J also referred to the 1982 Cork Report's proposal for the 10 percent Fund. As we mentioned in our previous column, the

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Cork Report was tasked with looking at U.K. insolvency law in the early 1980s and its recommendations for reform resulted, eventually, in the governing U.K. legislation—the Insolvency Act 1986. The report distinguished between floating charge creditors (who should not be able to share in the 10 percent Fund in respect of any shortfall) and fixed-charge creditors (who could).

However, the proposals of the Cork Report in respect of the 10 percent Fund were never taken up by Parliament, and there was no indication in the White Paper that they had had any influence on the introduction by the Enterprise Act of the prescribed part. There was no distinction in §176A between the "unsecured debts" of a floating or fixed charge-holder. Patten J found that the White Paper, Ministerial statements and the Cork Report were of limited value.

Unsecured Debts

Patten J looked at section 248 of the Act, which contains a definition of "secured creditor" (one holding security) and "unsecured creditor" (i.e., a creditor without security). Section 176A(3)

provides that where an officeholder thinks that the costs of making “a distribution to unsecured creditors” would be disproportionate to the benefits, there is no need to set aside the prescribed part. This indicates that the prescribed part is contemplated to be for the benefit of “unsecured creditors” only. On the application of §248, therefore, this would not include holders of floating or fixed charges. This emphasizes the identity of the creditor rather than the nature of its debt (as Patten J found was the case elsewhere in the insolvency legislation).

The key to the question was the meaning of “unsecured debts” in the context of §176A(2) as a whole. Although elsewhere in the insolvency legislation it was envisaged that a secured creditor could prove in an administration or liquidation for the unsecured part of its claim, such provisions were inconclusive. They did not indicate whether “unsecured debts” in §176A(2) should include such amounts.

Patten J indicated that the “most compelling argument” for excluding a secured creditor’s shortfall from section 176A was that the phrase “unsecured debts” must have the same meaning in both §176A(2)(a) and (b). If a secured creditor’s shortfall were included in the phrase, then §176A(2)(b) would be inoperable since the prescribed part would have discharged the “unsecured debts” due to the floating charge-holder in accordance with subsection (a). Section 176A(2)(b) could only make sense if unsecured debts of any type of secured creditor were excluded—*i.e.*, fixed or floating charge creditor.

As in *Re Permacell*, the High Court confirmed that the *pari passu* rule was necessarily modified so as to differentiate between unsecured creditors with no form of security and the unsecured claims of creditors with security. Although such a rule was fundamental, it was not immutable—it must be restricted if §176A is to have its desired economic effect. Accordingly, both floating charge-holders and fixed charge-holders are excluded from participating in the prescribed part in respect of their unsecured claims.

Comment

To the extent that *Re Permacell* left open the question whether fixed charge-holders might be able to participate in the prescribed part in respect of their shortfall, *Re Airbase* clarifies the position: They cannot. Prior to the Enterprise Act amendments (*i.e.*, before the prescribed part was introduced), the claims of fixed charge-holders in respect of any shortfall under their security would have ranked behind the claims of floating charge-holders and the class of preferential creditors (mainly employees). After the Enterprise Act, the decision clarifies that the situation has not changed. The unsecured portion of a fixed charge-holder’s debt has no special priority over the floating charge-holder. For fixed charge-holders, therefore, this decision should be economically neutral: Their position remains the same.

Unsecured creditors, of course, will be grateful for the additional clarification provided by the High Court. Had the decision been different, they would have seen their returns reduced significantly and the stated purpose of the legislation would have been diminished.

Finally, it is interesting to note the court’s willingness to look at the White Paper, Ministerial statements and the Cork Report when interpreting provisions of the Act. However, it also provides a worthwhile reminder that such resources should not be treated as providing the last word as they were eventually found to be inconclusive on the issue. They do not provide a substitute for the insolvency legislation as finally enacted. ■