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An oddity in the appointment of administrators in Scotland

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Introduction

After the Insolvency Act 1986 was transformed by the Enterprise Act 2002 Professor Roy Goode commented, "To read the amended Insolvency Act 1986 it no longer suffices to be a lawyer; it is necessary to become a physical geographer in order to find one's way around provisions which are randomly dispersed among the body of the Act, the bizarrely numbered Schedules A1 and B1 and the Insolvency Rules, with seemingly no logic in the distribution nor any conception that it might be useful if all the provisions dealing with the same subject were brought together in clearly stated requirements." (R.M. Goode, *Principles of Corporation Insolvency Law*, preface to the 3rd edition (2005)).

For the Scots lawyer the apparent random dispersal of rules does not just include the schedules to the 1986 Act and the Insolvency Rules, but also includes residual provisions applicable to floating charges found in the Companies Act 1985 which are incorporated into parts of the 1986 Act in a manner that may create problems.

In this note the incorporation of one provision from the 1985 Act into the 1986 Act as a result of the amendments introduced by the 2002 Act is considered, and a potential problem thereby created in relation to the position where a debtor company has granted two floating charges is identified.

Schedule B1 to the Insolvency Act 1986 and when administrators may be appointed

One of the most substantial reforms of the 2002 Act was the enhancement of corporate rescue procedures with a revised and improved system of administration, introduced by s 248 of the 2002 Act, which replaced Part II of the 1986 Act as originally enacted with a new Schedule B1 to the 1986 Act (hereafter "Sch B1"). Under these provisions administrators can be appointed by the court on application by the company, its directors, or creditors (under paras 10 – 13 of Sch B1) or using an out of court process. The out of court appointment is initiated by the company or directors (paras 22 – 34, Sch B1); or by a qualifying floating charge holder (paras 14 – 21, Sch B1). As well as the power to appoint an administrator directly the floating charge holder has a range of enhanced powers when contrasted with other parties potentially interested in administration. When the appointment of an administrator is initiated by an application to the court the floating charge holder may intervene and nominate its own preferred administrator (para 36, Sch B1), or where the company or directors intend to appoint an administrator out of court the charge holder must be given five business days notice of a company's intention to appoint an administrator (para 26, Sch B1) and during this time can initiate its own appointment of an administrator.

It is possible for there to be more than one creditor holding a floating charge over the assets of a debtor company. Where this occurs things get a little more complicated. In the provisions where the floating charge holder is entitled to receive notifications or to intervene, the rules are framed

generally to cover any (as in para 36, Sch B1) or all floating charge holders (as in para 26, Sch B1). However, where a floating charge holder has the power to appoint an administrator under para 14, Sch B1, what happens where there is more than one floating charge holder? Paragraph 15 of Sch B1 provides that a floating charge holder who wishes to appoint an administrator out of court must give two business days written notice to a prior floating charge holder. Given the notification that prior floating charge holder can then appoint its own choice as administrator. Who has the priority?

The ranking of floating charges outwith the appointment of administrators

Determining priorities between secured creditors is not uncommon in law. The law relating to ranking is about regulating these competitions. There are sophisticated common law rules (summarised by G.J. Bell in his Canons of Ranking in Volume II, p 413 of *Commentaries on the law of Scotland* (7th ed, ed McLaren)). And where the security is a wholly statutory creation, as with the floating charge, there are detailed legislative provisions. The rules regulating the ranking of floating charges are found in s 464 of the Companies Act 1985. This is, as lecturers advise students in a world weary way, a provision which repays careful study.

Section 464 sets out rules regulating competitions between the floating charge and involuntary securities such as lien and the landlord's hypothec (In subsection (2), discussed in *Grampian Regional Council v Drill Stem (Inspection Services) Ltd* 1994 SCLR 36) and a series of default rules applicable to competing voluntary securities (such as another floating charge, or a pledge, or a standard security) in subsection (4).

In these default rules where the floating charge is in competition with a voluntary security that is not a floating charge priority is determined by which is made a real right first (1985 Act, s 464 (4)(a) – a floating charge becomes a real right on attachment: *National Commercial Bank of Scotland Ltd v Liquidators of Telford Grier Mackay & Co Ltd* 1969 SC 181). Where the competition is between floating charges s 464 (4)(b) provides:

> "floating charges rank with one another according to the time of registration in accordance with Chapter II of Part XII".

And s 464 (4)(c) then provides for *pari passu* ranking if the floating charges are received by the registrar in the same postal delivery.

Chapter II of Part XII of the 1985 Act set out the rules on registration of company charges but was repealed by Companies Act 2006, Sch 16. The reference to Part XII in Section 464 remained unamended. However, the interpretation Act 1978, s 17 (2)(a) provides that where provisions are repealed and re-enacted (with or without modification) then reference to the repealed provision is to be construed as reference to the re-enacted provision. The legislation on registration of company charges was originally re-enacted as Part 25 chapter 2 of the 2006 Act, and this was itself repealed and replaced with Part 25, chapter A1 of the 2006 Act (inserted by The Companies Act 2006 (Amendment of Part 25) Regulations 2013 (SI 2013/600)). Thus, s 464 (4)(b) is now read as providing that "floating charges rank with one another according to the time of registration in accordance with Chapter A1 of Part 25 of the Companies Act 2006".

Section 464 (4) though only applies as a default rule. Section 464 (3) provides that the default rules in s 464 (4) do not apply where ranking is determined by a provision which is inserted in the floating charge itself. Such provisions are typically negative pledge clauses – a clause which prohibits the granter of the floating charge from creating a fixed security or further floating charge which would rank in priority to or *pari passu* with the floating charge (with or without consent). Negative pledge

clauses are used almost invariably in floating charges in practice (see Scottish Law Commission, *Report on registration of rights in security by companies* (Scot Law Com no 197, 2005) para 2.18) and so the default rule in s 464 (4) is rarely, if ever, used.

Where a floating charge contains a negative pledge clause the ranking is governed by the terms of the clause, or by s 464 (1A) of the 1985 Act, with the charge with negative pledge clause ranking in priority to any security (fixed or floating) which is created subsequent to it. This is confirmed by *AIB Finance Ltd v Bank of Scotland* 1993 SC 588.

To illustrate how the provision works consider an example. A Ltd grants and delivers a floating charge to Bank B containing a negative pledge clause prohibiting A Ltd from granting another security on February 1st and it is registered on 20th February, and A Ltd grants and delivers a floating charge to Bank C on February 10th which is registered on February 15th. The existence of the negative pledge clause means that Bank B, although registering after Bank C, will have the first ranking floating charge. Without this clause s 464 (4)(b) would mean that Bank C would rank ahead of Bank B.

The first ranking floating charge gives a priority in distribution of the assets of the debtor company – given its nature as a right in security. However, as is well known the floating charge is an unusual right in security. Where other rights in security give the secured creditor a power to realise the secured assets to pay off the secured debts a Scottish floating charge holder has no such right (cf the position in England: L Gullifer, *Goode and Gullifer on Legal Problems of Credit and Security* (6th edn, 2017) para 4.64). Instead the floating charge holder has the power to appoint an administrator (or – in limited cases under Insolvency Act 1986, ss 72B -72GA, or where the floating charge was created before 15 September 2003 (1986 Act, s 72A and Insolvency Act 1986, Section 72A (Appointed Date) Order 2003 (SI 2003/2095)) a receiver). It is this power of appointment that lies at the heart of the effectiveness of the floating charge to creditors and which prompts Prof Mokal to perceptively refer to the floating charge as a "residual management displacement device" (RJ Mokal, *Corporate Insolvency law: Theory and applications* (2005) p 223).

Priority of floating charge holders in the appointment of an administrator – a Scottish oddity

Given that the means for a floating charge holder to enforce the charge out of court is the power to appoint an administrator under para 14 of Sch B1 one would imagine that the floating charge holder with priority to appoint as determined by para 15 of Sch B1 should be the same person as the first ranking floating charge holder. This seems to be the case for England. Paragraph 15 (2)(a) of Sch B1 provides that the prior ranking floating charge is that which was created first, while para 15 (2)(b) provides that where the floating charge holders have entered a ranking agreement this will be respected. Paragraph 15 (2)(a) mirrors the English common law set out in *Re Benjamin Cope Ltd* [1914] 1 Ch 800. With no ranking agreement the first floating charge to be created has priority in ranking and has priority in determining who has the ultimate power to appoint an administrator.

However, for Scotland para 15 (2)(a) is amended by para 15 (3). This provides that para 15 (2) has effect in Scotland "as if" the words "it has priority of ranking in accordance with section 464 (4)(b) of the Companies Act 1985." "were substituted for" para 15 (2)(a).

The Scottish para 15 (2)(a) therefore reads:

> "One floating charge is prior to another for the purposes of this paragraph if –
>
> (a) It has priority of ranking in accordance with section 464 (4)(b) of the Companies Act 1985 (c. 6)"

This Scottish specific provision is an odd one.

It does not refer to s 464 of the 1985 Act generally – which is the section of the Act which regulates ranking (and hence priority) of floating charges. The rules on ranking of competing floating charges emerge from s 464 (1), (1A), (3), and (4) (with effect for subs (5) where there is notification by one charge holder to a prior charge holder). The amended para 15 (2)(a) in Sch B1 refers only to the default rule in s 464 (4)(b). And as we know from the work carried out by the Scottish Law Commission the default rule of s 464 (4) rarely applies because nearly all floating charges include a negative pledge clause.

At first sight then it appears that the natural reading of the provision is that by referring to a specific paragraph of a specific subsection of section 464 the rule undermines the normal rules of ranking floating charges.

Consider the example given earlier again. For the purposes of ranking in relating to priority of payment in the distribution of the assets of the company Bank B takes priority over Bank C because Bank B's floating charge was created first with a negative pledge clause prohibiting later charges. This is the effect of s 464 (1), (1A) and (3) of the 1985 Act. But for the purposes of appointing an administrator the prior floating charge as defined by para 15 (2)(a) (as inserted by para 15 (3)) of Sch B1 the order of priority is determined by s 464 (4)(b) of the 1985 Act. As Bank C registered the floating charge before Bank B, Bank C will have the ultimate power to appoints its nominee as administrator irrespective of the existence of a negative pledge clause.

It may be possible to avoid this outcome through a purposive reading of para 15 (2)(a) (as applicable to Scotland). Can the provision really be intended to undermine the normal rules of ranking of floating charges in s 464 of the 1985 Act, especially when the English version of para 15 (2)(a) appears to be in accordance with their normal rules of ranking?

One alternative reading might be to give enhanced weight to the words "in accordance with" in the substituted para 15 (2)(a). It could be argued that the priority given to the first registered floating charge will only arise where s 464 (4)(b) would otherwise give the first registered floating charge priority (ie, in a case where there is no negative pledge clause in a prior created floating charge). In that case though it would mean that para 15 (2)(a) would only apply in the unusual circumstances where a competition between floating charges was not resolved with a negative pledge clause. This would mean that the priority of ranking in para 15 (2)(a) would have to be resolved by some other means, probably the default law under s 464 of the 1985 Act. This though means that para 15 (2)(a) (as inserted by para 15 (3)) would be meaningless. Reference to s 464 (4)(b) only applying in those instances where the rest of s 464 does not apply is effectively how s 464 of the 1985 Act applies anyway. And this would run counter to the general presumption that "every word in a statute must be given some effective meaning". (*McMonagle v Westminster City Council* [1990] " AC 716, at 726D (per Lord Bridge). This presumption against surplus words in legislation is very strong.)

This then pushes towards suggesting the natural reading is the appropriate one. Paragraph 15 (2)(a) creates a different rule of priority for floating charge holders in appointing an administrator than the rule of priority which determines the order of payment.

It may be thought that para 15 (2)(b) can help with this problem. This provides that the prior floating charge holder can be determined through considering who is given priority "in accordance with an agreement to which the holder of each floating charge was party." While this applies where there is a ranking agreement between charge holders the ranking provisions in s 464 of the 1985 Act affecting negative pledge clauses apply without any requirement for agreement of any subsequent

secured creditor, including the holder of any floating charge granted after the negative pledge clause.

The effect of the inserted para 15 (2)(a) is an odd consequence, resulting from the provision being too specific. An amendment to provide that for Scotland para 15 (2)(a) takes effect as if “it has priority of ranking in accordance with section 464 of the Companies Act 1985” would avoid the potential problem and ensure that as a management displacement device, and as a right in security, a first granted floating charge with a negative pledge clause should have priority.