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Prescribed Part and Chargee Shortfalls

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In recent months two cases have come before the Chancery Division which have dealt with the question of whether holders of floating charges may prove for their shortfall in the prescribed part under section 176A of the Insolvency Act 1986. The first of these was *Permacell Finesse Limited* (In Liquidation) (2007) (Unreported), where the applicant Liquidators of Permacell sought directions in relation to section 176A; no submissions were made on behalf of the respondent charge holder. The second case was *Thornriley and another v HMRC and Harris N. A.* [2008] EWHC 124 (D), where the applicants were the administrators of companies over whom the second respondent held fixed and floating charges. The Court heard submissions from both the applicants and the respondents.

Permacell Finesse Limited

This case came before His Honour Judge Purle QC in the Chancery Division of the Birmingham District Registry and judgement was handed down on 30 November 2007.[1] The Liquidators of Permacell Finance Limited ('Permacell') sought directions on the following matter:

> 'Whether Synseal Holdings Limited ['Synseal'], a secured creditor of [Permacell] should be permitted to participate in the Prescribed Part (as defined by section 176A of the Insolvency Act 1986) in respect of the shortfall under its floating charge.'

Synseal indicated that it did not wish to incur the costs of representation at the hearing and was content to rely upon submissions made on behalf of the Liquidators.

Background

On 4 November 2005 Permacell created a floating charge in favour of Synseal. On 18 March 2006, the future Liquidators of Permacell were appointed as administrators by Synseal in its capacity as qualifying floating chargeholder. On 2 March 2007 Permacell moved into creditors' voluntary liquidation by Notice filed at Companies' House pursuant to paragraph 83 of Schedule B1 of the Insolvency Act 1986.

As at the date of administration, Synseal was owed GBP 2,307,000. During the course of the administration, all of Permacell's assets were realised. Out of those realisations, GBP 1,188,150 was distributed to Synseal, leaving a shortfall of GBP 918,850 under the floating charge. The prescribed part set aside was GBP 379,000. Unsecured creditors (not including Synseal in respect of its shortfall) were owed approximately GBP 3,104,000.

The legislation

The legislation which the Court was required to consider was section 176A of the Insolvency Act 1986. This provides as follows:

> 176A Share of assets for unsecured creditors
>
> (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.
>
> (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.
>
> (9) In this section –
>
> 'floating charge' means a charge which is a floating charge on its creation and which is cre-

Notes

1 The judgment is not reported although it is available on Lawtel.

ated after the first order under subsection (2)(a) comes into force, and

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

Section 176A was inserted by the Enterprise Act 2002 and came into force on 15 September 2003. Under subsection (1), the section applies where the company in question has gone into administration, is in liquidation and of which there is a receiver or a provisional liquidator. By virtue of sub-section (9), the section only applies to charges which were floating charges on their creation and which were created on or after 15 September 2003.

The prescribed part is ascertained by reference to the Insolvency Act (Prescribed Part) Order 2003. It cannot exceed GBP 600,000. Subject to this limit, it is calculated by reference to the company's net property: 50% of the first GBP 10,000 and 20% of anything above GBP 10,000.

The arguments in *Permacell*

The central question here was whether Synseal could prove for its shortfall and share in the prescribed part with the remaining creditors. The argument in favour of the view that Synseal could prove in respect of its shortfall was put on the basis that, first, ordinarily a secured creditor can prove for any shortfall and, secondly, that this conclusion was supported by the importance the law attached to the policy of pari passu distribution among creditors of the same class.

This view was rejected by His Honour Judge Purle QC for the following reasons:

a) The source of the principle of pari passu distribution is statute (the statutory scheme) and it does not operate as a free-standing principle against which statutory provisions fall to be construed: see *Re Polly Peck International plc* [1998] 2 BCLC 185.

b) The present case does not fall to be determined by the generalities of the statutory scheme but rather by the specific provisions of section 176A, which operate as a departure from the general rule that secured creditors rank ahead of unsecured creditors.

c) In this respect, the Enterprise Act 2002 redressed a long-overdue imbalance between preferential creditors, unsecured creditors and the holders of floating charges. Following the recommendation of the Cork Committee in its 1982 Report [Cmnd. 8558] the Enterprise Act 2002 removed the preference accorded to Crown debt and, in balancing this advantage to floating charge holders, took away from the latter a proportion of their security, capped at GBP 600,000.

d) It would thereby be surprising if the floating chargeholder, compelled to accept the setting aside of the prescribed part for the benefit of others, was then allowed to claw some of this back by claiming as an unsecured creditor; in many cases the shortfall would swamp the claims of unsecured creditors.

e) Section 176A(2)(b) provides that the officeholder shall not distribute the prescribed part to the holder of a floating charge 'except in so far as it exceeds the amount required for the satisfaction of unsecured debts'. If the floating chargeholder's debt is to rank as an unsecured debt, the exception can never, in the case of an insolvent company, apply. This is a good indication that 'unsecured debts' do not encompass the shortfall under a floating charge.

In his summing up, His Honour Judge Purle QC described the prohibition on distributing the prescribed part to a floating chargeholder as absolute.

Thornriley and another v HMRC and Harris

Since the decision in *Permacell*, the construction of section 176A(2) of the Insolvency Act 1986 has been considered by Mr. Justice Patten in *Thornriley and another v HMRC and Harris N. A.* [2008] EWHC 124 (D). Unlike Permacell, where only one party was represented, the Court heard submissions from Counsel for the applicants, who were the administrators of Airbase Services (UK) Limited ('Services') and Airbases Services International Limited ('International'), and from Counsel for the second respondent, the second respondent being the holder of fixed and floating charges over both companies.

During the course of the hearing Mr. Justice Patten did not receive submissions on *Permacell* as it was not cited to him. However, when preparing his judgment, he was provided with a copy of the case and received further submissions on it. On reading the judgment in *Permacell*, Mr. Justice Patten found that it accorded with his own views and did not propose to add to his findings. Although the Court in both cases reached the same conclusion, it is fair to say that the decision in *Thornriley* provides for a more detailed analysis of the language of the section.

The case put by the second respondent in *Thornriley* was as follows:

a) Under section 176A the prescribed part is made available to satisfy unsecured debts;

b) Harris' shortfall on both its fixed and floating charges is an unsecured debt;

c) Nothing in section 176A or its legislative history expressly excludes the shortfall as an unsecured debt;

d) The effect of section 176A is straightforward: without it the realisations represented by the prescribed part would have gone to the floating chargeholder as a secured creditor. All that section does is prevent that from happening. It does not prevent the floating (or fixed) chargeholder from participating as an unsecured creditor;

e) Any other result would be inconsistent with the application of the pari passu rule which requires debts (other than preferential debts) to rank equally between themselves

Mr. Justice Patten's response to these points was to advance three arguments in favour of an interpretation excluding the right of a floating chargeholder to prove for its unrealised balance in the prescribed part:

a) The question of whether an otherwise secured creditor falls within section 176A(2)(a) in respect of the unsecured part of his debt depends on how one construes 'unsecured debts' in the context of section 176A(2) as a whole. This will depend on whether it can be assumed that 'unsecured debts' are entirely general in meaning. This is not supported by section 248 of the Insolvency Act 1986. This view is also supported by other parts of the legislation and rules, including, for example, sub-rule (2)(c) of rule 2.95 which requires the administrator to give notice of any proposed distribution to creditors and provides that notice shall 'where the administrator proposes to make a distribution to unsecured creditors, state the value of the prescribed part, except where the court has made an order under section 176A(5).'

b) The second argument was in identical terms to that advanced in *Permacell* at (e) above: this is referred to as the 'most compelling argument' as, on the construction preferred by the second respondent, the provisions of section 176A(2)(b) are inoperable where the prescribed part of the company's net property is sufficient to discharge the debts of the unsecured creditors in full and thereby leaving a surplus.

c) This view of section 176A is consistent with position of fixed charge holders. Prior to the Enterprise Act 2002, and since then, they had and continue to have unfettered access to their security except that in respect of assets subject to a floating charge, they rank behind the claims of preferential creditors and floating charge holders. On the basis that the abolition of Crown preference was intended to enure for the benefit of unsecured creditors, the exclusion of fixed charge holders in parallel with floating charge holders cannot be said to be inconsistent with the stated purpose of the legislation.

Conclusion

It is therefore now clear that as long as the floating charge is in existence and unsecured creditors have not been fully paid the holder is not entitled to participate in the prescribed part. In the unlikely event that unsecured creditors receive 100p in the pound the holder of the floating charge is entitled to the return of the prescribed part or such balance as remains after the officeholder has completed the payment to unsecured creditors. Moreover there is nothing to prevent the chargee from giving up the security in toto and proving as an unsecured creditor. There nonetheless remain a number of questions for which the wording of section 176A is less comprehensible. Can the holder of a floating charge participate in the prescribed part in respect of a separate debt owed to him which is not secured by the floating charge? If there are two floating charges, can the holder of one participate in the prescribed part given up by the other? No doubt these and related questions will be determined in due course.

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