

STATEMENT OF INSOLVENCY PRACTICE 14 (SCOTLAND)

A RECEIVER'S RESPONSIBILITY TO PREFERENTIAL CREDITORS

1. INTRODUCTION

1.1 This statement of insolvency practice is to be read in conjunction with the Explanatory Forward.

1.2 This statement has been prepared to summarise what is considered to be the best practice to be adopted by receivers of the assets of companies where any of those assets are subject to a floating charge so that the office holder has legal obligations to creditors whose debts are preferential. Its purpose is to:

- Ensure that insolvency practitioners are familiar with the statutory provisions;
- Set out best practice with regard to the application of statutory provisions;
- Set out best practice with regard to the provision of information to creditors whose debts are preferential and to responses to enquiries by such creditors.

Whilst this statement does not specifically address the treatment of preferential claims in liquidations, insolvency practitioners acting as liquidators (or in any other relevant capacity) should have due regard to the principles which it contains.

1.3 The statement is divided into the following sections:

- The statutory provisions
- Categorisation of Assets and Allocation of Proceeds
- Apportionment of Costs
- Determination of preferential debts
- Payment of preferential debts
- Disclosure to creditors with preferential debts
- Other matters

2 THE STATUTORY PROVISIONS

2.1 The rights of creditors whose debts are preferential in a receivership derive from section 59 of the Insolvency Act 1986 "the Act".

Where a receiver is appointed on behalf of the holders of a floating charge and the company is not at the time in the course of being wound up, its preferential debts shall be paid out of the assets coming into the hands of the receiver in priority to any claims for principal or interest in respect of the floating charge by virtue of which the receiver was appointed.

Preferential debts are defined in section 386 of the Act and are set out in Schedule 6 to the Act (as amended from time to time), which is to be read in conjunction with Schedule 4 to the Pensions Schemes Act 1993 and are those which by the end of a period of 6 months after advertisement by the receiver for claims in the Edinburgh

Gazette and in a newspaper circulating in the district where the company carries on business either

- (a) have been intimated to him or
- (b) have become known to him.

The date at which they are to be ascertained is the date of the appointment of the receiver (Section 387(4) of the Act).

2.2 Receivers should note that the statutory provisions give a right to creditors whose debts are preferential to be paid those debts in priority to the claims of floating charge holders, and the corollary of this right is the obligation of the receiver to pay them. Failure by a receiver to pay preferential debts out of available assets is a breach of statutory duty. However it is recognised that circumstances may arise when it is administratively convenient or cost effective to co-operate with a company's liquidator and arrange for him to pay the receivership preferential debts, and guidance on such arrangements is given in paragraph 6.2 below. It should be noted that such arrangements do not exonerate the receiver from his obligations.

3 CATEGORISATION OF ASSETS AND ALLOCATION OF PROCEEDS

3.1 In order to ascertain which assets are subject to the statutory rights of preferential creditors it is necessary to confirm which assets are subject to a standard or other fixed security and which are subject to the floating charge.

3.2 The rights of statutory preferential creditors to a distribution from the assets require the receiver to identify the rights of other creditors in terms of Section 60(1) of the Insolvency Act (1986) and their order of priority.

3.3 It is not of itself sufficient for the charges to state that an asset is subject to a fixed charge or standard security for it to be subject to such a charge.

3.4 Receivers are reminded that it is the type of charge at the time of its creation which determines whether the assets are available to meet preferential debts. Crystallisation of a floating charge upon the appointment of a receiver does not affect the rights of creditors with preferential debts to be paid out of assets subject to a crystallised floating charge;

3.5 Section 59 of the Act requires that the preferential debts 'shall be paid out of the [floating charge] assets coming to the hands of the receiver in priority to' any claim for principal or interest by the floating charge holder. The effect is that a receiver is under a duty of care to the preferential creditors if, having had available assets in hand, he fails to apply them in terms of the order of priority set out in Section 60(1) including payment of the preferential debts. Where any action which he proposes to take could result in a diminution in the amount available to meet preferential debts the receiver should give the most serious consideration to the risks of such action.

3.6 When assets are sold as part of a going concern (or otherwise in parcels comprising both standard security and floating charge assets) the apportionment of the total consideration suggested by the purchaser (for example for his own financial reasons) may not properly reflect the financial interests of the different classes of creditors in the individual assets or categories of assets. In these circumstances the receiver should ensure that he will be able properly to discharge his obligations to

account to holders of standard securities or other fixed security on the one hand and creditors interested in assets subject to floating charges on the other.

4 APPORTIONMENT OF COSTS

4.1 The amount available to meet preferential debts is the funds realised from the disposal of assets subject to a floating charge net of the costs of realisation and subject to the order of priority set out in Section 60(1). It is dependent, therefore, not only on the correct categorisation of the assets but also on the appropriate allocation of costs in effecting realisations.

4.2 These costs will normally fall into one of three categories:

- Liabilities incurred by the company (the receiver having acted as agent) and costs incurred by the receiver and recoverable by him out of the company's assets under his statutory indemnity (other than those referred to below);
- The costs of the receiver in discharging his statutory duties;
- The remuneration and disbursements of the receiver.

4.3 The receiver's reasonable costs are sometimes readily identifiable as applicable to either the standard security or other fixed security or floating charge assets, but in other cases may not be so easily allocated between the two categories of assets.

Where costs are clearly identifiable as having been incurred in the realisation or collecting in of one or other of the two categories they should be recorded as such in the receiver's records so that they can be deducted from realisation proceeds in ascertaining the amount available for each class of creditors.

4.4 If costs cannot be clearly identified as referring to the realisation of assets in each category, or refer to assets in both categories, the Receiver will require to carry out an apportionment and, so far as possible, record his reasons for doing so.

A receiver has a duty to allocate costs appropriately but that allocation will involve the exercise of professional judgement undertaken with a full appreciation that it must be made with independence of mind and with integrity.

4.5 The key principles for a receiver in his consideration of the allocation of costs are:

- The statutory rights of preferential creditors as set out in the Insolvency Act 1986 and the decisions of the courts in cases under that Act and predecessor legislation;
- The provisions of the charges
- The maintenance of a proper balance as between the classes of creditors with whose interests he is required to deal in the light of their legal rights.

In order to enable a receiver to allocate costs on an appropriate basis, contemporaneous records of the dominant reasons for incurring costs should be maintained. These will also assist him in providing explanations as to how he arrived at what he considers to be an appropriate allocation and provide evidence should that allocation be challenged by any of the parties involved.

4.6 In allocating costs a receiver should have regard to:

- The objectives for which costs were incurred, it being recognised that certain types of costs may, properly, be allocated to the standard security or other fixed charge assets in one case and to the floating charge assets in another.¹ In another case such costs may enhance realisations in both categories.
- The benefits actually obtained for those financially interested in one or other category of asset in terms of protection of those assets or their value and any augmentation of that value.
- Whether the benefits to those interested in assets subject to a standard security or other fixed security have been enhanced by action which proves to be detrimental to those interested in floating charge assets (for example where trading losses are incurred to protect or enhance the value of property subject to a standard security).
- Whether the realisation of the undertaking and assets by means of a going concern sale has resulted in a reduction in the quantum of debts which are preferential due to the transfer of employment contracts.

4.7 A receivership arises only when there is a floating charge. A receiver whose appointment extends only to part of the property (rather than to the whole or substantially the whole of the property of the Company) has the same responsibilities with respect to the allocation of costs and payment of preferential debts as discussed in this SIP but with reference only to that property which has been attached.

In apportioning the costs of fulfilling their statutory duties and in the absence of any guidance from the courts, receivers should have regard to the general principle referred to in paragraph 4.5 above of maintaining a proper balance.

4.8 The allocation of a receiver's remuneration and disbursements should be undertaken adopting the same principles as those applicable to costs and he should ensure that he maintains contemporaneous records which will enable him to make an appropriate division of his remuneration and disbursements between the different categories of assets.

5 DETERMINATION OF PREFERENTIAL DEBTS

5.1 As stated in paragraphs 2.1 and 2.2 of this statement it is a receiver's obligation to pay preferential debts out of assets available for that purpose.

5.2 Following advertisement and initial notification to potential preferential creditors of his appointment and before beginning the process of determining preferential debts, a receiver should assess whether there are likely to be sufficient floating charge realisations to pay a distribution. Where no payment will be made, it is not necessary to agree preferential claims. However, in such circumstances the receiver should write to creditors whose claims are preferential explaining why he is unable to make a payment to them.

¹ For example the payment of rent on a leasehold property may be to preserve the value of the lease or to enable manufacturing to continue and work in progress to be completed.

- 5.3 Where there will be a distribution to preferential creditors, the receiver should assist those creditors, where possible, by providing adequate information to enable them to calculate their claims. In the case of all preferential creditors other than employees, the receiver is entitled to assume they have full knowledge of their legal entitlements under the Insolvency Act and should invite them to submit their claims. The receiver should then check those claims, and accept or reject them as appropriate.
- 5.4 In determining the preferential claims of employees, the receiver is not entitled to regard an individual employee as having full knowledge of his rights and entitlements. Accordingly, the receiver should obtain information from either the company's records or from the employee before calculating the claim (other than one which is payable to the Secretary of State by way of subrogation). The employee should be provided with details of the calculation of his claim and any further explanation that he may reasonably require.
- 5.5 Receivers are reminded that Schedule 6 (paragraph 11) of the Act provides that anyone who has advanced money for the purpose of paying wages, salaries or accrued holiday remuneration of any employee is a preferential creditor to the extent that the preferential claim of the employee is reduced by such advance.
- 5.6 When an employee's preferential debt has been paid out of the National Insurance Fund under the provisions of the Employment Rights Act 1995, the Secretary of State is entitled, by virtue of section 189 of that Act to the benefit of the employee's preferential debt, in priority to any residual claim of the employee himself. A receiver is not obliged to accept the preferential claim of the Secretary of State without satisfying himself that it is correct. If a receiver is not able to accept the Secretary of State's claim he should contact the Redundancy Payments Service to explain why and attempt to reach agreement on the amount to be admitted.

6 PAYMENT OF PREFERENTIAL DEBTS

- 6.1 As soon as practicable after funds become available and the amount of the preferential debts has been ascertained, receivers should take steps to pay them. Under the statutory provisions preferential debts do not attract interest (unless all creditors (except postponed debts) are being paid in full) and payments to creditors should not be unnecessarily delayed. A receiver who does not comply timeously with his obligations under Section 59 and against whom decree is obtained may find himself ordered to pay interest by the court. While insolvency practitioners cannot be expected to bear any financial risk by paying some preferential debts before all such debts are agreed, there are often circumstances when it is possible to make payment either in full or on account before all claims have been agreed and this course of action should be adopted whenever it is practicable to do so.
6. Situations may arise where, notwithstanding a receiver's statutory duty to pay preferential debts, it may (exceptionally) be administratively convenient or cost-effective for a receiver to make arrangements for the liquidator to make payment of the preferential debts arising in the receivership. Such arrangements are made at the receiver's risk, and should not be on any basis which could result in payment of an amount less than that which would have been available to meet those debts if the receiver had himself paid them – or which would cause delay in paying them.

6.3 The receiver should provide preferential creditors with details of any such arrangement and the reason for making them.

7 DISCLOSURE TO CREDITORS WITH PREFERENTIAL DEBTS

7.1 When the funds realised from assets subject to a floating charge are inadequate to pay the preferential debts in full, the receiver should send those creditors a statement setting out the costs charged against the proceeds of realisation of assets.

7.2 Any further information which a creditor with a preferential debt reasonably requires should be provided promptly.

8 OTHER MATTERS

8.1 Difficulties may arise in determining the rights of creditors to have debts paid preferentially in priority to a prior floating charge holder when the receiver has been appointed under a second or subsequent charge. The law in this area is complex and insolvency practitioners should seek legal advice (and if necessary apply to the court for directions) when appointed under such a charge.

8.2 Situations will arise where payments sent out are not encashed and the payee cannot readily be located. The insolvency legislation does not make provision for this eventuality and there have been no reported cases where the courts have decided the matter. A schedule of unclaimed dividends should be prepared and a special deposit account for these should be opened with the Accountant of Court's designated bank, the Royal Bank of Scotland PLC at North Bridge, Edinburgh branch with notification to the Accountant of Court including a schedule of unclaimed dividends.

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