



Realisation of floating charge security - obligation to account to preferential creditors

Summary

In a recent decision¹, the Court of Appeal² clarified the scope of s196 Companies Act 1985 (“CA”). This provision is concerned with the obligation of a floating charge holder (at a time when the debtor company is not being wound up) to account to the company’s preferential creditors out of any secured property of which it (the floating charge holder) takes possession.³

The Court (dealing with an appeal on the preliminary issue of whether HMRC (a preferential creditor in this case) had any real prospect of establishing that s196 CA had any application to the case) held that, in determining whether a charge holder “takes possession” of secured property (and hence whether s196 CA is relevant), it must distinguish between acts by which the charge holder realises its security and acts which are no more than the ordinary discharge of the debtor’s liability to the charge holder. The Court emphasised that it is important to consider the substance of the acts and not merely their form.

In this case the Court was satisfied that there was a real prospect that HMRC will succeed in establishing that s196 CA has application to the facts thereof.

¹ Her Majesty’s Commissioners for Revenue and Customs v The Royal Bank of Scotland Plc [2007] EWCA Civ 1262

² Smith, Wilson and Chadwick

³ This section is to be repealed by the Companies Act 2006 as from 6 April 2008 and replaced by s 754 Companies Act 2006 (it is not intended that this new provision will make any changes to the law)

Statutory provisions

s196 CA applies where debentures are secured by a charge which was, as created, a floating charge. It provides that:

“If possession is taken, by or on behalf of the holders of the debentures, of any property comprised in or subject to the charge, and the company is not at that time in the course of being wound up, the company’s preferential debts shall be paid out of the assets coming to the hands of the person taking possession in priority to any claims for principal or interest in respect of the debentures”.

Preferential debts are as listed in Schedule 6 of the Insolvency Act 1986 (which at the time relevant to this case included certain elements of VAT)⁴.

Overview of the underlying facts and the security

In summary, The Royal Bank of Scotland Plc (the “charge holder”) was the holder of a debenture issued by the Company. It was agreed that, for the purposes of the preliminary issue, this would be treated as a charge which, as created, was a floating charge (and hence within the ambit of s196 CA).

The Company experienced financial difficulties and, in contemplation of ceasing to trade and subsequent winding up, it formed/acquired two subsidiaries, sold and transferred its business and assets to those subsidiaries and sold the shares in those subsidiaries to a third party purchaser (the “share sale”). The company was subsequently wound up voluntarily.

Under the terms of the agreement between the Company and the subsidiaries (the “hive down agreements”), the subsidiaries were to pay both non-deferred consideration and deferred consideration. The latter was payable as and when the book debts and WIP transferred by the Company to the subsidiaries were collected. The total amount of the deferred consideration, if not paid in full by a certain date, was reduced by reference to the amount of book debts and WIP uncollected at that date (the “uncollected book debts”). The uncollected book debts would then be assigned by the subsidiaries to the charge holder.

The hive down agreements provided for the non-deferred and the deferred consideration to be paid to the Company’s solicitors who gave undertakings to the charge holder (conditional upon the completion of the share sale) to remit to it certain monies which were referable to the non-deferred and the deferred consideration. Thereafter the charge holder agreed to release from its security certain defined assets.

⁴ The Court was also concerned with the application of s175 Insolvency Act 1986

The judgment

The Court noted that, in determining whether s196 CA has any application, it is necessary to draw a line between acts which are, in substance (whatever their form), acts by which the charge holder realises its security and acts which are (in substance) no more than the ordinary discharge of the debtor's liability.

The need for this distinction is apparent if the terms of a standard bank debenture are considered. Any payments which are made by a company, which has issued such a debenture, to the credit of its bank account with the charge holder in the ordinary course of trade are likely to be payments made out of the proceeds of book debts subject to the floating charge. The Court thought that it would be surprising (to say the least) if s196 CA were to be applicable to such payments made in the ordinary course of trade.

The Court concluded that the monies paid by the Company's solicitors to the charge holder were paid in pursuance to the undertakings and not as a result of some independent decision by the Company to pay its debts out of monies under its control. The undertaking was given as part of the price which the charge holder required for not enforcing its security. If the undertaking had not been given it would not have released the assets from its security and it would have taken steps to enforce that security. Looking at the substance of the transaction, the payment of monies to the charge holder pursuant to the undertakings were (in substance) acts by which the charge holder realised its security, they were not acts which were (in substance) no more than the ordinary discharge of the Company's liabilities.

Conclusion

Although the categories of preferential debt are far narrower than was previously the case (and hence s196 CA is less likely to be applicable in practice), its scope should be considered in the context of any restructuring of company debt (effected outside the course of a formal insolvency regime) which, in substance, includes the realisation of floating charge security.

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