PRELIMINARY DRAFT 6 August 1975

PREFERENTIAL AND SECURED CREDITORS

1. An essential principle of bankruptcy is equality of distribution. However, all insolvency codes, while founded on the general principle of rateable distribution of an insolvent's assets among his creditors, make to a greater or less extent two principal exceptions: secured debts and preferential debts.

2. For the purpose of distributing the assets of a bankrupt, creditors are divided into two classes, secured creditors and unsecured creditors. The unsecured creditors are, in turn, divided into those entitled to preferential treatment and those who are not. A secured creditor is one whose debt is secured by a mortgage, charge or lien. His preference operates following agreement between the parties concerned prior to bankruptcy, but the preference given to an unsecured creditor arises by operation of the law.

3. In the United Kingdom, a fairly clear distinction is drawn between secured rights and preferential rights; but in Continental systems, all prior claims againt assets are referred to either as "special preferences" or as "general preferences".

Secured creditors

4. Special preferences, which correspond to secured rights in the United Kingdom, attach to specific property and the creditor is generally entitled to be paid out of the realisation of that property before any other creditor. In the case of a shortfall, he ranks as an ordinary unsecured creditor for the balance. Secured rights are in general not interfered with by the bankruptcy, so long as the creation of the security was not in itself a fraud upon or otherwise invalid as against the creditors. The scheme of the Convention seems to be generally satisfactory in that it preserves the rights of secured creditors under the law of the Member State in which the property charged was situated (Article 43(1)). Nor does it disturb the relative priority accorded to the security under that law in relation to other rights of preference (Article 44).

5. There are, however, two matters which concern us in regard to the provisions of Article 43(1). Firstly, its possible effect in relation to floating charges. The present wording might imply that a receiver for a debenture-holder could not be appointed to administer the debtor's property; the debenture-holder would simply have the preference afforded to him by the crystallised charge in the liquidator's administration. We consider that the clause should be renegotiated to recognise rights under floating charges, particularly in relation to property situated abroad.

6. Secondly, we think that where a secured right attaches to properties situated in two or more countries, provision should be made for the claim to be satisfied in proportional shares varying with the amount realised on each property. Article 41(2) makes such a provision, but only in respect of general preferences.

7. An exception to the general principle of lex situs is made regarding certain moveable property, in particular, ships, boats, aircraft or motor-driven land vehicles. Article 43(2) provides that secured rights and "generally all other rights", secured upon such moveable property will be governed by the law of the flag or of the State in which the property is registered. We think these provisions may present difficulties, not only in respect of "Flags of convenience" and hence the application of the laws of non-member States, but also with regard to the relative priority of local arrestments. Difficulties might also arise, particularly for a liquidator, where motor vehicles are registered in two or more countries. We have not received the specialised advice which would enable us to reach satisfactory conclusions in these matters and we recommend that the Department should engage in further consultations.

8. In regard to possessory liens, we do not find the principle in Article 43(3) objectionable, but there would appear to be uncertainty of time; a criticism which also applies to Article 43(2). We suggest that the phrase "For the purposes of the distribution of the proceeds of the realisation of the assets of the bankrupt" should govern all clauses of Article 43, and it should be made clear that the operative time in each case is the date when the bankruptcy is opened.

Preferential creditors

9. General preferences are subdivided into civil and commercial debts on the one hand and fiscal debts, social security debts and similar public debts on the other. The two divisions are treated separately in the Convention.

10. Neither the Convention nor the N-L Report, defines "civil and commercial debts". We understand that the protocol on accession to the Judgments Convention, which is restricted to civil and commercial matters, may include a definition and that the Council's Working Group has provisionally agreed to a text. We have taken this text as the basis for our consideration of civil and commercial debts, namely that "civil and commerical matters" do not include -

(1) revenue and customs matters, such as taxes, duties, levies and other charges of a like nature;

(2) administration matters, such as those involving relations between private individuals on the one hand and the State or another public entity, when not acting in the capacity of a private individual, on the other; and

(3) matters involving relations between States or public entities or authorities not acting in the same capacity as private individuals.

Preferential creditors in the United Kingdom

11. The categories of debts to which preference is accorded by the United Kingdom law may be summarised as follows:

(1) taxes (maximum one year's arrears, but the "best year" can be selected);

(2) rates (not exceeding "last year's" arrears);

(3) P.A.Y.E., V.A.T., and analogous imposts (not exceeding "last year's" arrears);

(4) unpaid employees' wages (maximum of 4 months' arrears of remuneration, not exceeding £200 in all per person) and holiday pay;

(5) sundry other pecuniary obligations to public bodies which have power to levy charges for public purposes.

12. These qualify as preferential debts and are made recoverable in priority to ordinary unsecured creditors, on grounds of public policy, in order either to benefit the public revenue or to fulfil other social objectives. Historically, the preferential debts system derives in the United Kingdom firstly, so far as concerns England and Northern Ireland from the Crown's prerogative power, and so far as concerns Scotland, from power conferred on the Crown by statute, to recover debts due to itself from its subjects for tax and other public obligations, by means of the executive power, a power later extended by statute to municipal rates and taxes in one form or another; secondly, the system derives from a desire to ensure that the employees of a bankrupt employer are not left unprovided for by reason of non-payment of arrears of wages outstanding when their employment ceased. However, the Crown no longer possesses, after a bankruptcy or winding-up has commenced, its former extensive rights of direct recovery from its debtors, by prerogative or other executive action. In this respect the situation in the United Kingdom differs from that in certain Member States. It may be noted, moreover, in distinction from the rules in other States that, with one exception, all creditors on whom statutory rights of preference are conferred, including the Crown, rank pari passu with one another for priority payment out of the assets. The exception is that in England, a landlord entitled to distrain for limited arrears of rent may be relegated to a second-stage or postponed preferential status, as against preferential creditors in the strict sense.

13. In the field of preferential debts, the respective provisions relating to bankruptcy and winding-up in the United Kingdom are substantially identical in their provisions, save in one important respect, which is to be found in the latter provisions but not in the former, namely the subrogation of persons who have advanced monies to a Company for the payment of wages to its employees; such persons are subrogated in the winding-up of the company to the same preferential rights which the employees would have enjoyed if they had remained unpaid. It has been submitted to us that in practice, claims for unpaid wages actually due to the employees play a relatively small part, but the subrogation rights of the company's bankers can be substantial and frequently form the largest single preferential claim.

14. It is the trustee or liquidator who has the general duty of determining, subject to the directions and adjudications of the courts exercising bankruptcy or winding-up jurisdiction, questions regarding the existence, the amout and the preferential status of debts. In cases where the debt has been established prior to the bankruptcy or winding-up order, by the judgment of a court of competent jurisdiction, the trustee or liquidator will in general be bound by that judgment, (though not if it was a judgment by consent, or one vitiated by collusion or fraud). Again, he may not be able, as a matter of right, to disturb a finalised tax assessment. But in all other cases, i.e. of unadjudicated debts, he has the right and duty to adjudicate upon them, subject to his decision being approved by the court. Furthermore, that court has also the jurisdiction to determine in any disputed case, whether and to what extent the debt, if and when established, enjoys preferential status.

Continental general preferences

15. As might be expected, the insolvency codes of the other States of the EEC demonstrate many of the same characteristics as those of the United Kingdom; but certain fundamental differences between those States' codes and the corresponding United Kingdom provisions, are to be noted, namely:

(1) (a) In so far as the same category of debt ranks preferentially in the United Kingdom and other Member States, there are considerable variations regarding the amount to which preference is granted;

(b) In most of the States, preferential debts do not share the same equal rank of preference, but enjoy different degrees of rankings;

(c) There is a greater variety of debts enjoying preference than in the United Kingdom.

(2) The concept of subrogation to the preferential rights of employee creditors, conferred by the United Kingdom winding-up provisions does not exist in all Member States.

(3) In some States, preferential debts may constitute prior charges on the securities held by secured creditors, whereas the only such prior charge enjoyed by preferential creditors in the United Kingdom are confined to the case where a floating charge is realised by the appointment of a receiver and manager.

(4) In some States, general preferences relate exclusively to moveable property; in other States, certain general preferences (i.e. employees' wages) may be applied against fixed assets but only if the realisations from moveable assets prove insufficient. It is only in Germany and the Netherlands that general preferences may be levied against the whole of the debtor's estate.

(5) (a) A broad distinction is drawn in most of the States between civil and commercial debts on the one hand and "fiscal debts" and what may be called "quasi-fiscal debts" on the other. The latter often include debts to the social security administration and, with fiscal debts, are regarded as enjoying special privileges.

(b) Some States possess certain prerogative or executive powers for recovering such debts considerably exceeding any privileges enjoyed by the Crown in the United Kingdom. The Convention envisages that such direct rights of recovery will continue to be exercisable notwithstanding the opening of the bankruptcy proceedings.

General preferences under the Convention

16. The relevant provisions are mainly contained in Articles 40, 41 and 42, which may be summarised as follows:

(1) In civil and commercial matters, creditors may invoke in respect of assets situated in each of the Member States such general rights of preference as the law of that State attaches to the debts to which they are entitled (Article 40).

(2) The principles governing the distribution of the proceeds of the realisation of the assets of the bankrupt are as follows:

(a) The subject-matter, extent and ranking of general preferences are to be determined by the law of the Member State in which the assets were situated on the day when the bankruptcy was opened (Article 41(1)).

(b) Assets recovered in a non-Member State or the proceeds of their realisation are to be aggregated with those situated in the State in which the bankruptcy has been opened (Article 41(1)).

(3) Where a general right of preference attaches to the same debt in several Member States, even with a different ranking, that right is to be effective in respect of the assets situated in each of those States in proportion to the aggregate amount of the sums available for the satisfaction of that debt in each of those States (Article 41(2)).

(4) (a) Where a general right of preference attaches to the same debt in several Member States for different amounts, that right is to be effective in respect of the assets situated in each of those States in proportion to the aggregate amount of the sums available for the satisfaction of that debt in each of those States, to the extent of the sums to which that right of preference applies in each State respectively (Article 41(3)).

(b) (i) If the preferential debt is not thereby wholly discharged, and if there remains in one or more of the States a surplus available in respect of the sums to which the right of preference there applies, the short-fall is to be met in proportion to those surpluses (Article 41(3)).

(ii) So long as the preferential debt has not been wholly discharged and there exist surpluses available to meet that debt, further distributions are to be made upon the same principle (Article 41(3)).

(5) Debts to which, in several Member States, general rights of preference of different ranking apply, are to be satisfied in the order prescribed in each of those States (Article 41(4)).

(6) In matters other than civil or commercial, including fiscal matters and social security matters, the public authorities, government departments and other public agencies of a Member State are, in every other Member State, to be unsecured creditors to the extent that they have not obtained full satisfaction in their own State (Article 42(1) and (2)).

17. It is not the intention of the Convention to disturb the internal provisions of each State in relation to preferential debts. Accordingly, on the footing that there will continue to exist, within the EEC or some of its Member States, and under the Convention, a system of locally-enforceable preferential debts, enforceable against the locally-based assets of a debtor made bankrupt in another State, the question arises as to how this system is tobe administered by the liquidator in practice. It is plain that, in implementing the requirements of Articles 40 to 42, he will need to establish and maintain, in respect of each State wherein assets of the bankrupt were located at the opening of the bankruptcy, a notional "local assets-pool" (French "sous-masse") for the purpose of making appropriate distributions therefrom to those creditors who are established as having enforceable rights against it. But neither the Convention, nor the N-L Report, envisages or requires the setting-up of "sub-liquidations", or the appointment of "sub-liquidators". There is, however, power, under Article 28, to appoint more than one liquidator (one or more of whom may be qualified under the laws of a State other than the State of the bankruptcy), and for the liquidator or liquidators to employ agents to assist him, also drawn from that class.

18. The Convention's system for dealing with preferential debts out of a local assets pool is not, strictly speaking, in conflict with the twin principles of unity and universality upon which the Convention as a whole is founded. The duty of the liquidator, it seems, is to administer those assets for the benefit of the preferential creditors interested therein, making the book-keeping entries requisite for giving effect to the principles

contained in Articles 40 to 42. What is less certain is the extent to which a State's direct rights of recovery in relation to fiscal or quasi-fiscal debts impinges on those principles to the detriment of other categories of preferential creditors and to inhibit the liquidator from reducing them into his official possession.

Fiscal debts

19. In this Country the Crown no longer possesses, after a bankruptcy or winding-up has been opened, its former extensive rights of direct recovery from its debtors, by prerogative or other executive action. Similar rights do exist, however, in some Member States and Articles 21(3) and 42(1) envisage that such rights will continue to be exercisable, notwithstanding the opening of bankruptcy proceedings. Such rights are inconsistent with the basic philosophy of the Convention, but it seems unlikely that individual States will readily give up provisions designed to ensure the recovery of tax claims. Nor could a foreign liquidator expect to prevent a State obtaining payment of its claim out of assets located in its territory.

20. We think that the continued existence of prerogative rights of direct recovery by some, though not all, Member States, raises questions of a political nature on which we feel unable to express an opinion. However, we submit that serious consideration should be given to this problem. A system of "self-help" which gives government authorities an unfair advantage over other creditors, seems inconsistent with the Community's emphasis on the rights of individual persons and firms, and with the intention to foster trade across frontiers.

21. Revenue, customs and excise, social security and similar authorities will not be entitled to preferential rights in any State other than the State in which the debts are owed. However, Article 42 provides that such creditors may prove as ordinary unsecured creditors for the unsatisfied portion of their claims, even if the bankruptcy is administered in another Member State. This is completely contrary to existing rules of Private International Law, and would abrogate the rule in Government of India v Taylor (1955) A.C. 49 to the effect that, as a matter of public policy, an English (or Scottish) Court will not enforce a foreign revenue claim.

22. It is arguable that the existing rules were established in accordance with the then currently accepted notions of public policy and that such rules require modification in the light of membership of the EEC; that membership of such a Community necessarily involves the reciprocal recognition of the fiscal obligations owed to the public authorities of each Member State. In our view such arguments might hold substance if there was some harmonisation of fiscal and quasi-fiscal preferences and of the rights of recovery of such debts. We are firmly of the opinion that at the present level of harmonisation, it would be wrong to accept the extensions provided for in Article 42 and we recommend that the article should be rejected.

Civil and commercial preferences

23. In relation to debts other than fiscal and quasi-fiscal debts Article 40 provides that a person entitled to a preferential claim in any Member State is entitled, in so far as he has not exhausted that claim in respect of the assets in his own State, to claim as a preferential creditor in other Member States so far as the assets in, and the laws of, those States permit. The rational basis or premise of this principle is the concept that the Member States constitute a conceptual unity for the purposes of bankruptcy. In consequence, creditors in any Member States will enjoy, so far as the assets in the Member States permit, the most favourable rights accorded to them by the laws of any of those States. This is clearly beneficial to the preferential creditors (including employees) as a class but, equally, is detrimental to creditors who do not enjoy preferences.

24. We have received strong criticism that the principles governing distribution set out in Article 41 are confusing, complex and impractical. While we fully agree with this criticism, we think the basic principles set out in Article 40 are at fault. We do not consider it appropriate that, when a company is subject to liquidation, its creditors may be accorded preferences which may adventitiously arise, or vary in scope and amount, depending upon the existence or non-existence of assets in other Member States. We can see no logic in the assumption, implied by Article 40, that a worker in one country should be entitled to preferential claims available under the laws of another country, simply because there are assets in the latter country.

25. In our view, the balance of the Convention is excessively weighted in favour of preferential creditors. Moreover, it is essential that the principles on which the rules for preferences are based, should be logical and as simple to comprehend as possible. Under the present rules in the United Kingdom, a liquidator would allow all employees, no matter where employed or living, the preferences allowed by United Kingdom law. But where there are assets in a country whose laws allow greater preferences, the liquidator cannot usually prevent employees in that country from obtaining the higher rate of preference from the realisation of those particular assets. We have come to the conclusion that a system based on similar principles should be adopted. We recognise that some inequities might arise under certain conditions, but this will be so with any system short of complete harmonisation.

26. We recommend that in civil and commercial matters, the principles governing the distribution to preferential creditors should be as follows:

(1) A preferential creditor should be entitled to the preference allowed to him by the law of his own State, out of the assets available to him in that State.

(2) If those assets are insufficient to satisfy his claim, or the pecuniary limit on his claim as such preferential creditor in his own State is lower than the limit prescribed by the laws of the State of the bankruptcy, he may claim in addition such further sums preferentially as he would be able to claim under the law of the State of the bankruptcy, out of the residue of the assets.

27. In considering the system put forward above, it is necessary, firstly, to distinguish between the realisation of assets in the State of bankruptcy, upon which its own preferential creditors will have first claim, and the residue of realisations, which will be available for any operation of rule 2. Secondly, that realisations in non-Member States will form part of the 'residue' and not be aggregated with realisations in the State of the bankruptcy. Thirdly, that where the residue is insufficient to pay claims arising under rule 2 in full, a dividend will be paid in proportion to the amount of each claim.

28. By way of example: supposing the main assets are in England, the State of the bankruptcy, where employees are paid their full preferential rights of up to 4 months' arrears of wages with a maximum of £200 per person. Further, that available assets in Italy are only sufficient to pay workers employed in that country 2 months of their 12 month preferential claim, and assets in Belgium are only sufficient to pay workers in Belgium 3 months of their 6 month preferential claim. Under rule 2, both the Italian and the Belgian workers will be able to claim such additional sums preferentially as will bring their total individual preferential payments up to 4 months (or £200). Should the residue of realisations be insufficient to meet these claims in full, it will be divisible between all claimants in proportion to their claims.

Subrogation

29. It was apparently assumed in the course of the negotiations that the preferential creditor who might principally benefit from this system would be the employee for unpaid wages. In practice, it is found by insolveny practitioners in the United Kingdom that claims for unpaid wages due to employees as such play a relatively small part in an insolvency, but that the subrogated claims of bankers and others who have advanced wages or holiday remuneration may be extremely important.

30. Neither the Convention nor the N-L Report legislate for, or refer to the case of the subrogated creditor for wages advances. Accordingly, it seems possible that the right of subrogation might not be admitted to a preferential ranking by some Member States. We consider it most desirable that it be made clear in the Convention whether or not the debt claimed by a subrogated creditor for wages advances is to be accorded the same rights of preference as the employees whose wages have been paid out of the moneys advanced.

31. Representations have been made to us both for and against the principle of subrogation. It has been suggested that there have been numerous occasions when supporting action by banks has saved companies from untimely failure and that such support might not have been given had the banks not been subrogated to the rights of the employees, who would not otherwise have been paid. Where a company's fixed assets are specifically mortgaged in favour of long term debentures, it has been suggested that banks look principally to their ability to make advances on a wages account to provide them with security; without this, the banks' ability to finance companies through temporary difficulties would be seriously diminshed.

32. The main objections put forward are firstly, taking into account the rights of subrogation, and fixed and floating charges secured on the assets, banks obtain an undue degree of preference, leaving little, in most cases, for ordinary creditors. Secondly, that the Blagden Committee on Bankruptcy Law (July, 1957) reported that the practical application of section 319(4) of the 1948 Act was open to abuse and that its introduction into bankruptcy law might encourage a debtor to carry on his business with knowledge of insolvency. Thirdly, that a creditor who had supplied raw materials, for example, to enable a company to continue trading, should be in no worse position than a creditor who provided cash to pay wages.

33. The British Bankers Association is not unduly worried at the prospect of the loss of subrogatory rights and indicates that such loss would be to the disadvantage of the client companies rather than of the banks. The Scottish clearing banks, on the other hand, suggest that wages preferences enable a bank to assist in the preservation of a labour force in a company until a liquidator is appointed.

34. We note that the 1973 Companies Bill, which was not enacted, proposed that arrears of wages for the week next before the relevant date would rank superior to other preferential debts; that any subrogatory rights in respect of that week's wages would also be "pre-preferential" and that all other subrogatory rights would cease to have any effect. The Bill also provided for similar amendments to be made to the 1914 Act. We also note that the Employment Protection Bill provides that the Redundancy Fund should pay

up to 8 weeks arrears of wages, holiday pay, etc, to employees whose employers have become insolvent. The Bill gives the Fund exactly the same priority as the employee now enjoys. We understand that a similar, but more extensive scheme is under consideration in Germany.

35. We think that the provision of subrogatory rights in respect of moneys advanced to pay wages is as much a social problem as it is a banking problem. On balance, we recommend that subrogatory rights should be recognised by all Member States.