Who gets the Pie? Distribution in UK corporate insolvency

Asad Khan asks who gets the biggest share of the pie during an insolvency

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It has been over 20 years since data was analysed to assess the rate of return to creditors, specifically those unsecured, during corporate insolvency. The last similar research was by R3 in 2001.[1] This article provides an overview of a recent empirical study conducted by the author.[2]

A company usually goes insolvent when it cannot satisfy its debts. There are around 20,000 corporate insolvencies in the UK every year.[3] During distribution, fixed charge holders are repaid first, followed by provisions for expenses, preferential creditors, prescribed part contributions, floating charge holders, unsecured creditors and, finally, deferred claimants.[4]

In 2001, R3 found that unsecured creditors received on average less than 7% repayment of debt and got nothing in over 75% of corporate voluntary liquidations ('CVLs'). The research was based on surveys and is fairly dated. Arguably, there was a need to provide updated statistics that examines a creditor's realistic prospect of repayment during insolvency. This may not only help parties assess their scope for returns and contract accordingly, but it could also help reveal areas for development to the regime.

Empirical research project findings

The empirical research discussed here analysed over a thousand English CVLs initiated between 2016 and 2018. Only concluded cases with complete data were examined. CVLs were chosen because they represent the most frequently occurring insolvency process, meaning that findings could be projected on all corporate insolvencies more generally.[5]

The research shows that the most regularly featured type of creditor in a CVL was the unsecured creditor, followed by the fixed charge, floating charge and then the preferential creditor. In terms of debt, the unsecured creditor was owed the most, followed by the floating charge, fixed charge and, lastly, the preferential stakeholder. This is to be expected as there will usually be many unsecured parties and only a few fixed, floating and preferential creditors. Interestingly, there were many instances where single unsecured creditors were owed significant sums and the class was not merely made up of several debts of insubstantial amounts.

Even after discounting HMRC's interests (the Crown was unsecured back then), it is still the unsecured creditor who was owed the most. However, unsecured parties got less than 2% in repayments. Furthermore, unsecured creditors enjoyed distribution in just 10% of CVLs and not 25% as found by R3. The position of unsecured creditors is effectively much more dire than previously thought.

It is perhaps expected that, as unsecured creditors are low in the order of priority, they would suffer. However, even secured creditors (fixed and floating charge holders) did not enjoy majority repayment, despite their superior rank. Fixed charge holders received about 50% repayment, while for the floating charge it was less than 2%. These findings question the ability of such instruments to mitigate against the risk of a debtor's insolvency. For preferential creditors, the rate of return was around 13%.

The fact is that a debtor goes insolvent because there are not enough assets to satisfy debts. Hence, it is understandable that all creditors face low returns. However, the question is why fixed charge holders only enjoyed 50% repayment and not more? By getting repaid first, the fixed charge holder should arguably be able to secure their interests fully or at least to a larger extent. Some explanations could be that the creditor under-secured their debt or the value of the asset diminished over time. For our purposes, it is noteworthy that returns to fixed charge holders are seldom over 50%.

Principally, there are no winners during distribution, as none of the creditors recoup a majority of their debt. If there is a so-called winner, it is the expenses of proceedings. Costs claimed over half the available realisations. Of the 900 CVLs where assets were available, expenses depleted the estate 80% of the time.

Though in many cases the available funds were low, it is still significant that expenses claimed over 51% of realisations and cost £10,000 on average. CVLs took about 2 years to conclude, during which time costs were being incurred to the detriment of distribution. Lower expenses would result in more available realisations to repay creditors. As such, cost and time efficiency emerge as important areas for improvement.

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The research also questions the significance of the prescribed part. Payments were only made in 4% of cases where a floating charge featured in the population, and the value of the fund covered less than 3% of unsecured debt. For a tool created to better the position of unsecured creditors,[6] the prescribed part arguably makes an insignificant impact. This is yet another area for development.

Regarding preferential parties, despite enjoying priority, the creditor class was repaid less than 13% of debts. Arguably, preferential status fails to provide adequate protection to those subject to it. The National Insurance Fund currently takes the place of employees during distribution. However, with just 13% rate of repayment, the Fund is potentially subrogating employees at a high cost to itself. Thus, improving protection to preferential creditors and lowering the National Insurance Fund's costs could be another area for reform.

HMRC recently became a secondary preferential creditor.[7] In many instances, the Crown is the single largest creditor. As an unsecured party, HMRC received less than 2% repayment. With preferential status, estimates claim that the Crown may recoup £195m every year.[8] However, according to this research, the likelier outcome is that HMRC would recoup just £20m per year and not £195m. This is a substantial difference.

As HMRC is well-diversified and gets around £800bn in tax each year,[9] an additional £20m, or £200m for that matter (which is just 0.025% of £800bn), is arguably insignificant. As a result, it could be maintained that Crown preference is unjustified. It may be better if, instead of prioritising HMRC, realisations are used to repay creditors who are potentially more directly affected by a debtor's insolvency. This may result in greater prospects for traders to be repaid, employees to receive wages, and customers to get refunds. Additionally, Crown preference may encourage HMRC to file for claims which could negatively impact the success of a potential rescue.

Summary

So, who gets the pie during insolvency? The answer is that everyone just gets crumbs. There are too many creditors, with too big an appetite, and not enough pie. What is more, half the pie is lost to costs.

Fixed charge holders enjoy the greatest rate of repayment, but they just get back half of their debt. For a creditor who is repaid first, it is surprising that the rate of return is not higher. Preferential creditors are second with 13% and then come floating charge holders and unsecured creditors who get less than 2%. Despite being owed the most, unsecured creditors get minimal returns. Compared to R3's findings, the data shows that the position of unsecured stakeholders is much more miserable.

The research highlights certain areas for improvements that could increase returns to creditors. The most obvious is to lower costs and make proceedings more efficient. Such discussions, however, go beyond the scope of this article. ■

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Footnotes:

1 The Association of Business Recovery Professionals, *Surveys of Business Recovery in the UK* (9th Survey 2001), 7 and 18, available at: www.spi.org.uk/9thc/. This study was cited in Riz Mokal, *Corporate Insolvency Law: Theory and Application* (OUP, 2005), 95. Also see Riz Mokal, 'Priority as Pathology: The Pari Passu Myth' (2001) 60(3) *Cambridge Law Journal* 581, 589.

2 An extended article was published in: (2023) 32(3) *International Insolvency Review* 447.

3 There were 22,109 in 2022. See Insolvency Service, Commentary – *Company Insolvency Statistics October to December 2022* (National Statistics, 31 January 2023), available at: www.gov.uk/government/statistics/company-insolvency-statistics-october-to-december-2022/commentary-company-insolvency-statistics-october-to-december-2022

4 Kristen van Zwieten (ed), *Goode's Principles of Corporate Insolvency Law* (5th edn) (Sweet & Maxwell, 2019), 2. Also see Vanessa Finch and David Milman, *Corporate Insolvency Law – Perspectives and Principles* (3rd edn) (Cambridge University Press, 2017), 56.

5 For example, see *Insolvency Service, Insolvency Statistics – October to December 2017* (National Statistics, 26 January 2018), available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/675931/Insolvency_Statistics_-_web.pdf; idem, *Insolvency Statistics – October to December 2018* (National Statistics, 29 January 2019), available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/780233/Commentary_domain_update.pdf

6 van Zwieten (ed) (above note 4), 243–245.

7 Pursuant to section 98, Finance Act 2020.

8 The Law Gazette, 'R3 Warns of Consequences of Finance Bill Insolvency Creditor Changes' *(The Law Gazette, 24 July 2020)*, available at: www.thegazette.co.uk/all-notices/content/103789. Also see HMRC, *Introduction of Changes to Protect Your Tax in Insolvency* (Policy Paper, 11 March 2020).

9 Matthew Keep, *Tax Statistics: An Overview (House of Commons Library*, 16 January 2023), available at: https://researchbriefings.files.parliament.uk/documents/CBP-8513/CBP-8513.pdf>.