COMPANY LAW REVIEW GROUP

REPORT OF THE COMPANY LAW REVIEW GROUP

REVIEW OF THE IMPLICATIONS OF THE SUPREME COURT JUDGMENT: IN THE MATTER OF J.D. BRIAN LTD T/A EAST COAST PRINT AND PUBLICITY AND RE EAST COAST CAR PARTS LTD [2015] IESC 62 (LAFFOY J.)

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Review of the Implications of the Supreme Court Judgment: In the matter of J.D. Brian Ltd t/a East Coast Print and Publicity and Re East Coast Car Parts Ltd [2015] IESC 62 (Laffoy J.)

Introduction

The Chair of the Company Law Review Group (CLRG) received a request from Richard Bruton, T.D., Minister for Jobs, Enterprise and Innovation on 14th July 2015 regarding the Supreme Court judgment of the 9th July 2015[1]. The Minister asked the Company Law Review Group "*to examine the judgment (the 'Belgard Motors case') and its implications for the priority of payments to creditors in company liquidations and to recommend what, if any, changes should be made to the Companies Act 2014, particularly having regard to paragraphs 91 – 98 of the judgment*".

An ad-hoc committee was convened comprising of the chairs of both the CLRG subcommittee on Charges and Registration (William Johnston), and the CLRG subcommittee on Corporate Insolvency (Barry Cahir), along with members of these subcommittees who volunteered to participate on the ad-hoc committee. A full list of members can be found in Appendix 1.

This report sets out the findings and a recommendation by the Company Law Review Group adopted at its plenary meeting on Friday 13th November 2015.

Overview of the Case

The main facts of the case were that each company created a floating charge in favour of Bank of Ireland as security for finance made available to it by the Bank. The Bank served a notice on each company, in accordance with the terms of the debenture (under which a floating charge was created), crystallising the floating charge into a fixed charge. Subsequently a liquidator was appointed to each company. The Supreme Court confirmed that the result of an effective crystallisation, prior to the appointment of a liquidator, is to improve the priority of the chargeholder ahead of the preferential creditors in respect of the assets caught by the crystallisation.

Order of Priority of Creditors of an Insolvent Company

Upon a company's receivership or liquidation, the effective priority of payments made to creditors after expenses ranks as follows:

- First, payments in respect of certain social welfare payments and payments that may arise to the Revenue Commissioners under Section 1001 of the Taxes Consolidation Act 1997 ("Section 1001"),

[1] http://www.supremecourt.ie/Judgments.nsf/1b0757edc371032e802572ea0061450e/8bdc10fdc70b564480257e7e003deb10?OpenDocument

- secondly, payments out of assets subject to a fixed charge to the fixed charge holder (on the grounds that such assets have been effectively assigned to the chargeholder and do not form part of the chargor's assets available to the receiver or liquidator),
- thirdly, certain payments to what are known as preferential creditors, principally the Revenue Commissioners (with regard to certain specific liabilities), local authorities for rates, and employees,
- fourthly, payments out of the assets the subject of the floating charge to the floating charge holder,
- fifthly, unsecured creditors,
- sixthly, subordinated creditors, and
- finally, shareholders.

If a floating charge is crystallised prior to the appointment of a receiver or liquidator to the chargor, the charge effectively becomes a fixed charge; the priority of the holder of the floating charge effectively leap frogs preferential creditors it would otherwise have ranked behind.

However, there was no widespread practice of such crystallisation as it was considered cumbersome to have an effective crystallisation through the necessity of imposing control and effective lock down of assets used by the company in its day to day trading – a point effectively re-iterated by the High Court judgment in the Belgard Motors case. There was thus no need to consider legislative amendments to ensure the priority order would not be disturbed.

Issues raised by the Case

In the Belgard Motors case, the security provided, as is now common, that upon any of certain stipulated events happening, the Bank could, by a notice to the company, and unknown to other creditors, convert the floating charge into a fixed charge. This is what the Bank did in the case in point.

Two principal issues arose when the Bank's notice of crystallisation was challenged. The first point was whether or not a floating charge holder could crystallise a charge in this manner. Although documentation providing for this has been market practice for perhaps 20 years there is no caselaw on this in Ireland (it had received approval in Australia).

In the Belgard Motors case, both the High Court and the Supreme Court decided that a floating charge could be crystallised provided it was done in accordance with the contractual terms of the security between the chargor and the chargeholder.

The second question is whether the crystallisation was effective. The High Court decided it was not, as the charge after crystallisation did not have the appropriate characteristics and control associated with a fixed charge. However, the Supreme Court decided, as it was the parties' intention to turn the charge into a fixed charge, effect should be given to that intention. The Supreme Court indicated also that as a result of that decision chargeholders could, without good cause turn a floating into a fixed charge, giving it priority over the preferential creditors and effectively utilise what it described as a flaw in the legislation. The Supreme Court's decision, without evidence that the chargeholder imposed any controls on the assets subject to the crystallised charge, has the

potential to create an increased likelihood of floating chargeholders imposing their priority in cases where the chargor is likely to become insolvent.

A summary of the legal issues surrounding the Supreme Court's decision is set out in Appendix 2.

Floating and Fixed Charges – The Basic Differences

The description, floating charge or fixed charge, which is given to any given charge is not determinative of the true nature of the charge. The law has developed so that charges are judged by their effect and not just by their description. In the UK, the House of Lords decision in National Westminster Bank Plc v Spectrum made it clear that the central feature which distinguished a floating charge from a fixed charge lay in the chargor's ability to control and manage the charged assets freely and without the chargee's consent. The effect then of the crystallisation of the floating charge into a fixed charge can be quite dramatic on a company as essentially it can no longer freely deal with any assets covered by the fixed charge.

Development of Floating Charge and Preferential Payments

The first recorded decision of the effectiveness of a floating charge was in 1870 but it was described by Lord MacNaghten as

> *"an equitable charge on the assets for the time being of a going concern. It attaches to the subject charged in the varying condition in which it happens to be from time to time. It is of the essence of such a charge that it remains dormant until the undertaking charged ceases to be a going concern, or until the person in whose favour the charge is created intervenes. His right to intervene may of course be suspended by agreement. But if there is no agreement for suspension, he may exercise his right whenever he pleases after default".* [2]

The principal advantage of this form of charge was that it enabled a company to receive finance and give security while at the same time continue to trade with its assets, usually stock and receivables, in the ordinary course of business without interference from the chargeholder.

In 1883, the Companies Act of that year introduced the concept of preferential payments in a company's winding up for wages and salaries.[3] The preference was extended to rates by the Preferential Payments in Bankruptcy (Ireland) Act 1889.

Subsequently under the Agricultural Credit Act 1927, both a fixed chattel mortgage and a floating chattel mortgage were specifically recognised. The Act provided for the conversion of a floating chattel mortgage into a fixed chattel mortgage upon certain requirements and constraints (this was subsequently amended and reiterated in the Agricultural Credit Act 1978). The measures in the Act were introduced specifically to facilitate farmers borrowing money to better their holdings.

The concept of preferential payments was retained and set out in Section 285 of the Companies Act 1963 which has been replaced by Section 621 of the Companies Act 2014. Bank financing in the 1960s typically involved a trading company giving a debenture to the bank to secure a specified sum

[2] House of Lords decision in Governments Stock and Other Securities Investment Company v Manila Railway Company [1897 A.C. 81]
[3] Companies Act 1883, c.28 s.4

of money; the debenture would incorporate a fixed charge over the company's premises and a floating charge over other assets principally stock and book debts. The leap-frogging as between the preferential creditors and the floating chargeholder continued in the 1970s with the extension of Revenue priority, in particular, the Value Added Tax Act 1972 which incorporated an increase of the wholesale and sales tax and increased employee entitlements. The extent of preferential payments increased under the Companies (Amendment) Act 1982 and has continued to increase with sporadic legislation the most recent being Section 49 of the Workplace Relations Act 2015.

The next stage of leap-frogging followed the UK High Court decision in *Siebe Gorman v Barclays Bank Limited* (1978)[4], when banks in Ireland provided in their debenture that a fixed charge would be taken over present and future book debts rather than a floating charge. Book debts are an asset which typically change from time to time and would normally in that sense be appropriate for a floating charge. In 1984, the High Court found that a fixed charge over book debts could not be created but this was successfully appealed the following year where the Supreme Court unanimously held a fixed charge to be effective (*Re: Keenan Brothers* [1985] IR).

The leap-frogging continued as within six months of the Keenan Brothers decision, a late amendment was introduced to the Finance Bill which became Section 115 of the Finance Act 1986, now Section 1001 of the Taxes Consolidation Act 1997. Essentially what this Section provided is that if a chargor is in arrears on its PAYE or VAT obligations on payments to the Revenue, the Revenue can serve a notice on any creditor of the chargor which has a fixed charge over the chargor's book debts to the effect that any monies received by the creditor from the chargor from the time of the notice, not only in respect of book debts but in respect of any other arrangements such as enforcement of security over land, that such monies must be remitted to the Revenue Commissioners in or towards the discharge of the arrears of PAYE or VAT. Thus the Revenue Commissioners obtained what is in effect super-preferential status not only in respect of book debts but in respect of the proceeds of all assets of a company which created a fixed charge over book debts in favour of the creditor**.** This provision, to our knowledge, is not found in other jurisdictions, frequently gives rise to surprise from foreign creditors when considering making finance available to Irish companies.

Subsequently in 1995, a small amendment was made to the Section[5] following recommendations from the Report of the Task Force on Small Businesses chaired by the Minister of State, Seamus Brennan TD, which reported that the Section was hampering the availability of finance to small business.

As a result of the Supreme Court's decision in the Belgard Motors case, the holder of a floating charge who crystallises the charge prior to the chargor's receivership or liquidation may now continue the leap-frogging tradition.

Consideration of Reform

It could be argued that the "leap-frogging" outlined in the previous paragraphs creates a degree of uncertainty which is unhelpful to conducting business and engaging in trade.

[4] Siebe Gorman & Co Ltd v Barclays Bank Ltd [1979] 2 Lloyd's Rep 142
[5] Finance Act 1995, s174

Statutory reform has been considered from time to time over the past 60 years without any substantive outcome. In 1958 the Law Reform Committee recommended the abolition of preference payments but this recommendation was not implemented in the Companies Act 1963. In 1972 the Bankruptcy Law Committee Report recommended the abolition of preferential payments. In 1994 the Company Law Review Group was asked to consider whether farmer creditors should be given preferential status. The Group answered in the negative but recommended "that a full examination be undertaken of relative burdens of risk from third party business failure". The Report stated at paragraph 8.8:

> *"We have taken particular note of the argument that the burden of risk in commercial transactions is inequitably distributed in that some parties have a greater capacity than others to secure their risk. The current situation and practices have, as mentioned earlier, developed over time and have been tested in the market-place. Nevertheless, it may be that the relative preferences obtaining should be examined periodically in the light of market-place development. An examination along these lines would include a look at all unsecured creditors generally in relation to other creditors. Such an examination will require consultation with many interests since it will touch on diverse aspects of commercial life and on the interests of the Exchequer. It will also benefit from a study of developments in other jurisdictions. We note that work of a similar nature has been undertaken and steps smaller or greater implemented in other jurisdictions. We refer in particular to the US experience and the Cork Committee report on Insolvency Law and Practice in the United Kingdom (Ref: Cmnd. 8558 - June 1982)."*

The Second Report of the Company Law Review Group,[6] issued in 2004, reviewed in some detail the preferences of employees and the Revenue without concluding on any recommendations. However, a more detailed consideration was given to the subject in the Company Law Review Group Report of 2007[7]. In particular substantive reasoning was set out both for supporting Revenue preferences and for abolishing preferences as well as an outline of the experience of other jurisdictions.

The 2007 Company Law Review Group's Report on preferential payments concluded with a number of specific recommendations involving the retention of many Revenue and employee priorities and the abolition of some Revenue and employee priorities.

To ensure that the burden of risk is equitably distributed, it may be appropriate to consider in the course of 2016 what, if any, changes should be made to the legislation governing the priority of payments on a company's receivership or liquidation.

Preferential Payments in Other Jurisdictions

In general, employee's unpaid wages and entitlements enjoy some type of preferential status on insolvency in almost every jurisdiction. There is no uniform approach in respect of a preferential status for revenue in respect of tax liabilities. Notably, the United Kingdom and Australia, have abolished the preference in respect of tax liabilities.

[6] http://www.clrg.org/publications/clrg-second-report-2004.pdf
[7] http://www.clrg.org/publications/clrg-fourth-report-2006-2007.pdf

The United Kingdom

Prior to the United Kingdom's abolition of the Crown's preference for revenue debt[8] UK company law was amended (following a court decision in the mid-1980s[9]) to the effect that reference to a floating charge in the Companies Act/Insolvency Act would be treated as a floating charge, as created. In other words, the character of the charge at the time of its creation, rather than at the time of the winding up of the company, became the determinative issue in deciding the order of priority. This mechanism retained the concept of a floating charge and crystallisation thereof for other purposes.

Preferential Payments in selected other Jurisdictions

The Hong Kong legal system is based on common law and accordingly the law of Hong Kong relating to security interests is broadly similar to UK law. A floating charge in an insolvency is defined as a floating charge, 'as created'. Similarly employees and the revenue are preferential creditors and rank ahead of floating charge holders.

As a general rule, in an insolvency in Canada, Australia and New Zealand, statutory preferential payments are paid, in priority of any security interest, out of circulating assets (which are alternatively described as inventory/receivables/current or movable assets).

Further details of the security interests available in each country mentioned above is at Appendix 3.

Registration of Charges and Third Parties

Prior to the 2014 Act, particulars of the charge such as details of any negative pledge clauses, details of crystallisation events in relation to floating charges and other restrictive provisions, were typically filed for registration. However Section 412(6) of the Companies Act 2014 implemented the Second Report of the Company Law Review Group (para 8.5.2) by providing that the Registrar shall not enter details of negative pledges or crystallisation events and the filing of any such detail shall have no effect. There is no statutory requirement to 're-register' a crystallised floating charge.

In the UK, it is settled that crystallisation of a floating charge does not lead to the creation of a new charge and hence does not trigger the registration requirements of Section 860 of the Companies Act 2006.

CLRG Proposal

The terms of the request from Minister Bruton to the Company Law Review Group in relation to the Supreme Court judgment were "*to examine the judgment and its implications for the priority of payments to creditors in company liquidation and to recommend what, if any, changes should be made to the Companies Act 2014, particularly having regard to paragrahs 91-98 of the Judgment*". In view of the uncertainty for preferential and other unsecured creditors which now prevails by virtue

[8] Enterprise Act 2002, s252(2)
[9] Re Brightlife Ltd [1987] Ch 200

of the judgment (and the developments in other jurisdictions with strong trading links with the State), it is recommended that the priority of payments on a company's insolvency be given full consideration bearing in mind the necessity to protect the rights of employees, creditors and the State. It should be noted, for the record, that the ad-hoc committee debated whether this recommendation is within the scope of the terms of request from the Minister.

The CLRG has considered three options:

1. Do nothing and await a full and considered review of the priority of payments. In view of the potential opened by the Supreme Court for crystallisation to be effected privately and shortly prior to enforcement, this may be unwise.

2. Make a simple change to the effect that floating charge means a floating charge as created for the purposes of Section 440 and Section 621 of the Companies Act 2014. This restores the position to what it effectively was in practice if not in law. It is a suggestion of the CLRG that it may be appropriate to further explore priority of payments on a company's receivership or liquidation in 2016. The likely implications of this proposal were considered and it was felt that the ability of companies to raise finance would not be adversely affected as there did not seem to be a widespread practice of crystallising floating charges before the appointment of a receiver or liquidator as it was considered the High Court's test for an effective crystallisation as outlined in the Belgard Motors case made it challenging for the secured creditors. It is considered the absence of such practice should not impact on the decision of banks or other lenders to provide credit to a company.

3. Adapt Section 31 of the Agricultural Credit Act 1978 which would tackle the Supreme Court's concern of abuse. The Companies Act 2014 could be amended to provide that whenever any monies become due for payment by a company to a creditor which has a floating charge over some or all of the company's assets or undertaking and such monies are in arrears for seven days, the chargee may serve on the company, a notice in writing declaring that the floating charge has crystallised and become fixed, and the chargee within seven days after the day on which the notice has been served files a notice in the Companies Registration Office that its floating charge has become fixed, the floating charge shall be deemed to have become fixed from the date and time of the filing of notice to that effect in the Companies Registration Office. This option was discussed as it was considered it would have had the dual advantage of enabling crystallisation in somewhat limited circumstances with transparency. However, it was considered to be somewhat unwieldy and filing a notice in the Companies Registration Office may be of limited value when the crystallisation has already been effected. It was also relevant that the new registration system introduced by Part 7 of the Companies Act 2014 had simplified the registration procedure in many ways and a further registration requirement would not be consistent with that approach.

   Recommendation:

   Accordingly, the Company Law Review Group recommends the second option be adopted and submitted to Minister Bruton. Suggested changes to implement the recommendation in the Companies Act 2014 are set out in Appendix 4.

Appendix 1 Membership of the Ad-hoc Committee

William Johnston (co-chair), Arthur Cox (Ministerial Appointee to the Company Law Review Group)

Barry Cahir (co-chair), Irish Society of Insolvency Practitioners

Jonathan Buttimore, Office of the Attorney General

Helen Curley, Department of Jobs, Enterprise and Innovation

Stephen Dowling, Bar Council

Bernice Evoy, Banking and Payments Federation, Ireland

Paddy Purtill, Revenue Commissioners

Vincent Madigan, (Ministerial Appointee to the Company Law Review Group)

David McFadden, Companies Registration Office

Jon Rock, Institute of Chartered Secretaries and Administrators in Ireland

Appendix 2: Executive Summary of the Legal Issues Surrounding the Supreme Court's Judgment in the matter of J.D. Brian Ltd t/a East Coast Print and Publicity and Re East Coast Car Parts Ltd [2015] IESC 62 (Laffoy J.)

Introduction – The Current Law in Ireland

At the time of the liquidation of the companies in this case, Section 285(7)(b) of the Companies Act 1963 stated that in a winding up the preferential debts of a company shall 'rank equally among themselves and be paid in full'. However, where there are insufficient assets the section provides that 'they shall abate in equal proportions'. Many of the preferential creditors are described in Section 285 of the 1963 Act and are listed there; most notably preferential creditors include the Revenue and certain protected categories of payments for employees. This Section has now been replaced by Section 621 of the Companies Act 2014. However, following the decision of the Supreme Court in *Re J.D. Brian Ltd t/a East Coast Print and Publicity* [2015] IESC 62 (Laffoy J.) ('the Belgard Motors case') debenture holders (such as banks) holding a floating charge, which has crystallised into a fixed charge, will rank in priority to any preferential creditors.

The bank in the Belgard Motors case served a document, which was called a 'Crystallisation Notice', on the beleaguered company prior to the commencement of winding up or the appointment of a receiver and there is now a fear that banks will utilise this 'Crystallisation Notice' to attempt to leap frog preferential creditors in the order of priority.

Floating and Fixed Charges – The Basic Differences

There is currently no definition of a fixed or floating charge in the Companies Act 2014. The title, floating charge or fixed charge, which is given to any given charge in a debenture is not in fact determinative in deciding what the true nature of the charge is. The law has developed so that charges are judged by their effect and not just by their description.

In the Supreme Court in *Re: Keenan Brothers Ltd* [1985] IR 401, Henchy J stated:

> *"One of the essential differences between a fixed charge and a floating charge given by a company is that a fixed charge takes effect, upon its creation, on the assets that are expressed to be subject to it, so that those assets, as they then exist, or, when the charge applies to future assets, as soon as they come into existence, will stand encumbered by the charge, and the company will be able to deal with those assets only to the extent permitted by the terms of the charge".*
>
> *"A floating charge, so long as it remains floating, avoids the restricting (and in some cases, paralysing) effect on the use of the assets of the company resulting from a fixed charge. While a charge remains a floating one, the company may, unless there is agreement to the contrary, deal with its assets in the ordinary course of business just as if there were no floating charge."*

In the United Kingdom, the House of Lords decision in *National Westminster Bank Plc v Spectrum Plus* [2005] UKHL 41 has brought a degree of certainty as to the true nature of fixed and floating charges. The decision made it clear that the central feature which distinguished a floating charge from a fixed charge lay in the chargor's ability to control and manage the charged assets. However, their Lordships agreed that it is still conceptually possible to create a fixed charge over book debts. Lord Hope stated:

> *"in order to create a fixed charge over book debts there must be a restriction in the debenture forbidding their disposal; a requirement that that they be paid into a blocked account and that such account is operated as a blocked account in fact. If the blocked account was never intended to be operated as one in fact and in practice the chargor was free to apply the book debt realisations as it wished then the charge will be construed to be [a] floating charge."*

The effect then of the crystallisation of a floating charge to a fixed charge can be quite dramatic on a business as essentially they are being asked to no longer deal with any assets covered by the charge.

Development of the Floating Charge in Common Law – 'A Defect in the Drafting'

The leading cases in the UK dealing with the crystallisation of floating charges and the priority which arises thereafter are: *Re Griffin Hotel Co. Ltd Joshua Tetley & Son Ltd v The Company* (1941) Ch 129 (*Re Griffin*) and *Re Brightlife Ltd* [1987] Ch. 200.

In *Re Griffin* the court was called upon to consider the proper statutory interpretation of Section 264 (4) of the English Companies Act of 1929. The wording of Section 264(4)(b) is identical in all material respects to Section 285(7)(b).

Bennett J. held that the phrase "any floating charge created by the company" in Section 264 (4) had no application to a charge originally created as a floating charge, but which had become a fixed charge prior to the date of the winding-up order. This ruling was made in reply to an argument that the phrase "any floating charge created by the company" included all charges which had originally been created as floating charges.

In *Re Brightlife Ltd* [1987] Ch. 200 Hoffmann J. (as he then was) considered the use of a crystallisation notice by a chargeholder over a company's assets. He found that the charge in question, although expressed as being a 'first specific charge', was a floating charge since it related to fluctuating assets. Furthermore, while some restriction was placed on the company's freedom to deal with its book debts, the company remained free to collect its debts and pay them into its bank account, which the company could use freely. However, since there was nothing which precluded the parties from stipulating in their agreement that a floating charge would crystallise into a fixed charge on the giving of notice by the chargeholder, by giving that notice exercising its right to do so, the chargeholder had effectively converted its floating charge into a fixed charge. It followed that since the charge had become a fixed charge before the commencement of the winding up of the company, preferential creditors such as the Customs and Excise had no priority under Section 614(2)(b) of the 1985 Act over the chargeholder's claim. This was the first time the effectiveness of the 'Crystallisation Notice' procedure had been tested in the courts.

It should be noted that at the time of Hoffmann J.'s judgement legislative changes were already imminent through the enactment of the Insolvency Act 1986. Irene Lynch Fannon notes in her recent article '*The Floating Charge Debate in Irish Law: The Path to Clarity*' (2015) 17 CLP 2015, 22 (8) 187-195, that in light of the impending legislation, the court in *Re Brightlife* may have felt limited in the options available to it. She notes at page 191 that:

> *"…the decision in Re Brightlife Ltd was delivered by Hoffmann J. in a legislative context where the "defect in the drafting" which had been revealed by Re Griffin Hotel Ltd was being expressly addressed through the enactment of the provisions of the Insolvency Act 1986. The court could therefore be regarded as being somewhat constrained in the approach available to it. Absent such constraint, the observations of Hoffmann J. (cited at para. 53 of the Supreme Court's decision in the Belgard Motors case) are apt:*
>
> *One imagines that [the legislative provisions in question] were intended to ensure that in all cases preferential debts had priority over the holder of a charge originally created as a floating charge. It would be difficult to think of any reason for making distinctions according to the moment at which the change crystallised or the event which brought this about. But Re Griffin Hotel Co. Ltd revealed a defect in the drafting…*
>
> *The observations of Finlay Geoghegan J. regarding both the fact that Hoffman J. felt bound by the former decision and was perhaps being polite regarding the validity of the reasoning are appealing in this context."*

As a result of these legislative developments, which have restated the law in respect of the crystallisation of floating charges, these decisions have been somewhat frozen in time and the issue of the status of a floating charge which has crystallised to a fixed charge has become a moot issue in English law.

Statutory Intervention in the United Kingdom

In 1986 English company law was amended to the effect that any reference to a floating charge in the Companies Act/Insolvency Act would henceforth be categorised as a floating charge **as created**. In other words, a subsequent crystallisation of the floating charge would have no effect on the priority of payments, so that preferential creditors would still rank ahead of the floating chargeholders in the event of a receivership or liquidation.

The cumulative effect of the legislative amendments was that the character of the charge at the time of its creation, rather than at the time of the winding up of the company, became the determinative issue in deciding the order of priority of payments.

At least one unintended consequence of the changes made to the definition of the floating charge in the United Kingdom has been identified. Originally, the subordination of the floating charge in favour of preferential creditors was limited to those preferential claims which arose before the crystallisation of the floating charge. However, after the amendment, the subordination also encompassed those preferential claims which arose after the crystallisation of the charge.

For instance, prior to the amendment of the definition, an employee could recover unpaid wages up to and until the date of the crystallisation of the floating charge into a fixed charge. There was no process for an employee to recover wages which arose after the crystallisation of the charge, but

before the cessation of business. After the introduction of the new definition, employees' unpaid wages were recoverable for the entire period up to and including the winding up of the company.

Some attempts were made by banks over the years to side step the statutory interventions, in particular the Insolvency Act 1986, which substantially weakened the effectiveness of a crystallised floating charge. In some circumstances banks thought it was possible to draft an effective fixed charge/mortgage over shifting and circulating assets by providing that the charge/mortgage extends to future property and that the chargee/mortgagee maintains control over the charged asset. This was illustrated by *Siebe Gorman v Barclays Bank Limited* [1979] 2 Lloyds Rep. 142 where the courts upheld as valid an attempt to create a fixed charge over book debts. By the terms of that charge, the chargee exercised sufficient control over the book debts (including requiring the chargor company to pay all proceeds into his account with the chargee bank) that the vital element of the floating charge, namely, the chargor's freedom to manage its assets in the ordinary course of business, was missing.

However, as noted above, such attempts have ultimately not succeeded and many charges/mortgages have been construed by the courts as 'disguised floating charges', notwithstanding the parties' describing the charge/mortgage as 'fixed'. The courts have resisted these 'disguised floating charges' where legally, or in practice, the chargor is given the power to deal with the assets in the ordinary course of business. As considered above, the House of Lords in *National Westminster Bank v Spectrum Plus Ltd* [2005] UKHL 41 clarified the position in respect of book debts and overturned the decision in *Siebe Gorman* retrospectively.

Preferential Payments – International Trends

The treatment of certain creditors in an insolvency as preferential creditors is an area which many other jurisdictions have grappled with. To date, no consensus approach has emerged but certain trends have emerged which are worth noting. In general, employees' unpaid wages and entitlements enjoy some type of preferential status in almost every jurisdiction. There is no uniform approach in respect of a preferential status for the revenue in respect of outstanding tax liabilities. Some common law jurisdictions like Canada, New Zealand and Hong Kong have retained the preferential treatment for revenue debts. Other jurisdictions, most notably the United Kingdom and Australia, have abolished the revenue preference in exchange for legislative amendments providing for the ring fencing of assets in an insolvency for the benefit of unsecured creditors.

Security Interests and Preferential Payments in Other Jurisdictions

A brief comparative analysis of the development of security law and preferential payments in other jurisdictions shows that there are three distinct systems of security interests in operation.

First, in Ireland and the United Kingdom the treatment of various security interests is based on their characterisation as either a fixed or floating charge. In general, floating charges are more vulnerable than fixed charges due to the registration system and the chance that they may be set aside if they have been created within 12 months of an insolvency. Furthermore, floating charges rank below the expansive list of preferential creditors and in the UK and Ireland.

The Hong Kong legal system is based on common law and accordingly, the law of Hong Kong relating to security interests is broadly similar to English law as it stood prior to the Enterprise Act 2002. A new definition of a floating charge was introduced in 1987 to reflect the changes in the United Kingdom. As a result, a floating charge in an insolvency is defined as a floating charge, 'as created'. Employees and the revenue are preferential creditors and rank ahead of floating chargeholders.

In contrast, Canada, Australia and New Zealand are just some of the common law jurisdictions which have abandoned the floating charge in favour of more modern forms of security interests, which they have been codified in a manner broadly in line with Article 9 of the Uniform Commercial Code (UCC) in the United States. Article 9 of the UCC is founded on the notion of substance over form. There is a common set of rules for perfection of all security. It is enough for parties to grant 'security' over assets rather than having to specifically mortgage, assign, charge or pledge it. There is also an all-inclusive system of registration of security interests which determines priority. Priority depends on the time of registration or taking of possession of the secured asset.

As a general rule, in an insolvency in Canada, Australia and New Zealand statutory payments in favour of preferential creditors are based on the characterisation of the assets covered by the charge, not the characterisation of the charge itself. As a result, the system provides that statutory preferential payments are paid in priority of any security interest out of circulating assets (which are alternatively described as inventory/receivables/current or movable assets). Thus, the debate on whether a particular charge is a fixed or floating charge is avoided entirely.

Finally, the development of a conservative banking and security interest sector in Denmark, Sweden and Finland has necessitated the introduction of a new form of floating charge. These charges, alternatively referred to as enterprise mortgages or business mortgages, provide a line of credit for businesses in exchange for a floating charge over their trading stock, inventory and receivables. These floating charges all require 'perfection', essentially registration, in order for them to confer priority over unsecured creditors.

Finland and Sweden also operate 'pledge' type security interests over tangible movable property like machinery, bank accounts, shares and patents. Perfection/crystallisation of the pledge is achieved by gaining possession and/or registration of the pledge. In addition, it should be noted that Finland, like the United Kingdom, have adopted a ring fencing approach which protects 50% of the business's assets (apart from real assets) for equal division between unsecured creditors. This is done at the expense of business mortgage/floating charge holders.

Registration of Charges and Third Parties

The question then arises how the crystallisation of floating charges works in reality and in particular, how crystallisation by notice, as was the case in the Belgard Motors litigation, would affect the rights of third parties, especially unsecured creditors like suppliers. The registration of charges effectively renders private crystallisation notices into matters of public record and accordingly merits some consideration.

Under the new Companies Act 2014, all charges should be registered within 21 days of their creation save for charges over assets set out in Section 408 of the Act. The priority as between charges has, to a large extent, been amended to give priority to the first chargee to file rather than the first to

create a charge. The Act currently provides that failure to file the prescribed particulars of a registerable charge will render the charge void against any creditor or liquidator of the company.

Prior to the 2014 Act, particulars of the charge, such as details of any negative pledge clauses, details of crystallisation events in relation to floating charges and other restrictive provisions, were collected by the Registrar. However, since the enactment of the new act, Section 413(5) of the Companies Act 2014 restricts the particulars which are capable of being delivered for registration. These details are now considered to be extraneous material and are not capable of registration.

Currently in the United Kingdom, all floating charges need to be registered, whereas not all fixed charges do. Section 859D of the Companies Act 2006 requires that a floating charge is registered and certain detailed particulars of the charge are to be included in the registration documents. These particulars include whether or not the instrument is expressed to contain a floating charge and whether it covers all the property and undertakings of the company. An unregistered charge will also be void against a liquidator, administrator or creditor of the company.

In the United Kingdom it is settled law that the crystallisation of a floating charge does not lead to the creation of a new charge. Accordingly, the crystallisation does not trigger the registration requirements set out above and there is no danger of the crystallised charge being called into question under Section 245 of the Insolvency Act 1986 (which invalidates any floating charges created in the 12 months prior to a company going into a winding up). The courts in the United Kingdom have yet to decide whether or not decrystallisation involves the creation of a new charge. There is no conclusive authority on this point in Irish law.

The Agricultural Credit Act 1978

The final recommendation of the CLRG refers to The Agricultural Credit Act 1978. It's predecessor the Agricultural Credit Act 1927, was introduced to encourage farmers to borrow money to better their holdings. As a *quid pro quo* for lending to farmers the banks were given increased powers to enforce their security at short notice.

The Agricultural Credit Act is an example of a statutory precedent for the use of the 'Crystallisation Notice', in so far as it provided for the conversion of a floating chattel mortgage into a fixed chattel mortgage on notice to the farmer/borrower. Its effect was that a floating chattel mortgage which had been converted by notice to a fixed charge conferred on the bank the right to take possession of the property charged. This could only be done upon the happening of an event specified in the charge. Typically, specified events include: breach of covenant to repay, death or bankruptcy of the farmer or his making a composition or arrangement with creditors. After five clear days, or such less time as may be allowed by the charge, the bank had the power to sell the secured property by auction or private treaty.

Thus, within a short period of time the bank could effectively take possession and sell any secured assets.

Appendix 3: A general review of floating charges and preferential creditors in other common law and selected EU jurisdictions

Canada

In Canada the floating charge has been abolished in favour of a statutory fixed charge which attaches to [all of] the debtor's assets from time to time.

This is a fixed security interest which:

(i) attaches to assets as and when the debtor acquires them;

(ii) becomes unattached as and when the debtor disposes of assets with the secured party's express or implied authority; and

(iii) attaches to the proceeds of assets. The key difference between a Personal Property Security Act (PPSA) security interest and a floating charge is, therefore, that a PPSA security interest attaches at the point when the debtor has rights in the collateral, whereas a floating charge does not attach until crystallisation.

The Crown preference operates in Canada through a 'deemed trust' which gives the Crown a proprietary interest in any tax collected in subordination of any security interest (floating or fixed) with the exception of real property mortgages (Income Tax Act 1985, s227 (4.1). Unpaid wages also have priority over secured claims over current assets, defined as 'unrestricted cash, or any other asset that, in the normal course of operations, is expected to be converted into cash or consumed in the production of income within one year or within the normal operating cycle when it is longer than a year'(Section. 2(5) Wage Earner Protection Program Act 2005).

New Zealand

In New Zealand much of the Crown preference has been abolished. There are still a number of preferential creditors who gain priority in both a receivership and a winding up. Before the New Zealand PPSA 1999, (which introduced a regime similar to the US and Canada), these creditors had priority over floating charge holders. After the introduction of the PPSA, the floating charge was abolished. Under the Companies Act 1993 (NZ) Sch 7 cl 2(1), preferential creditors were given priority over the claims of any security interest to the extent that the security interest:

(i) is over all or part of the company's accounts receivable and inventory, and

(ii) is not a purchase money security interest, and

(iii) does not arise from the transfer of an account receivable for which new value

Statutory payments in an insolvency in favour of preferential and general unsecured creditors are based on a characterisation of the assets covered by the charge, not the characterisation of the charge itself. Charges over inventory and receivables are subject to claims by these protected creditors, charges over other assets are not.

Australia

In Australia, the Personal Property Security Act (PPSA) 2009 created a new regime to determine whether an effective security interest has been created. The effectiveness of a security interest is dependent on both "attachment" and "perfection" having occurred. Attachment relates to the creation of the security interest — in order for there to be a security interest at all, it must "attach" to specific assets. The effect of attachment is to give the secured party proprietary rights as against the debtor.

For the security interest to be effective against third parties, it must be 'perfected'. This is achieved by one of the following:

(i) **Possession**

(ii) **Control** - Broadly speaking, a secured party has control when it is in a position to dispose of the collateral without the grantor's consent.

(iii) **Registration** -

Australia abolished priority for general tax liabilities in 1993, replacing it with a regime that allowed recovery proceedings to be brought by the Revenue Commissioners earlier, with the potential for penalties against directors personally (Insolvency (Tax Priorities) Legislation Amendment Act 1993).

Hong Kong

The Hong Kong legal system is based on common law. Accordingly, the law of Hong Kong relating to security interests is largely similar to UK law.

The new Companies Ordinance (Cap. 622) has recently been brought into operation in Hong Kong in 2014, in some ways it is comparable to Ireland's Companies Act 2014 as it has largely updated and codified the company law regime in Hong Kong.

Some of the major reforms it introduced in respect of charges were:

- "automatic" acceleration (or crystallisation) provisions were replaced with a "discretionary" acceleration provision, giving a choice to the lender as to whether the secured amount is to become immediately payable.

The Hong Kong Government is in the process of reforming the larger area of insolvency law and has simply kept its previous company ordinance 'Cap 32' provisions which includes a system of preferential creditors which include employees' unpaid wages and compensation claims and any statutory debts due to the government. These preferred creditors are paid ahead of a holder of a floating charge. In an insolvency, a floating charge is considered to be a floating charge 'as created'.

Denmark

Unsecured creditors rank as follows:

(i) **Pre-preferential creditors.** Before any debts are paid, pre-preferential claims, for example the cost and expenses of the administration of the estate, are paid in equal proportions.

(ii) **Preferential creditors.** After payment of pre-preferential claims, preferential claims are paid in equal proportions. Preferential claims include reasonable costs and expenses incurred to provide a collective arrangement of the debtor's financial affairs by a reorganisation, dissolution process, composition or similar schemes.

(iii) **Privileged creditors.** Privileged claims (for example, employees' salaries) rank after preferential claims. „

(iv) **Ordinary creditors.** Ordinary claims are, for example, unsecured loans and value added tax. These claims are subordinated to privileged claims.

Sweden

In the case of the borrower's insolvency, creditors have the following priority (Priority of Rights Act 1970)*:*

(i) Debts secured on specific property or by special procedures, such as mortgages over real property, pledges or liens.

(ii) Expenses of winding up the company (that is, the costs and remuneration of the receiver in bankruptcy).

(iii) The administrator's costs and remuneration in a company reorganisation.

(iv) The company's audit costs.

(v) Debts which the Enforcement Authority (*Kronofogdemyndigheten*) has secured on particular assets before the bankruptcy through its debt collection powers

(vi) Debts secured by a floating charge.

(vii) Employees' salaries.

(viii) Unsecured debts.

(ix) Shareholders' equity.

Appendix 4 Changes to the Companies Act 2014

Recommendation of the Company Law Review Group:

Make a simple change to the effect that floating charge means a floating charge as created for the purposes of Section 440 and Section 621 of the Companies Act 2014. This restores the position to what it effectively was in practice if not in law prior to the Supreme Court Judgment of 9th July 2015.

Recommended changes to the Companies Act 2014:

1. In section 440(1)(a) replace “a floating charge” with “a charge created as a floating charge”.
2. In section 621(7)(b) replace “any floating charge” with “any charge created as a floating charge”