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Leyland Daf – Some Practical Difficulties

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The Opinions of the House of Lords in *Buchler v Talbot Re Leyland Daf Limited* [2004] BCC 214 will result in a number of practical conundrums which may well result in quIrky and unpredictable outcomes.

As by now will be appreciated by those practising in the field of corporate insolvency, the House of Lords decided on 4 March that in cases in which the Company has granted a floating charge, the costs and expenses of the liquidation will rank *after* sums payable both to preferential creditors and to the holders of a floating charge and will not be payable out of floating charge security. This conclusion may come as a surprise to insolvency practitioners who have for many years regarded the costs of the liquidation as having priority over both.

The pertinent facts of *Leyland Daf* may be shortly summarized. The Company granted a debenture containing fixed and floating charges in 1992. In 1993 the debenture holder appointed Administrative Receivers who proceeded to realize the Company's assets. They paid receivership preferential creditors totalling GBP 8m and made interim distributions to the debenture holder of approximately GBP 110m. By the time of the hearing in the House of Lords the Administrative Receivers held a balance of GBP 72m.

In the meantime, in 1996 the Company went into liquidation. The liquidators had realized approximately GBP 1.4m, but had incurred costs, remuneration and corporation tax of GBP 9.5m. The issue in the case was whether the liquidators were entitled to recover the shortfall out of the funds held by the Administrative Receivers. The liquidators' contention was based on the propositions that (i) liquidation expenses were payable in priority to the claims of preferential creditors; (ii) the claims of preferential creditors were payable out of the Company's assets subject to a floating charge in priority to the claims of the debenture holders; therefore (iii) liquidation costs and expenses were payable out of the Company assets subject to the floating charge in priority to both preferential creditors and the floating charge holder.

Whilst this argument succeeded both at first instance before Rimer J [2001] 1 BCLC 419 and in the Court of Appeal [2002] 1 BCLC 571, it was flatly rejected by the House of Lords. Three reasoned judgments were given by Lords Nicholls, Hoffman and Millett, all of whom rejected the argument on what may be regarded as both historic and policy grounds.

The issue turns on the proper construction of what is now section 175 Insolvency Act 1986. This provides (in so far as material):

> (1) In a winding up the company's preferential debts ... shall be paid in priority to all other debts.
> (2) Preferential debts –
> (a) rank equally among themselves *after the expenses of the winding up* and shall be paid in full, unless *the assets* are insufficient to meet them, in which case they abate in equal proportions, and
> (b) so far as *the assets of the company available for payment of the general creditors* are insufficient to meet them, have priority over the claims of [floating charge holders] and shall be paid accordingly out of any property comprised in or subject to that charge (emphases added).

The present section has been in existence in substantially the same form since 1897, it having been introduced by s.2 of Preferential Payments in Bankruptcy (Amendment) Act. Preferential debts were first introduced into the law of company insolvency in s.4 Companies Act 1883 which gave preferential status to the claims of unpaid wages and salaries of clerks, servants, labourers and workmen. It was extended in 1888 to include rates and taxes.

The contemporaneous development of the floating charge in the late 19th century resulted in the claims of the preferential creditors in many cases being worthless. As all (or substantially all) of the assets of the Company were subject to security, there was nothing left for those creditors whom Parliament had intended to have preferential status. Neither they nor ordinary unsecured creditors had any entitlement to be paid out of secured assets. It was a consequence of this that s.2 of the 1897 Act was introduced in the following terms:

> ... [preferential debts] shall, so far as the assets of the company available for payment of general creditors may be insufficient to meet them, have priority over the claims of [floating charge holders]

and shall be paid accordingly out of any property comprised in or subject to such charge

The effect of the provision was to enable preferential creditors (and only such creditors) to be paid in priority to the floating charge. Lord Nicholls said of this provision (Paragraphs 14–15):

> To my mind the effect of section 2 admits of no doubt or ambiguity in the relevant respect. Thenceforth preferential debts as defined in the 1888 Act were to be paid out of the property comprised in a floating charge so far as the non-charged assets were insufficient to discharge those debts. The proprietary rights of a debenture holder were, to that extent, bitten into. That was the object and effect of the provision.
>
> I can see nothing in this provision to suggest that, additionally, liquidation expenses as such were thenceforth to be discharged out of the charged property. Those expenses are not mentioned in section 2.

Importantly, he went on, there was no ground for implying in respect of liquidation expenses an additional incursion into the debenture holder's rights to their charged property.

> In the distribution of *non-charged* assets of the company liquidation expenses rank ahead of the claims of preferential creditors. But unlike the non-charged assets, the *charged* assets belong to the debenture holders to the extent of the amounts secured. There is nothing inherently surprising in Parliament deciding that in future the proprietary interests of a debenture holder in his fund, that is, the charged assets, shall be eroded to the extent of the claims of preferential creditors without making any similar incursion in respect of liquidation expenses. The fact that liquidation expenses enjoy priority over the claims of preferential creditors in a winding up is not of itself a reason for according to liquidation expenses the like priority inn respect of charged assets (Paragraph 16)

These passages contain the central reasoning which is expressed in all of the three leading opinions:

(1) Charge holders look to their security for the discharge of the Company's debt;[1]
(2) There is a limited express encroachment into the charge holder's proprietary rights in respect only of preferential claims;
(3) There is no implied encroachment in respect of the costs and expenses of the liquidation;
(4) The claims of preferential creditors are to be met out of the assets subject to the floating charge as far as the non charged assets were insufficient to discharge those debts.

This latter proposition is clearly expressed in what is now s.175(2)(b). Lord Nicholls' historic survey renders it explicable. Preferential creditors (like unsecured creditors) are to be paid out of the *uncharged* assets. It is only to the extent that the uncharged assets are insufficient to discharge the preferential claims are they entitled to have recourse to the assets subject to the floating charge.

In many cases in which there is a debenture, all of the assets are subject to the security. In those instances there will be no uncharged assets. Practically, the preferential claims will only be met out of the assets subject to the floating charge.

The principle here is developed in both the Opinions of Lords Hoffman and Millett. The central theme is that there are two separate funds – a secured fund (the Debenture holders) and an unsecured fund (the non-charged or 'free' assets). Bankruptcy and liquidation are regimes designed for realization of uncharged assets. The costs and attributable to such regimes are to be met out of the uncharged assets. They are not to be borne by the charge holder (whether fixed or floating). Specific exceptions to this principle (such as realization of secured assets by a liquidator) are considered below.

The conclusion of the House of Lords was that the courts below had been wrong to treat the issue as one of priority between the claims of the liquidator, preferential creditors and floating charge holder. Once it is appreciated that the costs of the liquidation are to be met out of uncharged assets then the result is clear. The liquidator's claim in *Leyland Daf* failed. He has no recourse to the floating charge for his expenses.

Practical effect

The practical effect of the House of Lords' decision is exemplified by their overruling of the Court of Appeal decision in *Re Barleycorn Enterprises Limited* [1970] Ch 465. In that case the assets of the Company in liquidation were GBP 4744; preferential creditors were owed GBP 5161 and the Bank which had a fixed and floating charge were owed GBP 6972 (some of which was part of the preferential creditors claim in respect of monies advanced for wages). Needless to say all of the assets were charged. The preferential creditors would have to look to the floating charge for satisfaction.

Notes

1 A charged creditor is to be considered as entirely outside the company, who is merely seeking to enforce a claim, not against the company, but to his own property – per James LJ in *Re David Lloyd & Co* (1877) 6 Ch D 339.

The issue in *Barleycorn* was whether the costs of accountants in assisting in preparing the statement of affairs (and thus a liquidation expense) were to be paid in priority to the preferential creditors and the floating charge holder. The Court of Appeal had decided that they were and that the proper order of priority was (i) liquidation costs; (ii) preferential creditors and (iii) floating charge holder.

The House of Lords has held that *Barleycorn* was wrongly decided. As there were no free, uncharged assets, there was nothing out of which the liquidation costs and expenses were to be met. The assets in the liquidator's hands were subject to the floating charge and as such were payable to the preferential creditors and (had there been a surplus) to the floating charge holder. Only in the event that the floating charge holder was repaid in full would monies be available to pay the liquidation costs and expenses.

Section 175(2)(a) states that the preferential debts 'rank equally among themselves after the expenses of the winding up and shall be paid in full, unless *the assets* are insufficient to meet them'. Lord Millett held that the expression 'the assets' referred to the *unsecured* not secured assets. Accordingly the liquidation expenses would only enjoy priority over the preferential creditors in respect of the unsecured assets, not the secured ones.

The upshot of all of this is that the order of priority of payments is to be separately treated as between secured and unsecured funds. The Lord Millett gave two instances:

Order of priority – charged assets in administrative receivership

(i) costs of preserving and realizing charged assets;
(ii) receiver's remuneration and costs and expenses of receivership;
(iii) receivership preferential debts;
(iv) floating charge debts;
(v) the Company.

Order of priority – free assets in liquidation (s.175)

(i) costs of preserving and realizing assets;
(ii) liquidators remuneration and costs and expenses of winding up;
(iii) liquidation preferential debts;
(iv) floating charge holder to extent that preferential debts have been paid out of assets subject to the floating charge;
(v) unsecured creditors.

There is a third example which though not expressly set out by Lord Millett would seem to follow from their Lordship's reasoning:

Order of priority – liquidation where floating charge

(i) liquidator costs of preserving and realizing assets cf. rule 4.127B Insolvency Rules 1986 (as amended by Insolvency (Amendment) Rules 2004) and dealing with preferential creditors' claims (see below);
(ii) liquidation preferential debts;
(iii) floating charge holders;
(iv) liquidator's remuneration and costs and expenses of winding up;
(v) unsecured creditors.

Disaster

As has been appreciated by the insolvency profession, the effect of the House of Lords decision is little short of disastrous for liquidators. In many live liquidations the Company's assets will be entirely charged to a debenture holder. In accordance with accepted law and practice (at least since the decision in *Barleycorn* and up to and including the Court of Appeal's decision in *Leyland Daf)* liquidator's remuneration and the other costs and expenses of the liquidation will have been paid in priority to preferential creditors and floating charge holders. The House of Lords has held that that is wrong. The consequence will be that liquidators will find in many instances that there will be no funds available to meet costs and expenses (and may also find that they are challenged in respect of payments already made by them including payment of their own remuneration).

There are however a number crumbs (or maybe even bite-sized morsels) of comfort:

1. The House of Lords recognized the principle that a liquidator is entitled to charge the secured creditor the cost of preserving and realising assets subject to the security;

2. There is in any event a statutory basis for such charges – r4.218(1) Insolvency Rules 1986. This provides that where a liquidator *sells* an asset on behalf of a secured creditor he is entitled to retain out of the proceeds of sale such remuneration as would be chargeable by the Official Receiver in the same circumstances;

3. The new r.4.217B Insolvency Rules 1986 (as amended by the Insolvency (Amendment) Rules 2004) enables a liquidator to charge the secured creditor on a corresponding Official Receiver's scale in respect of any asset *realised* on for a fixed or floating chargeholder;

4. Lord Nicholls acknowledged the principle that if there are no uncharged assets, a liquidator could charge the floating charge holder the cost of identifying and paying preferential creditors (Paragraph 19). Whilst not spelled out in his

opinion, it would follow that the agreement of preferential creditor claims is a necessary incident of calculating the amount due to the floating charge holder;

5. There must a cogent argument that the costs of dealing with, e.g., ROT creditors or trust claims may fall within the concept of preserving assets subject to security. As is commonplace in receiverships, the effect of a successful claim by such a third party will be to deplete the sums available to pay the debenture holder. The same principle must similarly apply in liquidation. A liquidator would however be well advised to seek to obtain the agreement of the floating charge holder to agree that the liquidator's costs of such action would come out of the floating charge (whether or not the liquidator succeeds in resisting the claim).

There is a further possibility that arises out of an obiter comment of Lord Millett's in reference to the decision in *Barleycorn*. He remarked that in that case the liquidation costs may have retained priority over the preferential claims if the floating charge holder could have been persuaded to release its security. The reality was that the floating charge was worthless (all of the assets would on any basis have been eaten up by the floating charge). Quite apart from whether a floating charge holder would be prepared to release its (albeit valueless) security, the principle behind the remark is revealing. If there are no secured assets (either because there never was any security or because it has been released) the liquidation expenses will have priority over the preferential claims.

This conclusion may strike insolvency practitioners as more than a little odd. The question of liquidation expense priority may be altered to the detriment of the preferential creditors (and without their consent) as a consequence of any agreement by a floating charge holder who has no interest in the matter.

There are one or two further conundrums. What of a case in which the debenture holder is entirely repaid out of fixed charge assets? Does the liquidator in that instance enjoy priority over the preferential creditors. It seems to the present writer that the answer to this question ought to be yes. Whilst the assets are technically subject to a floating charge, the assets are being realised for the preferential creditors, not the floating charge holder.[2]

Enterprise Act 2002

The regime enacted by the Enterprise Act 2002 offers some further food for thought.

Prescribed part

Section 176A Insolvency Act 1986 (as amended) introduced the concept that a liquidator or an Administrator must 'make a prescribed part of the Company's net property available for the satisfaction of unsecured debts'. The prescribed part is payable out of assets that would otherwise have been available in satisfaction of claims of floating charge holders. The question is whether a liquidator would be able to contend that this being a sum that has been removed from the floating charge holder's security, is a free asset and ought to be available for payment of liquidation expenses. It may be thought that the proper answer is no. There is no express reservation of costs and expenses of the liquidation. Further, its purpose is to provide some fund to unsecured creditors who in many liquidations receive little or nothing.

As against this it will no doubt be contended that the sums have only been realized by the efforts of the liquidator and that they simply go to swell the pool of free assets available for distribution to unsecured creditors. Once in that pool they have no special status and, as with all unsecured assets, are subject to the costs of liquidation.

Administrations

Insofar as concerns Administrations, Paragraph 65 of Schedule B1 to the Insolvency Act 1986 (as amended) provides that an Administrator may make a distribution to a creditor and that section 175 shall apply in relation to a distribution as it applies to a winding up. Whilst it may be considered that the effect of the House of Lords decision would equally apply to the costs of Administrations, this would appear not to be the case. Paragraph 99(3) preserves the regime formerly contained in section 19(3) of the Act – namely that the Administrators' remuneration and expenses shall be paid in priority to floating charge security. The effect of all of this would appear to be that Administrators are to distribute floating charge realizations to preferential creditors before debenture holders (assuming there are insufficient uncharged assets). However, unlike liquidations the Administrators' remuneration is paid in priority.

Notes

2 A further conundrum arises in the case of r.4.97 Insolvency Rules 1986 which enables the liquidator to redeem a secured creditor's security at the value placed on it in that creditor's proof. In a case like *Barleycorn* where the security was in reality worth nil then a secured creditor who submitted a proof may be redeemed for a nil or nominal sum. The effect again may be to release the security with the effect of elevating the liquidator's priority over preferential creditors.

Furthermore, Paragraph 38 of Sch B1 of the amended Act introduced a new provision entitling the liquidator to make an Administration application. It may well be that liquidators whose remuneration and other expenses are now at risk will resort to making an application to convert the liquidation to Administration with a view to regaining their lost priorities. It may well be considered that applications by liquidators solely for this purpose will be improper and may not be granted

Closed liquidations

If all of the above is not bad enough news for liquidators, what makes it even worse is the possibility of claims being brought by disgruntled preferential creditors or floating charge holders in respect of distributions already made (including cases which are now closed). In those cases remuneration will have been paid to liquidators and or payments made to third parties on the basis of the law as understood following the decision in *Barleycorn.*

It is now well established that payments made under a mistake of law are recoverable – *Kleinwort Benson Ltd v Lincoln City Council* [1999] AC 349. It is generally not a defence to such a claim that the payments were made in accordance with the law and practice as understood at the time.

It is submitted that a number of defences may be open to liquidators to such claims. In addition to the standard restitutionary defences of change of position and estoppel, there is a powerful argument that the liquidator as an officer of the Company ought to be excused from liability pursuant to s.727 Companies Act 1985 on the ground that he has acted honestly, reasonably and ought fairly to be excused. It is submitted that the section is entirely apt to deal with cases in which liquidators have made distributions in accordance with what was regarded as an established and correct view of the law.

Summary

Most insolvency practitioners have by now appreciated that there are substantial risks in taking new appointments as liquidators save in cases in which there is no floating charge or there is likely to be a significant surplus after payment of the floating charge holder and preferential creditors. Where possible, insolvency practitioners will wish to take appointments as Administrators (where their expense priority is preserved). Where this is not possible, they will need to be cautious to judge that they will be remunerated before agreeing the appointment.