

The Proposed Preferential Priority of Prepaying Consumers: A Fair Pack of Insolvency Recommendations?

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Abstract

This article examines the Law Commission's proposal to Parliament that prepaying consumers should be given preferential status in retail insolvencies. The article highlights the challenges of such status to financing practices and corporate insolvency outcomes. It also provides an alternative perspective to the rationalisation of unsecured creditors' interests in insolvency.

A. Introductory

The Law Commission recently presented to Parliament an extensive – if not thorough – report¹ on the impact of retail insolvencies on prepaying consumers. Concerns around a number of insolvencies involving Christmas savings schemes and other retail outlets drove the consultation preceding the report and the ensuing recommendations contained in the report. A poster case for the Commission in this respect was *Farepak*.² The Commission has made a number of recommendations, which putatively address the financial position of prepaying consumers in the insolvency of such businesses. The recommendations range from a statutory elevation for such consumers in the index of insolvency distribution to adjustment of the rules that underpin transfer of ownership in purchased goods. This article scrutinises the rationale of some of these provisions. In particular, it analyses the case for making consumers preferential creditors, and questions the reasoning for recommending a statutory arbitrage between unsecured creditors in insolvency. Overall,

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¹ Law Commission, *Consumer Prepayments on Retailer Insolvency* (Law Com No 368, 2016) (LCR 368).

² [2006] EWHC 3272 (Ch). See also *Re Farepak Food and Gifts Ltd (No.2)* [2009] EWHC 2580 (Ch).

it argues that concerns addressed in the report point to a more pressing issue in our corporate insolvency framework: the inefficacy of the current protection afforded to unsecured creditors under the Insolvency Act through the prescribed part fund.

The fact that the economy is acutely dependent on the wellbeing of companies is trite. Companies, being the principal unit of commercial life,³ have significant impact on the livelihood of stakeholders such as creditors, equity investors, employees and consumers.⁴ One could therefore suggest that if companies fail, the economy or at least several sectors of it would suffer a degree of hardship. The Law Commission's recent report on consumer prepayments in insolvency reinforces this proposition by highlighting the impact of retail insolvencies on consumers.⁵ Such is the weight of the impact that novel recommendations for the treatment of prepaying consumers⁶ in a retailer's insolvency now lie before Parliament. Before scrutinising some of these recommendations, a cursory consideration of some statistics is apposite. The retail industry is an indicium of economic performance⁷ and, it is said, generates around 5% of UK's GDP.⁸ Since 1988, the value of retail sales has steadily increased;⁹ although since 2010, there have been around 13,124 retail insolvencies.¹⁰ What these data tell us is that the industry is clearly important to the economy. However, comparable insolvency figures for the construction and administrative/support service¹¹ industries come in at circa 20,892 and 15,992 respectively.¹²

³ *Prest v Petrodel Resources Ltd & Ors* [2013] UKSC 34, para 8 per Lord Sumption.

⁴ CW Frost, 'Bankruptcy Redistributive Policies and the Limits of the Judicial Process' (1995) 74 NCL Rev 75, 76.

⁵ LCR 368. See also Law Commission, *Consumer Prepayments on Retailer Insolvency: A Consultation Paper* (Law Com No 221, 2015) (LC CP 221).

⁶ That is, an individual acting for purposes that are wholly or mainly outside that individual's trade, business, craft or profession. See Consumer Rights Act 2015, s 2.

⁷ Information available at <<https://www.ons.gov.uk/businessindustryandtrade/retailindustry#datasets>> accessed 19 August 2016.

⁸ Information available at <<http://www.retaileconomics.co.uk/library-retail-stats-and-facts.asp>> accessed 23 August 2016. In 2014, the industry recorded 11% of UK's economic output; see <<http://researchbriefings.files.parliament.uk/documents/SN06186/SN06186.pdf>> accessed 19 August 2016.

⁹ See n.7 above.

¹⁰ Original and revised statistics available at <<https://www.gov.uk/government/statistics/insolvency-statistics-april-to-june-2016>>.

¹¹ Recent statistics show that the services sector (Professional, scientific and technical) recorded the most significant growth in British industry; see

<<http://www.ons.gov.uk/businessindustryandtrade/business/activitysizeandlocation/bulletins/ukbusinessactivitysizeandlocation/2015-10-06>> accessed 19 April 2016. For the impact of this industry on the fate of unsecured creditors under the prescribed part, see K Akintola, 'What is left of the Floating Charge? An Empirical Outlook' (2015) 7 JIBFL 404, 406.

¹² See n.10 above.

The remainder of this article is split into five sections. Section B will consider the justification for the special treatment of consumers, including the veracity of the claim that prepayments benefit floating charge holders. Section C explores the cost of agreeing such preferential claims¹³ (due to the eligibility criteria) and its impact on administration expenses as well as the claims of other creditors. Section D questions the legitimacy of trusts created for consumers in the 'twilight period'¹⁴, particularly in light of the voidable preference provision. Section E attempts to demonstrate that the primary issue underlying the Commission's recommendations is that the prescribed part¹⁵ is not a suitable means of guaranteeing unsecured creditor realisations in insolvency. Section F of this article concludes with some recommendations.

B. The Unconvincing Case for Consumer Preference

As the Commission rightly observed,¹⁶ the occurrence of insolvency is often an emotive issue in society.¹⁷ Equally emotive are the arguments that circumscribe the political decision on the composition of preferential cohort in a company's insolvency.¹⁸ This is so because in many countries the candidates eligible for preferential treatment typically include those creditors without the benefit of security, who are particularly deemed too unsophisticated to protect themselves against the advent of insolvency with any degree of effectiveness. As we shall see shortly, this is a component of the justifications advanced by the Commission in favour of consumers. Unsecured creditors generally have historically evoked such sentiment,¹⁹ albeit with limited statutory success.²⁰ Business failures are

¹³ That is, the debts of creditors, which rank after the expenses of insolvency but have priority over claims of floating charge holders. See Insolvency Act 1986, s 175.

¹⁴ For an overview of obligations of corporate actors in the 'twilight zone', see D Milman, 'Strategies for Regulating Managerial Performance in the 'Twilight Zone' - Familiar Dilemmas: New Considerations' [2004] JBL 493.

¹⁵ That is, the share of assets subject to a floating charge that may be made available for unsecured creditors pursuant to section 176A of the Insolvency Act.

¹⁶ LCR 368, ch.4.

¹⁷ The recent demise of BHS is a case in point.

¹⁸ See for example one of the parliamentary sessions that led to the Preferential Payments in Bankruptcy Amendment Act 1897; *Hansard, Parliamentary Debates* (4th Series) 60 Vict, vol XLVI (10 February 1897), 73 col 1.

¹⁹ For example, Lord Macnaghten once said as follows "I have long thought, and I believe some of your Lordships also think, that the ordinary trade creditors of a trading company *ought to have a preferential claim on the assets in liquidation* in respect of debts incurred within a certain limited time before the winding up." See *Salomon v Salomon* [1897] AC 22, 53 (emphasis mine).

²⁰ See Sections E-F below.

unavoidable and would often involve winners and losers. Therefore, what is required is an insolvency framework that efficiently manages the varied interests of stakeholders when such failures occur, and minimises the negative impact of such failures on the economy.

The Law Commission recommended to Parliament that prepaying consumers should have preferential status in a retail company's insolvency (subordinated to that of employees) if the prepayment is for the sum of £250 or more, is made by a method (such as cash or cheque) not protected through chargeback or other means, and made to the insolvent business in the preceding six months.²¹ The Law Commission supported its recommendation with a three-pronged justification. These are: (a) consumers are vulnerable and may suffer unexpected hardship; (b) prepaying consumers provide cash flow to businesses without being in a position to assess the credit risk; and (c) the index of insolvency distribution sets up a perverse incentive as prepayments directly benefit floating charge holders while providing a direct loss to consumers.²² These arguments will now be examined in turn.

The first of the justifications is the least convincing. The Law Commission itself acknowledged this.²³ The argument that prepaying consumers are vulnerable and suffer hardship is particularly characteristic of most unsecured creditors in a company's insolvency. While there is evidence that certain trade-unsecured creditors are able to adjust the price of trade credit based on a debtor's credit worthiness and propensity for misbehaviour, such creditors are clearly the exception within the spectrum of unsecured creditors.²⁴ The majority of unsecured creditors are non-adjusting creditors, such as tort victims, unsophisticated traders, self-employed proprietors, and consumers. To this end, one fails to see a reason to prefer prepaying consumers alone. It is also worth noting that the individual claims of such non-adjusting creditors would typically be a pittance.²⁵ As a

²¹ LCR 368, 8.92, 8.109.

²² LCR 368, 8.50-8.69.

²³ *ibid*, 8.53.

²⁴ V Finch, 'Security, Insolvency and Risk: Who Pays the Price?' (1999) 62 MLR 633, 644.

²⁵ LCR 368, 4.4 – 4.5. Empirical studies have also shown that while an insolvent company's unsecured debt may appear large, it is typically made up of discrete paltry sums, with the large sums owed to HM Customs and Revenue, pension funds, the company's directors, or another company in the corporate group. See S Frisby, 'The Effect of the Enterprise Act 2002: Empirical Research into Corporate Insolvency' in WG Ringe, L Gullifer and P Théry (eds) *Current Issues in European Financial and Insolvency Law: Perspectives from France and the UK* (Hart 2009), pp. 45-66.

result, if any member of this group is particularly deserving of protection, their claims could be funded by the state in a manner that mirrors the Redundancy Payments Service's payment of the unsecured aspect of employees' claims (such as statutory redundancy) and the subsequent subrogation of the state as an unsecured creditor in the company's insolvency.²⁶ This would take care of such vulnerable claimants without distorting the current index of priority in insolvency, or creating a legislation-led arbitrage between unsecured creditors. In any event, one could argue that the impact of a retailer's insolvency on a prepaying consumer (owed whatever sum of money) would be less severe than the impact on a non-consumer/trade creditor. This is because the failure of a large business, such as a prominent retailer, could cause a chain reaction of failures, negatively affecting its trading counterparts, including the employees, creditors, and local community of such counterparts.²⁷ Put differently, trade creditors have more at stake than prepaying consumers do. Moreover, providing this protection for some unsecured creditors may be a signal to other unsecured creditors that their class requires additional protection. This could cause non-preferential unsecured creditors to pull themselves up by their bootstraps through an increase in the price of goods and services supplied, or the use of quasi-security such as retention of title.

The second justification touches upon the inability of consumers to assess risk whilst effectively providing something akin to a loan to the business (because the business uses prepayments as a source of cash flow) in the eve of insolvency. A number of rebuttals exist to this point. Firstly, as already noted above, majority of unsecured creditors - not just consumers - are unable to assess properly the risk of doing business or extending oblique credit to businesses.²⁸ Secondly, in choosing to deal with a corporate body, it would seem that as a matter of law all creditors implicitly accept the incidents of dealing with a juristic person. One of such incidents is the fact that the burden of insolvency generally

²⁶ Employment Rights Act 1996, Part XII.

²⁷ R Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet and Maxwell 2011), para 2-14.

²⁸ See n.24 above.

rests upon corporate assets, which may be scarce. The following passage from *Salomon v Salomon* is instructive in this respect:

“The unsecured creditors of A Salomon and Co Ltd may be entitled to sympathy, but they have only themselves to blame for their misfortunes. They trusted the company, I suppose, because they had long dealt with Mr Salomon, and he had always paid his way, but they had full notice that they were no longer dealing with an individual, and they must be taken to have been cognisant of the memorandum and of the articles of association”²⁹

Moreover, it is not objectionable in English law for a company to trade with its customers’ deposits or prepayments at a time when there is a reasonable prospect of avoiding insolvency.³⁰ As was noted in *Farepak*, in the absence of evidence of the parties’ intentions to the contrary, it is commercially implausible to expect companies, including banks, to segregate consumer prepayments until delivery of goods or services.³¹

Thirdly, it would seem that there is some respite under property law where prepayments are extracted at a time when the company is not in a position to fulfil the consumer’s request for goods or services.³² In *Neste Oy v Lloyds Bank Plc (The Tiiskeri, The Nestegas and The Enskeri)*,³³ payments were made from a principal to its agent. The directors of the agent had resolved to cease trading and to request that its bank appoint a receiver. They accepted a further payment from the principal. The Court held that the payments were held on constructive trust for the payee. Although this reasoning was not entirely accepted in *Farepak*,³⁴ Mann J considered that it was plausible to constitute Farepak as a constructive trustee “... if it could be established that moneys were paid to Farepak by customers at a time when Farepak had decided that it had ceased trading, and

²⁹ [1897] AC 22, 52 *per* Lord Macnaghten.

³⁰ *Re Uno Plc* [2006] BCC 725. See also the statement of Peter Smith J in the abortive disqualification proceedings in *Farepak* (HM court website, 21 June 2012), para 34.

³¹ *Re Farepak Food and Gifts Ltd* [2006] EWHC 3272 (Ch), paras 34-35.

³² In paragraph 8.55 of its report, the Law Commission gave examples of cases in which payments were made by consumers only for the trader to go into insolvency the same or following day.

³³ [1983] 2 Lloyd’s Rep. 658. This case has come under a lot of scrutiny, most recently by the supreme court. See n.37 below.

³⁴ *Re Farepak Food and Gifts Ltd* [2006] EWHC 3272 (Ch), paras 38-39.

indeed at a time when it had indicated that payments should not be received"³⁵ The constructive trust reasoning can also be seen in *Re Crown Currency Exchange Ltd*.³⁶ Here, the court held that funds paid into an account in the period after the bank had stopped making payments out of the account and when the account holder entered into administration were held on constructive trust. The payments had been made in the mistaken belief that the company was in a position to provide consideration for them. The presence of such mistake in finding a constructive trust is crucial. Recently, the Supreme Court in *Bailey and another v Angove's PTY Ltd*³⁷ impugned the finding of Bingham J in *Neste Oy*. It stated that the finding of constructive trust in these circumstances should be limited to cases where the intention of the payer to transfer the entirety of his beneficial interest in the money to the payee was vitiated, for example by mistake, or where in the eyes of equity the money had come into the wrong hands.³⁸ Put this way, we are starkly reminded that in only exceptional circumstances will English law supplant personal rights with proprietary interests in order to dislodge the *pari passu* principle of distribution.

Fourthly, insolvency law also provides some protection in respect of unconscionable receipts of payments under the fraudulent trading provisions.³⁹ Although it is sometimes difficult to discern a definitive test for establishing intent to defraud creditors, there is authority to support the proposition that directors would incur personal liability where the company carries on business and incurs debts at a time when there is, to the directors' knowledge, no reasonable prospect of the creditors receiving payment of those debts.⁴⁰

The fifth counterargument to the second justification is that rather than alter the insolvency priority of consumers, Parliamentary time would be better expended on a scheme that aims to improve the transparency of a company's credit and risk profile, thus making it easier for such unsecured creditors to assess risk and adjust properly.⁴¹ Lastly, the second and third justifications raise the question of a company's cash flow. Businesses

³⁵ *ibid*, paras 39-40. See also *Re Farepak Food and Gifts Ltd (No.2)* [2009] EWHC 2580 (Ch).

³⁶ [2015] EWHC 1876 (Ch).

³⁷ [2016] UKSC 47.

³⁸ *ibid*, paras 30-32.

³⁹ Insolvency Act 1986, s 213.

⁴⁰ *Re William C Leitch Brothers Ltd* [1932] 2 Ch 71. There could also be relief under the tort of deceit.

⁴¹ L Gullifer and J Payne, *Corporate Finance Law: Principles and Policy* (2nd edn, Hart 2015), 7.6-7.7.

require free flow of working capital in order to have a sustainable existence. As such, what is required is a streamlining of the cash flow options of retailers. In the context of receivables financing, there is recent draft legislation that will nullify anti-assignment clauses.⁴² Perhaps, other alternative financing schemes such as supply-chain finance should also be assessed in order to increase the pool of financing for retailers.

The Law Commission's final justification suggests that prepayments directly benefit floating charge holders to the detriment of consumers. This justification rests upon a number of misconceived premises. The first is that, perhaps due to the focus on banks in the report, floating charge holders seem to be taken by the Commission to be representative of secured creditors in general. Cash or cheque payments, *qua* current assets, may be collateralised under a fixed charge security. Secondly, it wrongfully presupposes that secured creditors, or indeed floating charge holders, would always be in a position to "encourage ... failing businesses to seek additional cash payments" from consumers.⁴³ This would not always be the case, particularly when the floating chargee is not an institutional lender. The third concerns the issue of financial benefit to floating charge holders. Studies have shown that it is not unusual to find that on commencement of insolvency, floating chargees' exposure are fully or largely secured by fixed charges, with the floating charge acting as an insolvency expedient.⁴⁴ This author has argued elsewhere that this financing arrangement is a result of statutory inroads into the rights of floating chargees by the Insolvency Act 1986.⁴⁵ This is not to suggest that sole floating charges are not in use or that there is no benefit to a creditor under a lightweight floating charge.⁴⁶ Sole floating charges may be taken, but it is hard to conceive them being taken to secure a large financial exposure or by those high profile (institutional) creditors the Commission seemed to have in mind in its report.

⁴² Small Business, Enterprise and Employment Act 2015, s 1. See also Business Contract Terms (Restrictions on Assignment of Receivables) Regulations 2015 (due to come into effect in 2016).

⁴³ LCR 368, 8.68.

⁴⁴ C Rumbelow, 'Mortgages by companies: A problem' [1989] *LSG* 32; F Oditah, 'Lightweight Floating Charges' [1991] *JBL* 49.

⁴⁵ Akintola, 'What is left of the Floating Charge? An Empirical Outlook' n.11 above.

⁴⁶ That is to say, where there are no assets within the floating charge at the time of executing the debenture. See *Re Croftbell Ltd* [1990] *BCLC* 844.

Further to the above, the Law Commission suggested that by giving prepaying consumers preferential status, banks would be encouraged to monitor the fiscal situation of the business.⁴⁷ This is somewhat moot because lead creditors such as banks, with the benefit of a fixed and floating charge, are already able to - and often - monitor corporate debtors, gather information concerning the activities of the debtor, and take effective steps to limit that debtor's use of corporate assets.⁴⁸ Such secured creditor control engenders fiscal value outside and within insolvency.⁴⁹ This produces benefit for the entire cohort of creditors. However, it must be acknowledged that it is often possible to overstate the benefits of lead creditors and, consequently, the need for directors to be monitored. The futile disqualification proceedings and the ensuing statement of Peter Smith J in *Farepak* suggest that marked care ought to be taken to avoid distorting public opinion of the role of corporate actors in distressed entities.⁵⁰

Finally, it is important to remind ourselves of the fact that security, such as the floating charge, has the propensity to reduce corporate failure, particularly where it is given in exchange for new value (money or money's worth) to the company.⁵¹ In any event, it is difficult to follow the suggestion that preferential priority of consumers would ensure that lenders focus on the underlying strength of the business rather than securing their lending on consumer deposits.⁵² With respect, prudent lenders would often look at the financial viability of the business rather than collateral. That said, to exclude consumer deposits from the weighting of viability could destroy the ethos of the corporate financing landscape (with particular consequences for small and mid-sized businesses) given that companies typically hold more current or circulating assets than fixed assets.⁵³ Cash

⁴⁷ LCR 368, 8.68. The Commission seemed to accept the argument that floating charge holders are not able to monitor a company's business and should not be required to do so. See LCR 368, 8.76-8.77.

⁴⁸ For example, by displacing the debtor's management through the appointment of an insolvency practitioner. For a discussion on management displacement under administrative receivership (which is equally possible in administration through para 14, sch B1 Insolvency Act 1986), see J Armour and S Frisby, 'Rethinking Receivership' (2001) 21 *Oxford Journal of Legal Studies* 73; R Mokal, 'Administrative Receivership and the Floating Charge' in R Mokal, *Corporate Insolvency Law: Theory and Application* (OUP 2005).

⁴⁹ Gullifer and Payne, *Corporate Finance Law: Principles and Policy*, n.41 above, 7.6.2.1.

⁵⁰ D Milman, *Governance of Distressed Firms* (Edward Elgar 2013), 2.4.

⁵¹ S Schwarcz, 'The Easy Case for the Priority of Secured Claims in Bankruptcy' (1997) 47 *Duke LJ* 425.

⁵² LCR 368, 8.75.

⁵³ RR Pennington, 'The Genesis of the Floating Charge' (1960) 23 *MLR* 630, 631; *Buchler v Talbot* [2004] 2 AC 298, para 2 *per* Lord Nicholls.

deposits are current assets; their utility to the business transcends their actual money value and extends to the release of loan capital to the company without necessarily crippling the company's business. Moreover, looking at past and current corporate financing matrix, there is nothing to suggest that there would be an easier or cheaper alternative to the finance afforded to a company through consumer prepayments.⁵⁴

C. The Cost of Consumer Preference

The Law Commission asserts that its recommendation would not affect insolvency expenses and employee claims, although it would have a marginal but acceptable impact on the claims of floating charge holders and other unsecured creditors.⁵⁵ This section will focus on the impact of the proposal on insolvency expenses. Before doing this, a quick word on unsecured and floating charge creditor claims. Much has been said in the preceding section about the lack of reason in creating a further distinction between unsecured creditors under insolvency legislation. In the Law Commission's assessment of unsecured creditors, realisation of unsecured claims were tied to the prescribed part fund.⁵⁶ Taking into account the absolute priority rule in insolvency by which senior claimants are fully satisfied before junior claimants,⁵⁷ an increase in the number of preferential creditors could further reduce the instances of prescribed part carve-outs. As things stand, the use of the prescribed part and the returns to unsecured creditors thereunder is far from impressive.⁵⁸ This is an acute point bearing in mind that the proposal on consumer preference does not come with a cap on the amount that would be treated preferentially. In relation to the likely impact on floating charge holders, consultees made the point that the Commission's proposals would affect the availability and cost of loan

⁵⁴ A Ogus and C Rowley, *Prepayments and Insolvency* (OFT Occasional Paper, 1984), p.28.

⁵⁵ LCR 368, 8.71 – 8.75, 8.78-8.81.

⁵⁶ LCR 368, 8.29.

⁵⁷ R Mokal, 'Liquidation Expenses and Floating Charges – The Separate Funds Fallacy' [2004] LMCLQ 387, 397-398.

⁵⁸ See Section E below.

capital.⁵⁹ The Commission could be excused for being agnostic given that this often seems to be the default response to proposed floating charge inroads.⁶⁰ What ought to be taken seriously, however, is the ability of lenders to engage in avoidance behaviour in their bid to continue to provide finance.⁶¹ Such behaviour could have a negative impact on other aspects of the insolvency process, such as the funding of insolvency expenses to which I now turn.⁶²

Few would dispute the fact that the core challenge with the insolvency expenses regime concerns administration expenses. This is because, unlike liquidations, the duties of office-holders in administrations are quite broad, time sensitive and intensive, often requiring the exercise of commercial judgment. These features are particularly replete in trading administrations, where significant expense could be incurred for the purpose of funding the operations or restructuring of the ailing business and paying the remuneration of the office-holder. Liquidations also come with costs and recent changes to fee structures in certain types of insolvency may exacerbate the weight of such costs on creditors.⁶³ Although the Law Commission rejected views that its proposed limited priority for prepaying consumers would increase the costs of insolvency, it noted that the potential impact of its recommendation on insolvency practitioners' work would need to be assessed.⁶⁴ It is suggested that the Commission's sentiment towards prepaying consumers should be balanced against the following considerations.

Firstly, the workload of insolvency practitioners in an insolvency scenario has increased. This is partly due to the streamlined administration procedure introduced by the Enterprise Act 2002, which places a lot of emphasis on the collective nature of the insolvency process and, as a result, demands a high degree of creditor participation. From

⁵⁹ LCR 368, 8.72. Preferential claims provisions have been said to reduce the attractiveness of the floating charge to creditors; see *Agnew v Commissioner for Inland Revenue (Re Brumark Investments)* [2001] 2 AC 710, para 17.

⁶⁰ A similar response was given when the prescribed part fund was proposed. See G McCormack, 'The Priority of Secured Credit: An Anglo American Perspective' [2003] JBL 389-419, 389

⁶¹ J Armour, 'Should We Redistribute in Insolvency?' in J Getzler and J Payne (eds), *Company Charges: Spectrum and beyond* (OUP 2006), ch 9.

⁶² For a discussion on the impact of receivables financing on administration funding, see P Walton, 'Fixed and Floating Charges: the Great British Fund Off' (2015) 1 JIBFL 3.

⁶³ See Insolvency Proceedings (Fees) Order 2016.

⁶⁴ LCR 368, D.24, D.35(2).

seeking creditor approval before incurring certain litigation expenses⁶⁵ to examining a plethora of minuscule claims in order to carve out or disapply the prescribed part fund,⁶⁶ office-holders are increasingly asked to do more work for the sake of transparency.⁶⁷ While such transparency is good, the work associated with it invariably comes at a cost to creditors. Such cost is chargeable as an expense of the insolvency process; if high, it would affect returns to preferential, floating charge and unsecured creditors. Following the *Kempson* review,⁶⁸ insolvency practitioners are now required to provide an estimate of fees and expenses upfront to creditors.⁶⁹ An upward revision of such estimate would require approval at an additional cost to creditors. Interestingly, such information would be provided to many unsecured creditors with little financial interest in an insolvency process and who may not utilize such information or participate in the collective process at all. To ask office-holders to deal with many preferential claims that have little financial value may worsen the position in this regard. Although the Law Commission's assessment is that due to the eligibility criteria there would be few consumers claiming as junior preferential creditors,⁷⁰ this may not be the case as such improved priority may cause consumers, where they can, to ensure that their pre-insolvency prepayment falls within the prescribed minimum amount for preferential priority. Of course, this perverse incentive would be helped by the fact that the eligible prepayment, as proposed, could be a series of payments made in the six months leading up to insolvency.⁷¹ Such alteration in behaviour would mean that office-holders will be obliged to deal with discrete paltry claims, increasing the cost of the insolvency process and worsening the position of all stakeholders.

⁶⁵ Insolvency Amendment Rules 2008 (SI 2008/737) inserted rr 4.218A-E into the Insolvency Rules 1986.

⁶⁶ The size of distribution to each creditor seems irrelevant in disapplying the prescribed part. See *Re International Sections Ltd* [2009] EWHC 137 (Ch); *Stephen & Hill (Administrators of QMD Hotels Ltd), Noters* [2012] BCC 794. In addition, there is no prospect of a selective disapplication – see *Re Courts plc* [2009] 1 WLR 1499.

⁶⁷ D Milman, 'Promoting Distributional Justice on Corporate Insolvency in the 21st Century' in J Steele and WH Van Boom (eds), *Mass Justice: Challenges of Representation and Distribution* (Edward Elgar 2011), pp.175-176. There might be some reprieve to office-holders due to the new section 246C Insolvency Act 1986, which will enable creditors to opt out of receiving certain notices. See Small Business, Enterprise and Employment Act 2015, s 124.

⁶⁸ E Kempson, *Review of Insolvency Practitioner Fees: Report to the Insolvency Service* <<http://www.bis.gov.uk/insolvency/insolvency-profession/review-of-ip-fees>> accessed 1 August 2016.

⁶⁹ Insolvency (Amendment) Rules (SI 2015/443).

⁷⁰ LCR 368, D.14.

⁷¹ *ibid*, Recommendation 4b(3).

Secondly, with increased workload comes the question as to how insolvency practitioners will be remunerated. Research has already shown that it is not unusual to find a shortfall between the fees incurred by office-holders and actual returns to them, due largely to insufficient realisations.⁷² It is therefore commonplace for insolvency expenses to be paid through 'voluntary' funding by secured creditors holding a fixed charge.⁷³ In addition to payment of expenses, there are other benefits from such funding. Secured creditors will have increased control over the insolvency process as their consent will be required for the incurring of expenses. As a result, it could ensure that there are funds to implement potentially value-maximising strategies for the benefit of the general body of creditors under the scrutiny of an experienced lender. Crucially, unsecured creditors would benefit from this scrutiny without incurring monitoring costs. However, such funding is not entirely altruistic. It is reasonable to expect that voluntary funding of insolvency expenses would only be available where there is no threat to the existence of assets within the creditor's security. Typically, secured creditors would take a hybrid of fixed and floating charges, relying on the latter as a management displacing and realisation mop-up device. If there is further impediment to relying on the floating charge for some realisation, and the assets within the fixed charge are insufficient to satisfy the creditor's claim, would a secured creditor be willing to engage in voluntary funding? Where the lender is under secured by reference to his fixed charge, further inroads into the floating charge could lead to inertia when it comes to providing insolvency funding. Again, this would not be helped by the fact that, as recommended, the priority of such consumers does not come with a maximum cap on the amount to be treated preferentially. Moreover, the office-holder cannot deprive preferential creditors of their contingent entitlement just as he can in the case of the prescribed part fund.

⁷² Kempson, *Review of Insolvency Practitioner Fees: Report to the Insolvency Service*, n.68 above.

⁷³ Gullifer and Payne, *Corporate Finance Law: Principles and Policy*, n.41 above, 7.3.3.3.4(b).

D. Twilight Trusts

In insolvency law, only assets to which the company is beneficially entitled can be held on a statutory trust for distribution to the company's creditors.⁷⁴ The use of trusts prior to insolvency serves as an expedient, which prevents assets from falling into the company's beneficial ownership. The Law Commission considered imposing the use of trusts on businesses that receive consumer prepayments, but dropped the idea due, *inter alia*, to the cost of managing trusts.⁷⁵ This segment focuses purely on the validity of express trusts created in the twilight period.

Often enough, well-meaning directors of ailing businesses will consider options for protecting their counterparties (who would otherwise be unsecured creditors in the event of insolvency), including the creation of a trust for them.⁷⁶ However, the validity of such actions is not a given due to the fact that the twilight period comes with a range of implications. For example, in this period, directors have a duty towards the company to have regard to the general body of creditors.⁷⁷ In furtherance of this duty, transactions entered into by the company during this period, which interfere with the advantages of creditors acting as a group (and by extension, the *pari passu* principle), are liable to be reopened and set aside in insolvency through office-holder actions.⁷⁸ With respect to express trusts, the preferences provision is worthy of note, particularly on the point of whether or not the beneficiary of the trust was already a creditor at the time of the transaction.⁷⁹ This is the focal point of the discussion that follows because the proposition that a trust creates a factual preference should be demonstrable, and the question of desire to prefer the beneficiary could be inferred from the intention to create the trust, where there is no countervailing commercial justification for such transaction.

⁷⁴ *Ayerst v C. & K. (Constructions) Ltd* [1976] AC 167.

⁷⁵ LCR 368, 3.4, C.16-27.

⁷⁶ Sometimes, the intention of the directors may be less than altruistic. See P Cranston and H Sims, 'Twilight Trusts: Protection from those you cannot trust?' available at <http://www.guildhallchambers.co.uk/files/InsolvSemnotesJune09Twilighttrusts_PeterCranston&HughSims.pdf> accessed 1 September 2016.

⁷⁷ *West Mercia Safetyware Limited v Dodd* [1988] BCLC 250.

⁷⁸ Insolvency Act 1986, ss 238-239, and 245; F Oditah, 'Assets and treatments of Claims in Insolvency' (1992) 108 LQR 459, 464.

⁷⁹ For the elements of the provision, see *ibid*, s 239; *Re MC Bacon Ltd* [1990] BCC 78.

In *Re Kayford Ltd*,⁸⁰ the company supplied goods by mail order, for which customers paid in advance. The company was in financial difficulties and took advice as to how best to protect its prepaying consumers. Its accountants suggested paying the money into a 'Customer Trust Deposit' account. The court upheld the trust, rejecting any notion of a fraudulent preference on the basis that the purpose of declaring a trust in favour of prepaying consumers is to prevent them from becoming creditors by making them beneficiaries under a trust.⁸¹ By contrast, Mann J considered in *Farepak* that there was a case for holding a declaration of trust by the company in favour of certain consumers a preference because the relevant consumers had already become creditors when they paid money to the company via its agents.⁸² What these cases tell us is that in order to avoid being impeached by the preferences provision, it is pertinent that a trust created in the *relevant time* is in place before consumers make payments to the company. If this is not the case, the prepaying consumers, having advanced money to the company, will be owed a personal claim in their capacity as creditors. As such, any conversion of their claim into a proprietary claim against the money would be a factual improvement from their pre-trust position, relative to other unsecured creditors, and could therefore be set aside under section 239 if the relevant desire can be established. The preceding analysis would suggest, of course, that where consumer prepayments are made in instalments, only instalments that precede the creation of the twilight trust would fall to be considered as part of the insolvent's estate. Those instalments received after the creation of the trust would be treated as trust assets if they meet the declared intention of the company creating the trust. To put it pithily, in such circumstances, consumers making prepayments may wear two hats in insolvency: one of creditor, and one of beneficiary.

Finally, the foregoing should not be taken as a suggestion that it is easy - as a matter of law - to establish such trusts or commercially desirable to so do. As *Kayford* and *Farepak* show, there could be difficulties circumscribing such trust in terms of identifying

⁸⁰ [1975] 1 WLR 270.

⁸¹ *ibid*, 281.

⁸² [2006] EWHC 3272 (Ch), para 52.

the intention of the company (let us assume that the kind of consumers the Commission seeks to protect would hardly be in a position to bargain for a trust) to create the trust. Where it is not apparent, such intention may only be deducible from actions of corporate directors evincing such intention.⁸³ Such uncertainty could put the protection out of consumers' reach. Similarly, the commingling of prepayments in the company's bank account may threaten the finding of a trust.⁸⁴ Lastly, vagueness in the term that is used to define the beneficiaries of the trust may also jeopardise the trust on account of lack of certainty of beneficiaries.⁸⁵ On the point of desirability, one should also consider that these sorts of trusts could cause office-holders to have recourse to the courts for directions on distribution of monies or an order to invalidate the transaction. Such proceedings are not without cost and will bear on the measure of distributable assets. Even where a successful challenge is made, the cost could outweigh the benefit of setting aside the transaction, thus depleting the pool of distributable assets for the entire body of creditors. Perhaps the new section 246ZD of the Insolvency Act 1986, enabling office-holders to assign causes of action, would be helpful in this respect.

E. The Prescribed Part Phantasm

It is a self-evident truth that unsecured creditors, as residual claimants, would typically get little or no returns out of insolvency proceedings. Historical and recent data suggest that this is a continuum.⁸⁶ This is hardly surprising, bearing in mind that the very definition of insolvency indicates that a company would have insufficient assets to meet its liabilities as they fall due, or in the long term.⁸⁷ This reality scarcely can be changed. As such, as far as unsecured creditors are concerned, English Law has been on a quest to improve

⁸³ Ogus and Rowley, *Prepayments and Insolvency*, n.54 above, p.6.

⁸⁴ It is however not fatal if the prepayments are not in the trust account. See *OT Computers Ltd (in administration) v First National Tricity Finance* [2003] EWHC 1010 (Ch); *Re Kaupthing Singer & Friedlander Ltd (in administration)* [2010] BCLC 673 [152]-[155].

⁸⁵ *OT Computers Ltd (in administration) v First National Tricity Finance*, *ibid*.

⁸⁶ Society of Practitioners of Insolvency, *Eight Survey of Company Insolvency in the United Kingdom, 1997/1998* (1999), p.20; R Mokal, 'Priority as Pathology' (2001) 60 CLJ 581, 588-589; LCR 368, 8.28.

⁸⁷ Insolvency Act 1986, ss 123(1)(e) and 123(2). On the use of "balance sheet test" as the basis of presenting a winding-up petition, see *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL PLC* [2013] UKSC 28.

their level of realisation out of distributable assets in an insolvency scenario. The prescribed part provision is a prime example of such legislative efforts.⁸⁸

The introduction of the prescribed part was predicated on the notion that Crown preference should be abolished and the benefit of such obliteration should go to unsecured creditors rather than floating charge holders.⁸⁹ This benefit is realised by redistributing assets that are subject to a floating charge security in favour of unsecured creditors. It is somewhat utilitarian: subordinate the property rights of few in order to enrich many.⁹⁰ Currently, as the Commission noted, many insolvencies only offer distribution to unsecured creditors through the prescribed part fund.⁹¹ However, the level of use of the prescribed part is quite low, and the level of returns to unsecured creditors under the fund makes for depressing reading.⁹² It would seem that the performance of the prescribed part has played a role in the Commission seeking alternative answers for consumers.⁹³ What follows is an exposition of some of the reasons for the poor state of the prescribed part.

Firstly, the redistributive provisions under the Insolvency Act⁹⁴ have led to increased fragmentation in the capital structure of companies as lenders seek to avoid the impact of those provisions on the floating charge. Thus, financiers do not commonly rely upon the floating charge for realisation. Where a financier is paid in full under a master factoring agreement or fixed charge, he would not have to claim under the floating charge, and as a result, there would not be any net property within the meaning of section 176A(6), Insolvency Act, 1986.

Secondly, as the Commission observed, the cost of distributing the prescribed part tends to be high due to the large number of unsecured creditors with small claims.⁹⁵ This invariably means that office-holders have to incur many costs in order to agree every

⁸⁸ Insolvency Act 1986, s 176A.

⁸⁹ Department of Trade and Industry ('DTI'), *Insolvency - A Second Chance* (White Paper, Cm 5234, 2001), para 2.19.

⁹⁰ D Milman and D Mond, *Security and Corporate Rescue* (Hodgsons 1999), p.8.

⁹¹ LCR 368, 8.29.

⁹² S Frisby, *Report on Insolvency Outcomes: Presented to the Insolvency Service* (26 June 2006), pp.55-56; P Walton and C Umfreville, *Pre-Pack Empirical Research: Characteristic and Outcome Analysis of Pre-Pack Administration* (Final Report to the Graham Review, April 2014); Akintola, 'What is left of the Floating Charge? An Empirical Outlook' n.11 above, 406.

⁹³ LCR 368, 8.33.

⁹⁴ Insolvency Act 1986, s 175, s 176ZA, s 176A, and sch B1, para 70.

⁹⁵ LCR 368, 8.30.

single creditor claim. Where the funds are eroded in costs before distribution, one is left to wonder whether the prescribed part provision engenders commercially sensible outcomes for insolvency stakeholders. In any event, the consequence of this is that office-holders commonly make applications to the court for the prescribed part to be disapplied where the burden of administering the fund would be disproportionate to the benefits that unsecured creditors will derive thereunder.⁹⁶ It remains to be seen whether recent changes to the insolvency legislation will make a difference in this regard. For example, one could speculate that enabling an administrator to make a prescribed part distribution without a court order would improve the use of the prescribed part and unsecured creditors' returns thereunder.⁹⁷ It is however unlikely that the provision that will enable creditors to opt out of receiving certain notices will make little difference in this respect due to the fact that office-holders will still be obliged to send notices pertaining to distribution.⁹⁸ The foregoing narrative suggests that the prescribed part may deliver meaningful value where there are few unsecured creditors. However, such deductive reasoning would only hold true where there are floating charge assets within the definition of the section. Therein lies another challenge: majority of businesses in the UK are SMEs, which may hold insignificant floating charge assets, and the uptake of alternative financing arrangements - such as factoring and invoice discounting⁹⁹ - by small and large businesses may continue to defeat the rationale behind the prescribed part.

Thirdly, given that the prescribed part bites post-Enterprise Act floating charges, lenders holding pre- and post-Enterprise Act floating charges will rely on the former for realisation in order to circumvent the application of the prescribed part.

The final reason we can chalk up to the law of unintended consequences. The abolition of Crown preference invariably means that HMRC, as unsecured creditors, will utilise insolvency procedures suitable for that class of creditors (such as compulsory

⁹⁶ Insolvency Act 1986, s 176A(5).

⁹⁷ Small Business, Enterprise and Employment Act 2015, s 128 (amending Insolvency Act 1986, Sch B1, para 65(3)).

⁹⁸ *ibid*, s 124, inserting s 246C into Insolvency Act 1986.

⁹⁹ N Ruddy, S Mills and N Davidson, *Salinger on Factoring: The Law and Practice of Invoice Finance* (5th edn, Sweet & Maxwell 2013), ch.2; H Beale, L Gullifer and S Paterson, 'Ban on Assignment Clauses: Views from the Coalface' BJB & FL 30(8) 463, 464.

liquidations¹⁰⁰) and participate in distributions applicable to that class, including prescribed part distributions. It is commonplace to find that, in a particular insolvency, the size of debt owed to HMRC is disproportionately huge when compared to those of other unsecured creditors.¹⁰¹ It makes sense therefore that the Crown's unsecured status makes it the primary beneficiary of many prescribed part distributions.¹⁰² The question for policy makers is this: Why abolish Crown preference for the benefit of unsecured creditors if the Crown would absorb that benefit?

F. Postscript

The Law Commission is right in highlighting the plight of consumers in insolvency. However, other unsecured creditors do not fare better. One suspects that if the unsecured creditors' lifeboat – the prescribed part – was not sinking, the preferential recommendation would not have been made. While a review of the prescribed part was outside the Commission's terms of reference, the discussions in this article intimate that a reconsideration of the prescribed part provision is imperative. Here are a few suggestions in this respect. One option is to extend the provision to fixed charges. This could deal with the current lack of floating charge assets that is undermining the provision. The downside, however, is that such an approach would raise the rhetoric of an increase in the cost of credit. Another option is that, rather than rely on voluntary contributions from fixed chargees to fund office-holder expenses, fixed chargees and alternative financiers like factors and invoice discounters should be compelled to contribute to office-holders' costs.

¹⁰⁰ S Frisby, 'Insolvency Law and Insolvency Practice: Principles and Pragmatism Diverge?' (2011) 64 (1) *Current Legal Problems* 349, 352; D Milman, 'Corporate insolvency in 2015: the ever-changing legal landscape' *Company Law Newsletter* (2015) 369, 1-5.

¹⁰¹ Empirical research conducted by this author into 2,129 companies that entered into creditors voluntary liquidation or administration between 2006 and 2011 revealed that HMRC was the largest single unsecured creditor in no less than 47% of the cases where a prescribed part distribution was made. If we add the cases where HMRC was the second largest, the percentage goes up to at least 52%. See also Frisby, 'The Effect of the Enterprise Act 2002: Empirical Research into Corporate Insolvency', n.25 above; R3, *The Likely Effect of the Jackson Reforms on Insolvency Litigation - An Empirical Investigation* (April 2014), p.15.

¹⁰² Frisby, *Report on Insolvency Outcomes: Presented to the Insolvency Service*, n.92 above, p.56. Cf Walton and C Umfrville, *Pre-Pack Empirical Research: Characteristic and Outcome Analysis of Pre-Pack Administration*, n.92 above, p.33. Walton and Umfrville's findings were attributed to the paucity of data available from IP filings at Companies House.

This would provide more funds to meet expenses, ensuring that available assets meet preferential claims and prescribed part distributions. Finally, the Crown could be proscribed from participating in the prescribed part fund, or participate as junior unsecured creditors after other unsecured creditors have received a dividend. One suspects that this is likely to be the most popular choice within the lending industry.