Fixed and floating charge holders cannot have their cake and eat it

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IN MY BRIEFING IN *IHL*157 (p73), COMMENTING ON the advantages and disadvantages of fixed and floating charges, I noted that one of the disadvantages of being the proprietor of a floating charge is that you take subject to the prescribed part set aside in accordance with s176A of the Insolvency Act 1986 (the 1986 Act).

This article examines two recent cases where it has been held that the holder of a fixed and/or floating charge is unable to participate in the prescribed part in respect of any shortfall under its security, notwithstanding that in other situations the shortfall may be treated and classed as an unsecured claim.

RE AIRBASE SERVICES (UK) LTD AND *RE PERMACELL FINESSE LTD*

Patten J gave judgment in the matter of *Re Airbase Services (UK) Ltd; In re Airbase International Services Ltd (both in administration)* [2008] on 5 February 2008. The case was heard in the London High Court on 17 December 2007, with both the secured creditor, Harris NA (the Bank) (as successor by merger to Harris Trust & Savings Bank) and HM Revenue & Customs (HMRC) (on behalf of itself and the unsecured creditors) making full submissions.

At the time of the hearing none of parties were aware of the 30 November decision of HHJ Purle QC in the Birmingham District Registry in *Re Permacell Finesse Ltd* [2007]. Unlike the *Re Airbase* case, only the liquidators' counsel appeared at the *Re Permacell* hearing before HHJ Purle QC, but the judge commented that he was 'extremely grateful to [counsel] for the fair and balanced way in which he undertook that task'.

Following the discovery of the decision in *Re Permacell*, counsel for the Bank and HMRC in *Re Airbase* filed further written submissions to Patten J. However, as the decision in *Re Permacell* was not dissimilar to his own conclusions, Patten J did not make any comment in his judgment as to whether *Re Permacell* was binding or could be distinguished.

PRESCRIBED PART

The 'prescribed part' was introduced by the Enterprise Act 2002 by inserting a new s176A into the 1986 Act.

Pursuant to s176A(2) of the 1986 Act, a liquidator, administrator, provisional liquidator 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.

The term 'net property' is defined in s176A(6) as:

> '... the amount of its property which would, but for [s176A] be available for the satisfaction of claims of holders of debentures secured by, or holders of, any floating charge created by the company.'

A prescribed part need only be set aside when a floating charge was created on or after 15 September 2003. If the company's net property is less than the prescribed minimum (currently £10,000) and the liquidator, administrator or receiver thinks that the cost of making a distribution to unsecured creditors would be disproportionate to the benefit, the section does not apply. If the net property is greater than the prescribed minimum, but the liquidator, administrator or receiver thinks that the cost of making a distribution to unsecured creditors would be disproportionate to the benefit, the officeholder must seek a court order (see *Re Hydroserve* [2007], where such an order was granted).

THE ISSUE

The issue to be determined in both cases was whether the prescribed part of the relevant companies' net property was available to satisfy any part of the debts due to a creditor that held security by way of fixed and floating charges, where the creditor had a shortfall in the value of its security.

The arguments put forward in each of the cases and the judge's ruling on those arguments are considered below in detail.

UNSECURED DEBT

The central argument advanced by the Bank in *Re Airbase* was that the secured creditor's shortfall should be treated as an unsecured debt. As an unsecured debt it should be treated as all other unsecured debts, such that the secured creditor can participate in the prescribed part *pari passu* (on an equal footing) to the other unsecured creditors.

In forwarding this argument, the Bank submitted that a shortfall could be regarded as an unsecured debt in the following circumstances:

- in an administration a secured creditor may prove for the balance of its debt after deducting the amount it has realised under its security (Insolvency Rules 1986, Rule 2.83(1)); or
- voluntarily surrender its security for the general benefit of creditors and prove for the whole of its debt as if it were unsecured (Rule 2.83(2)); or

- it may vote in respect of the unsecured balance of its debt or the entire amount of the debt if there is insufficient property to enable a distribution to unsecured creditors apart from the prescribed part (Rule 2.40(1) and (2)); and

- it may receive a dividend calculated on the basis that the amount proved is to be treated as an unsecured claim (Rule 2.102).

The prescribed part was available for the satisfaction of unsecured debts and therefore the Bank should be able to share in it for its unsecured debt along with the other unsecured creditors – unless there was express provision in s176A to the contrary, which there is not.

HMRC argued in contrast that the Bank was not owed an 'unsecured debt' because an unsecured debt is a debt owed to an 'unsecured creditor' (ie, one that has never held security). The Bank, HMRC argued, was not an unsecured creditor because it was the proprietor of fixed and floating charges. The term 'unsecured creditor' is defined in s248(1)(a) of the 1986 Act, along with the term 'secured creditor', as:

> '"Secured creditor", in relation to a company, means a creditor of the company who holds in respect of his debt a security over property of the company; and "unsecured creditor" is to be read accordingly.'

HMRC argued that the Bank's shortfall arose in respect of a liability within the scope of its security rather than as a separate unsecured debt, and so should not be treated as an unsecured debt in the context of s176A.

In *Re Airbase*, Patten J acknowledged that:

> 'There is no doubt that a secured creditor is entitled to prove as an unsecured creditor for any part of the debt not covered by the value of the security and in relation to that part of its claim a secured creditor... stands at the end of the queue in the same way as any other unsecured creditor.'

He also accepted that the term 'unsecured debts' could in isolation include debts due to secured creditors. However, he concluded that on the specific wording of s176A the term 'unsecured debts' could not have been intended to include debts owed to creditors that hold security. He held that s176A distinguished between debts owed to unsecured creditors with no security and debts owed to secured creditors with a shortfall.

'Patten J concluded in *Re Airbase* that on the specific wording of s176A the term "unsecured debts" could not have been intended to include debts owed to creditors that hold security.'

In *Re Permacell*, HHJ Purle QC also commented that s176A was a departure from the general rule that secured creditors rank ahead of unsecured creditors and stated that the issue was to be determined by reference to the specific provisions of s176A.

PRINCIPLE OF *PARI PASSU*

In both *Re Airbase* and *Re Permacell* the argument was put that to treat the floating-charge holder's shortfall as an unsecured debt was in line with the policy of *pari passu* – that all unsecured debts of an insolvent debtor should rank equally. Both judges held, however, that their conclusion that the secured creditor's debt was not to be treated as an unsecured debt for the purposes of s176A did not offend the fundamental principle of *pari passu*.

HHJ Purle QC considered the principle of *pari passu* to be one of statute, which did not operate as a freestanding principle against which specific statutory provisions fall to be construed. He held that the question before him was to be determined by particular reference to the specific provisions of s176A, rather than by reference to the generalities of the statutory scheme of *pari passu*.

Patten J similarly concluded in *Re Airbase* that the *pari passu* principle was not immutable and its application had to be restricted and modified to give s176A 'its desired economic effect'. He therefore did not consider it to breach the principle if a distinction was made between unsecured creditors with no form of security and the unsecured claims of secured creditors.

RELEVANCE OF THE SECTION 176A(2)(b) EXCEPTION

Both HHJ Purle QC and Patten J were of the view that the wording in s176A(2)(b) – which provides that a distribution may be made to a floating-charge holder where the prescribed part exceeds the amount required for the satisfaction of the unsecured debts – was a compelling reason that their conclusion that the term 'unsecured debts' should not include a charge holder's shortfall was correct.

Patten J concluded that subsection 176A(2)(b) would be inoperable if he had reached the opposite view, because if the charge holder was participating then there is no purpose to a provision that the

charge holder can participate if there is a surplus. HHJ Purle QC also held the view that s176A(2)(b) would never apply in the case of an insolvent company if a shortfall could rank as an unsecured debt. He accepted that at least arithmetically it may be possible if a company were not too heavily insolvent and you separate the shortfall in excess of the prescribed part and the amount of the actual prescribed part. He concluded however that the language of the section did not plausibly produce that result.

LEGISLATIVE INTENT

In both cases, the courts considered the White Paper published in July 2001 (*Productivity and Enterprise: Insolvency – A Second Chance*, cm 5234) and the 1982 Cork Report (*Insolvency Law and Practice: Report of the Review Committee*, cmnd 8558). Patten J also considered the discussions that took place in the House of Lords regarding the 2002 Enterprise Bill.

HHJ Purle QC concluded that it was evidently the policy of the legislature:

> '... to create a fund out of the floating-charge holder's security to which unsecured creditors alone could have recourse, in return for the advantage afforded to floating-charge holders by the abolition of the preferential status of Crown debt, which would otherwise come ahead of a floating charge'.

He therefore considered that it would be surprising if:

> '... a floating charge holder, compelled to accept the setting-aside of the prescribed part for the benefit of others, should then be allowed to claw some of it back by claiming as an unsecured creditor for that part and more'.

Patten J regarded such historical documents as only being helpful in setting out the background debate, although he concluded that the intention was to benefit unsecured creditors.

Both judges noted that if the proprietor of a charge could participate in the prescribed part it would seriously decrease the benefit of the fund for the unsecured creditors. It was also clear that in light of the judges' views that the policy behind the prescribed part was to benefit the unsecured creditors who had never held any security, they did not wish to reach a conclusion that cut across that policy intention.

IS A FIXED-CHARGE HOLDER ANY DIFFERENT?

In both cases the charge holder held fixed and floating charges, but in the *Re Permacell* decision only the charge holder's position as the proprietor of a floating charge is referred to in the judgment. In *Re Airbase* the Bank advanced the argument that even if it was not entitled to participate in relation to its shortfall under its floating charge, it should be entitled to participate in relation to its shortfall under its fixed charge, as s176A makes no mention of excluding the proprietor of a fixed charge.

Patten J concluded there was no distinction between fixed- and floating-charge holders in s176A and therefore if the words of the section excluded unsecured portions of a debt of an otherwise secured creditor it must apply to both categories of secured creditor alike. Consequently, he concluded that the exclusion of fixed-charge holders, in parallel with floating-charge holders, was consistent with the stated purpose of the legislation and the wording of s176A.

IMPACT GOING FORWARD

The *Re Airbase* and *Re Permacell* decisions have clarified a section of the 1986 Act which had previously been open to two schools of opinion on how it should be interpreted. It is now clear that the proprietor of a fixed or floating charge will be unable to prove in the prescribed part in relation to any shortfall under its security. If a charge holder is owed a debt, which is not covered by its security, such that it is a 'genuine' unsecured creditor, then it should be able to prove along with the other unsecured creditors and receive a dividend from the prescribed part.

The cases are obviously a success for HMRC and the unsecured creditors, who would no doubt in most cases have received significantly less by way of the prescribed part if secured creditors could participate. For the secured creditor, any hope that it may have been able to class its shortfall as an unsecured debt for the purposes of s176A (as it can in other circumstances) has been denied. In calculating its realisations a secured creditor cannot hope to have any slice of the prescribed-part cake.

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Re Airbase Services (UK) Ltd; In re Airbase International Services Ltd (both in administration) [2008] EWHC 124 (Ch)

Re Hydroserve [2007] ALL ER (D) 184

Re Permacell Finesse Ltd [2007] (Unreported, 30 November 2007)