Restructuring and Insolvency
Case Law Update

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On 31 December 2014, the Financial Services (Banking Reform) Act 2014 (Commencement No 7) Order 2014, SI 2014/3160 extended the list of unsecured debts afforded preferential status in insolvency proceedings. Following this recent change, it is worth reminding ourselves how assets are distributed in a corporate insolvency.

General Principles

One of the primary functions of both administration and liquidation is to realise the assets of the insolvent company and to distribute cash realisations made from those assets among the insolvent company's creditors. The Insolvency Act 1986 and the Insolvency Rules 1986 created a statutory scheme which sets out how asset realisations must be applied to meet creditor claims in an administration or liquidation.

In summary, assets realised must be distributed as follows:

- Firstly, realisations from assets subject to fixed charges must be paid to fixed charge holders (after deduction of the costs of realisation);
- Secondly, any remaining funds should be used to pay the remuneration and expenses of the insolvency practitioner. There are various categories of expenses which, again, each rank in priority;
- Thirdly, any remaining funds should be used to pay preferential creditors. We shall discussed preferential creditors further below);
- Fourthly, realisations of assets subject to floating charges should be paid to the holders of such floating charges although a "prescribed part" should be set aside from these realisations to pay unsecured creditors;
- Fifthly, any remaining funds should be distributed amongst unsecured creditors (this includes HMRC); and
- Finally, any remaining funds should be distributed to the shareholders.

Recent Changes

Depositors protected by the Financial Services Compensation Scheme (the "FCSC") now enjoy preferential status to the extent that amounts owed to them do not exceed the compensation they are entitled to under the scheme (currently £85,000).

The categories of preferential debts listed in schedule 6 to the Insolvency Act 1986 therefore now comprise:

- Contributions to occupational pension schemes, etc (category 4);
- Remuneration, etc, of employees (category 5);
- Levies on coal and steel production (category 6); and
- Deposits covered by FCSC (category 7).

As explained above, in the event of insolvency, the interest of these preferential creditors shall rank in priority to those which are unsecured or hold the benefit of a floating charge.

A new class of preferential debts

The Banks and Building Societies (Deposit Preference and Priorities) Order 2014 has further created a new class of “secondary preferential debts” which apply to all insolvency proceedings commenced from 1 January 2015. These secondary preferential debts shall be paid after the “ordinary preferential debts” discussed above. They comprise:

1. the amount which is owed to a depositor eligible under the FCSC but which exceeds the compensation payable by the FCSC (£85,000); and
2. deposits made through a non-EEA branch of an authorised credit institution which would be eligible for compensation from the FCSC if made through an EEA branch of that credit institution.

Similarly to ordinary preferential debts, secondary preferential debts shall rank equally among themselves but ahead of unsecured creditors and floating charge holders.

A new class of preferential debts

Both existing and prospective creditors should carefully consider the impact the introduction of a new category of preferential creditor and a new class of preferential debts will have on current or proposed arrangements. Floating charge holders should, in particular, note these recent developments and appreciate the extent to which their security is affected.

For further information, please contact James Walton or the Partner with whom you usually deal.