The Prescribed Part for Unsecured Creditors: A Further Review

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Abstract

This article provides an update on the role of the prescribed part fund as a realisation tonic for unsecured creditors in contemporary English insolvency proceedings. This update reflects upon recent empirical data on the use of the fund, the profile of creditors that benefit from the fund as well as the Government's plans to increase the fund's upper limit and to restore some of the Crown's preferential status in insolvency proceedings.

1. Background

In an earlier review of the prescribed part fund established by section 176A of the Insolvency Act (IA) 1986, this writer highlighted some difficulties with both the idea and operation of the fund.[1] The scope of difficulties encompassed the fund's inroad into the proprietary interest of the floating charge holder, the volume of the fund in typical insolvency proceedings (notwithstanding the extant statutory benchmark), the cost of the fund and its disapplication by office-holders, and the profile of unsecured creditors that benefit from the fund. The net result of these difficulties at the time of that review was that Parliament's effort to redistribute corporate assets in favour of unsecured creditors through the prescribed part fund only yielded marginal fruits for this class of insolvency claimants. Yet, that review suggested – perhaps injudiciously – that contemplating the abolition of the fund was a tad premature. Indeed it was sanguine about the benefits

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[1] See K Akintola, 'The Prescribed Part for Unsecured Creditors: A Pithy Review' (2017) 30(4) Insolvency Intelligence 55.

certain reforms[2] to our corporate insolvency framework could bring to the cost of insolvency proceedings and, *pro tanto*, returns enjoyed by the general body of creditors.

A number of significant developments have occurred since that review. At the macroeconomic level, it has been a challenging business climate for companies in the wake of the current political flux. This is a real threat to the survival of companies. Such an inauspicious business environment would have a bearing on the ability of companies to honour their credit obligations as well as the supply of credit. This threat is reflected in recent insolvency statistics, which show that the number of company insolvencies in 2018 increased to circa 16,000, the highest level since 2014.[3] The offshoot of this is a decidedly bleak prognosis for unsecured creditors if we accept that (a) the prescribed part fund is now the main source of unsecured creditor recovery in many insolvency proceedings,[4] (b) the fund is hardly set aside in many eligible insolvencies and, where set side, only delivers trivial returns to unsecured creditors,[5] and (c) in any event, unsecured provable debts have a low ranking in the *waterfall*.[6] A further development lies at Governmental level with the recent decisions to increase the current cap on the fund from £600,000 to £800,000[7] and to reinstate HMRC's preferential status from 6 April 2020 with respect to VAT, PAYE Income Tax, employee national insurance contributions (NICs), and construction industry scheme deductions.[8] On a personal level, this writer has happily benefited from additional empirical data that could, when compared to data presented in the earlier review, provide further clarity on the utility of the fund in contemporary insolvency proceedings.[9]

This latest review of the prescribed part fund examines the impact of these developments on the sustainable existence of the fund. It strongly contends that the

[2] Small Business, Enterprise and Employment Act (SBEEA) 2015: s 119 inserting IA 1986, s 176ZB; ss 122 and 124 brought into force by Insolvency (England and Wales) Rules 2016/1024 (IR 2016), pt 1 (ch 9); and s 128 amending IA 1986, Sch B1, para 65(3) .

[3] <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/774327/Commentary.pdf> accessed 1 February 2019.

[4] See for example, Law Commission, *Consumer Prepayments on Retailer Insolvency* (Law Com No 368, 2016) (LCR 368), 8.29

[5] Akintola, 'The Prescribed Part for Unsecured Creditors: A Pithy Review', n.1 above.

[6] *Re Lehman Bros International (Europe) (in administration)* [2017] UKSC 38, [2017] 2 WLR 1497 at [17].

[7] Department for Business, Energy and Industrial Strategy (DBEIS), *Insolvency and Corporate Governance: Government Response* (August 2018), 1.82-1.84.

[8] HM Treasury, *Budget 2018* (HC 1629, October 2018), 3.87.

[9] I am hugely indebted to Sofia Ellina for giving me access to the quantitative data she has gathered for her doctoral thesis. That data provided a backdrop for me to gather further data and conduct further analysis on the prescribed part fund.

aforementioned decisions of the Government are pointlessly obtrusive and would likely further impair meaningful returns to unsecured creditors. It makes a case for another reform to the operation of the fund in addition to the statutory "creditor-profiling" proposed in the earlier review. This reform involves expanding the scope of "a company's net property" under the prescribed part provision.[10] If such changes are not made, then this article suggests that it should be a curtain call for the role of the prescribed part fund in English insolvency law.

The remainder of this article is split into 3 sections. Section 2 examines recent data on the use of the prescribed part fund in insolvency proceedings and highlights the difficulties presented by the narrow concept of a company's net property and the marshalling of unsecured claims under the fund. Section 3 examines the implications of the Government's decisions to the application of the fund and realisations of unsecured creditors. Section 4 provides some concluding thoughts.

2. Further Empirical Findings

The earlier review reported some data on the prescribed part culled from this writer's survey of 2,129 companies that went into administration and/ creditors' voluntary winding up between 2006 and 2011. That data showed that out of 704 post-Enterprise Act 2002 (EA) floating charges,[11] only 95 prescribed part funds were set aside. Of those 95:

- the average unsecured claims stood at £2,935,230;
- the average prescribed part dividend was £63,152;
- the average number of unsecured creditors was 71; and
- the average dividend ratio to individual creditors was 7.3p in the £.

[10] IA 1986, s 176A(6) provides that 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." (Emphasis added).

[11] The fund only applies to floating charges created after the statutory provision was brought into force i.e. from 15 September 2003. See IA 1986, S 176A(9).

What follows is an account and analysis of more recent empirical data on the prescribed part.[12] The data is based on 600 randomly selected companies that entered into administration between 2012 and 2016. While 419 of those companies had a registered floating charge against their name, 386 of those charges were taken by the secured creditor after the commencement of the EA. 50 prescribed part funds were set aside by office-holders in this data sample. Of these 50 prescribed part cases:

- average unsecured claims stood at £4,390,737;
- the average general return to unsecured creditors was £101,775;
- the average prescribed part dividend was £101,381;
- the average number of unsecured creditors was 93;
- HMRC was an unsecured creditor in no fewer than 39 of those prescribed part cases; and
- the average dividend ratio to individual unsecured creditors was 6p in the £.

This data provides some interesting points of reflection. First, there seems to be no noticeable increase in the use of the prescribed part fund from the earlier review. In the previous and current data, the use of the prescribed part fund (relative to eligible post-EA floating charges) stands at circa 13%. Secondly, the small differentiation between general unsecured creditor returns and returns under the prescribed part fund reinforce suggestions that the prescribed part is, typically, the only source of unsecured creditor recovery in insolvency. While this is a divergence from the original idea that the fund should be a top-up for unsecured creditors (by giving them any benefits that accrue from the abolition of Crown preference),[13] it also suggests that in a practical sense we have effectively subordinated floating charge holders to unsecured creditors in the insolvency

[12] The usual caveats on empirical data apply. What is reported here is based on information that was observable from downloaded insolvency filings of office-holders. Further, due to the time period of the formal insolvencies of the companies involved in this data sample, this data cannot capture the putative benefits of reforms introduced by the SBEEA 2015 and IR 2016.

[13] Department of Trade and Industry ('DTI'), *Insolvency - A Second Chance* (White Paper, Cmnd 5234, 2001), 2.19.

waterfall. Thirdly, individual returns under the fund continue to be a pittance. In this data, the average dividend ratio was propped up by one case of a return of 100p in the £ to a creditor owed a measly £823. If we take out that case from the sample, the average dividend ratio drops from 6p to 4p in the £.[14] The link between the number of unsecured creditors and the resulting cost of setting aside the fund continues to be the key issue here. Office-holders indicate this correlation (or causation) in their progress or final reports. The more creditors there are on a particular case, the higher the resultant costs will usually be.[15] This invariably leads to lower returns to unsecured creditors under the fund.[16]

Finally, it is worth reproducing data on two examples from this sample, which shed light on simple difficulties encountered by office-holders in setting aside the fund. Such difficulties unvaryingly affect the use of the prescribed part. In the first case, the administrators did not set aside the fund. They estimated the company's net property as defined in section 176A(6) of the IA 1986 to be £31,795.56 and the prescribed part to be £9,972.97. Yet, they did not make a prescribed part distribution because "… the estimate of the company's net property is less than the minimum prescribed by the Insolvency Act 1986 (Prescribed Part) Order 2003 and … in accordance with section 176A(3)(b) … the costs of making a distribution of the prescribed part to unsecured creditors would be disproportionate to the benefits."[17] That sum of £9,972.97 was paid to the bank charge holder as a floating charge realisation. This is a perplexing insolvency outcome. Section 176A(6) defines a company's net property as the amount of its property which would, but for the section, be available for satisfaction of claims of floating charge holders. Given that the floating charge holder suffered a shortfall of circa £38,000 in this case, that amount of £31,795.56 falls within the definition of a company's net property. Further, contrary to

[14] One is reminded of the phrase "lies, damned lies and statistics" as this average measurement of the dividend ratio masks the reality that many creditors received less than 1p in the £ under the fund.
[15] In this sample, it was possible to track the cost of the prescribed part in 26 cases. Average and mode cost of prescribed part was circa £20,000. This figure should be compared with the average number of unsecured creditors in the sample i.e. 93.
[16] The expenses (or "costs") associated with the prescribed part fund must be paid out of the fund. See IR 2016, r 3.50(2) and the postscript of HHJ Purle QC in *Re International Sections Ltd* [2009] BCC 574 at [16].
[17] Administrators' Final Report attached to Notice of move from Administration to Dissolution.

the administrators' statement, the net property was well above the statutory minimum of £10,000.[18] Thus, net of expenses associated with the prescribed part, that sum of £9,972.97 should have been distributed to unsecured creditors under the fund. The only justification for the outcome arrived at by the administrators is that the fund was disapplied because the cost of making the distribution would be disproportionate to its benefits; but such disapplication would require a court order.[19]

The second case is at the other end of the spectrum. Here, the net property of the company was £7,249 and the prescribed part was £3,624. After deducting prescribed part costs of £2,500, the sum of £1,124 was distributed to 41 unsecured creditors, representing a dividend of 0.21p in the £.[20] This case represents a positive approach to the use of the prescribed part fund. Indeed, a combined reading of section 176A(3) of the IA 1986 and Article 3(1)(a) of the Insolvency Act 1986 (Prescribed Part) Order 2003 indicates that a prescribed part fund could be set aside where the company's net property does not exceed the statutory minimum of £10,000. In such instance, however, the office-holder could disapply (without a court order) the prescribed part under section 176A(3)(b) if he thinks that the cost of making a distribution to unsecured creditors would be disproportionate to the benefits. It is rather striking that the administrator in this case elected not to exercise that discretion given the paltry net value of the fund, the number of unsecured creditors and the poor dividend ratio. However, one can only speculate that this was a commercial decision that must have been made in light of the peculiar circumstances of the case.

3. Government Decisions

What follows is a cursory examination of two Governmental interventions into the prescribed part fund identified in the first section of this article. While the decision to increase the current cap on the fund from £600,000 to approximately £800,000 is a direct

[18] The Insolvency Act 1986 (Prescribed Part) Order 2003, SI 12003/2097, Art 2.
[19] IA 1986, s 176A(5); IR 2016, r 12.15; *Re International Sections Ltd* [2009] BCC 574 (order refused on dividend of 1.48p in £); *QMD Hotels Ltd Administrators, Noters* [2012] BCC 794 (order refused on dividend of 1.8p in £); *Joint Administrators of Castlebridge Plant Ltd, Noters* [2017] BCC 87 (order refused on dividend of 0.58p in £). *Cf Re Hydroserve Ltd* [2008] BCC 175 (order granted on dividend of circa 1p in £).
[20] Administrator's Progress Report.

intervention, the decision to partly reinstate HMRC's preferential status may be characterised as an oblique intervention.

It would appear that the justification for increasing the cap is the desire to "… help unsecured creditors … in a way that remains linked to the original policy intent of transferring funds given up by the Crown to unsecured creditors."[21] A preliminary observation by the keen reader should be that the policy aspect of this rationale is now wonky in light of the subsequent decision to partially reinstate the Crown's preferential status. In any event, that policy rationale is conceptually questionable.[22] Further, while the empathy for unsecured creditors' piteous returns in insolvency is laudable, it is doubtful that increasing the cap on the prescribed part fund would deliver better – if any – benefits for unsecured creditors in insolvency proceedings. The decision seems to presume that there would be sufficient assets to enable an office-holder ring-fence this amount. Yet, the operation of the prescribed part fund suggests that this may not be the case as the statutory notion of a company's net property is too narrow. Even in big insolvencies where, ostensibly, there may be corporate assets for the satisfaction of insolvency claimants, the reliance by the post-EA floating charge holder on other financing expedients[23] for realisation could negatively affect the existence (or size) of a company's net property and the fund.

It would appear therefore that the goal ought to be the maximisation of unsecured creditor recovery through a reconsideration of the concept of net property under section 176A(6) and a continued push to reduce insolvency costs. While we wait for the opportunity to appraise the cost-saving benefits of changes introduced by the SBEEA 2015 and IR 2016, it is important to emphasise that the judiciary is able to scrutinise and, where needed, cut back unnecessary costs incurred by office-holders to the detriment of creditors under the prescribed part. For example, in *QMD Hotels Ltd Administrators, Noters*[24] the court derided the administrators' overzealous approach to the adjudication of unsecured

[21] DBEIS, *Insolvency and Corporate Governance: Government Response*, 1.84.
[22] Akintola, 'The Prescribed Part for Unsecured Creditors: A Pithy Review', n.1 above, 55-56.
[23] For example factoring, fixed charges, lightweight floating charges or pre-EA floating charges.
[24] [2012] BCC 794.

claims and directed them to do no more work than was necessary in order to reduce the cost of the prescribed part fund from £5000 to £570.

Finally on this decision to increase the prescribed part cap, the Government noted that prescribed part payments rarely reach the current cap.[25] This is backed by recent data reported in section 2 of this article. In that dataset, there were 3 cases where the maximum value of the prescribed part was set aside. Thus, as the Government conceded, cases where the putative benefits of this decision would be experienced would be the exception not the norm.

The Government's decision to reinstate HMRC's preferential status[26] will also have implications for insolvency outcomes, including the use of and recoveries under the prescribed part. Politically, it smacks of Government departments not communicating properly, if, as we have already seen, the decision to increase the prescribed part cap was tied to the extant abolition on Crown preference. Moreover, if a *quid pro quo* for abolishing Crown preference is the creation of the prescribed part where there is a post-EA floating charge,[27] reinstating Crown preference should raise serious questions on the continued legitimacy of the prescribed part fund. Further, where there is no post-EA floating charge under this proposed regime, reinstating Crown preference will have the direct effect of the Government taking assets earmarked for unsecured creditors under the current regime. One also needs to ask why the Government is reneging on plans to modernise our insolvency framework along the trends in other jurisdictions like Germany and Australia?[28] To put it differently, why should debts owed to the community (or the Crown) be paid in priority to debts owed to private creditors?[29]

Legally, this decision will have a palpable impact on unsecured creditor and floating charge recoveries since there is no statutory cap on Crown preference as there is on the preferential claims of employees for remuneration.[30] This position is exacerbated by the

[25] n.20 above.
[26] HM Treasury, *Budget 2018*, 3.87.
[27] DTI, *Insolvency - A Second Chance*, 2.19.
[28] *ibid.* While German law does not give priority on any unsecured claim, Australian law (like current English law) does not confer priority on tax claims.
[29] *Report of the Review Committee on Insolvency Law and Practice* (Cmnd 8558, 1982), para 1410.
[30] IA 1986, s 386 and sch 6, para 9; Insolvency Proceedings (Monetary Limits) Order 1986, Art 4.

legal rules on insolvency distribution. First, the *pari passu* principle merely applies to preferential debts *inter se*.[31] Secondly, an imitation of the absolute priority rule in the *waterfall* dictates that senior claimants are to be fully satisfied before junior claimants.[32] The application of these rules form part of the basis of this writer's argument elsewhere that an increase in the cohort of preferential creditors would negatively affect the utility of the prescribed part fund.[33]

4. Final Thoughts

It seems likely that implementation of the Government's decisions would – as it should – generate some discussion on the sustainable role of the prescribed part. When coupled with empirical data on the performance of the prescribed part, the partial reversion to the pre-EA position on Crown preference presents a strong case for abolishing or curtailing (rather than increasing) the scope of the fund.

If the prescribed part is to survive calls for its abolition, then for the umpteenth time this writer suggests reforms to its operation so that it can deliver meaningful value to unsecured creditors in a manner that fairly distributes the burden associated with its existence among other insolvency claimants. A starting point would be the expansion of the statutory concept of a company's net property so that a wider pool of assets can be caught by the prescribed part provision. This could involve extending the concept to other financing expedients like fixed charges and receivables financing agreements.[34] There are clearly questions of property law and financial law (access to or cost of credit) to overcome in this suggestion. Nevertheless it seems that the Government is not overly moved by

[31] IA 1986, s 107 and s 175(1A)(1B); V Finch, 'Is Pari Passu Passe?' (2000) 5 Insolvency Lawyer 194.

[32] R Mokal, 'Liquidation Expenses and Floating Charges – The Separate Funds Fallacy' [2004] LMCLQ 387, 397-398. For plans to curb the application of this American-derived rule in English corporate restructurings, see DBEIS, *Insolvency and Corporate Governance: Government Response*, 5.156-5.168.

[33] Kayode Akintola, 'The Proposed Preferential Priority of Prepaying Consumers: A Fair Pack of Insolvency Recommendations?' in (2018) 1 JBL 1 at 8. For the Government's subsequent decision to reject the giving of preferential status to prepaying consumers in insolvency, see DBEIS, *Law Commission Report on Consumer Prepayments on Retailer Insolvency: Government Response* (December 2018) pp.15-17.

[34] An analogous argument has been made by Walton who suggested that factoring agreements inhibit the payment of insolvency expenses and, for that reason, should be re-characterised as security agreements in order to be caught by the expenses regime. See P Walton, 'Fixed and Floating Charges: the Great British Fund Off' (2015) 1 JIBFL 3.

such concerns. Indeed, current floating charge inroads plainly ignore such concerns and suggest that our insolvency framework is, in part, the product of political decisions that are made to address wider economic concerns.

In terms of the statutory creditor-profiling suggested in the earlier review, there is now conceivably a stronger case to oust the Crown on policy grounds as a prescribed part claimant with respect to the remnant of its unsecured status. A major impediment to this reform is the application of the *pari passu* principle to the prescribed part, which protects equal treatment of unsecured creditors in distributions under the fund.[35] But such exclusion of certain *unsecured claims* is not altogether strange to our jurisprudence. After all, on policy grounds, secured creditors are excluded from participating in the fund with respect to the unsecured portion of their claims.[36]

[35] *Re Courts Plc (In Liquidation)* [2008] BCC 917.

[36] *Re Permacell Finesse Ltd (In Liquidation)* [2008] BCC 208; *Thorniley v Revenue and Customs Commissioners* [2008] BCC 213. *Cf Re PAL SC Realisations 2007 Ltd (In Liquidation)* [2010] EWHC 2850 (Ch); and *Re JT Frith Ltd* [2012] BCC 634.