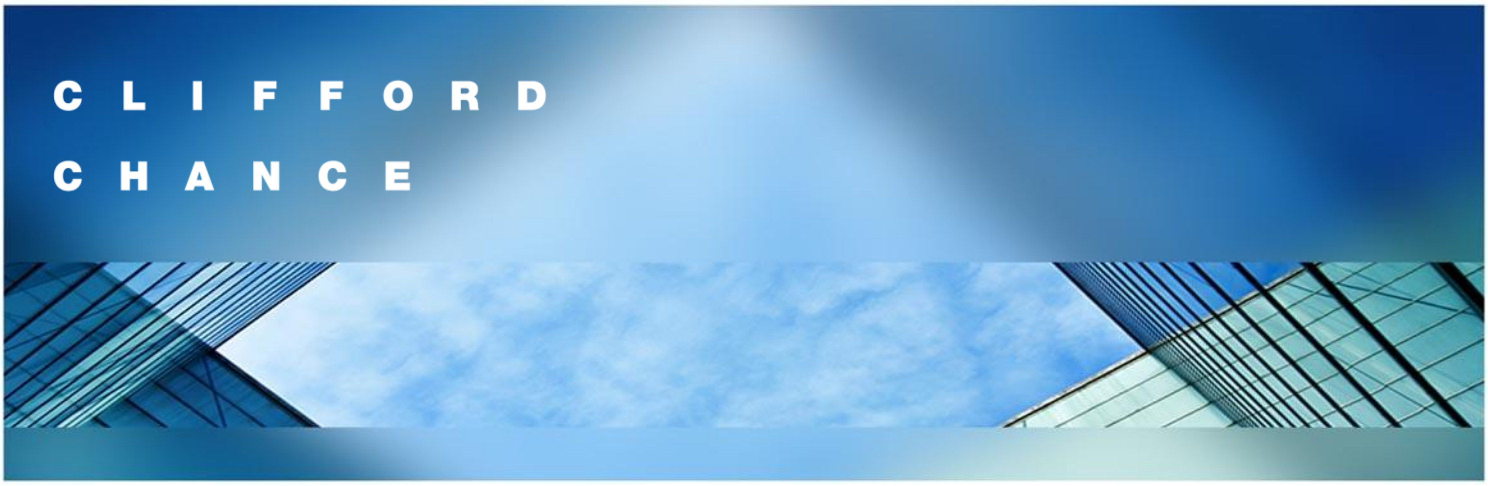

THE PARTIAL RESTORATION OF UK CROWN PREFERENCE WITH EFFECT FROM 1 DECEMBER 2020

As of 1 December 2020, The Insolvency Act 1986 (HMRC Debts: Priority on Insolvency) Regulations 2020 will come into force, partially restoring the Crown's status as a preferential creditor in the order of distribution in insolvency proceedings. It will also apply to all insolvency proceedings commenced after 1 December 2020 **even where** the floating charge security was created prior to that date, having retrospective application in this respect.

Key issues

- A new priority for VAT, PAYE and employee NIC in insolvency proceedings commenced after 1 December
- Means that HMRC ranks ahead of floating charge holders and unsecured creditors
- New priority applies to floating charges created before 1 December

This means that while HMRC will continue to rank behind fixed charge holders and expenses, it will now rank ahead of floating charge holders and unsecured creditors for the following taxes collected and held by businesses on behalf of their employees and customers: i) VAT; ii) PAYE Income Tax; iii) employee National Insurance contributions; iv) student loan deductions; and v) Construction Industry Scheme deductions (collectively, **preferred priority taxes**).

Consequently, the order of distribution will be as follows:

1. Fixed charge holder(s)
2. Liquidation/administration expenses
3. Preferential creditors
   - Ordinary preferential creditors (e.g. deposits under FSCS, employee wages, holiday pay etc.)
   - Secondary preferential creditors (e.g. deposits not protected by FSCS **and now payments due to HMRC for preferred priority taxes**)
4. The prescribed part for unsecured creditors
5. Floating charge holder(s)
6. Unsecured creditors (**including, as will continue to be the case, HMRC in respect of any corporation tax, employer National Insurance contributions and capital gain taxes**)
7. Shareholders

This therefore shows a partial restoration of Crown preference since HMRC's position prior to 2003 was as a secondary preferential creditor for all unpaid taxes, not just preferred priority taxes.

While one may appreciate the basis of the government's policy, in that a number of recent high-profile corporate failures have drawn heavily upon financial support from public funds, the partial restoration of Crown preference has not been well received. Criticism has centred on the threat to the UK's rescue culture and its chilling effect on unsecured creditors, as well as it potentially being a catalyst for insolvencies, and a self-defeating policy in light of all the government support being offered due to the pandemic, including a deferral of certain taxes.

Despite this frosty reception, the government has concluded that the partial restoration of Crown preference will not have any significant economic impact, essentially on the basis that the taxes ought to have been paid over in the ordinary course of business. It may also be seen as a responsible action for the government to take to protect the public purse in these uncertain economic times. Yet, there are arguments that it may in fact have negative consequences for many stakeholders including the many businesses which are at the heart of the government's rescue strategy.

Unsecured creditors

The revised order of priority will mean unsecured creditors will recover a reduced amount in an insolvency with knock-on effects felt by their businesses. A mitigating factor, however, is that the maximum amount of the prescribed part was increased under Insolvency Act 1986 (Prescribed Part) (Amendment) Order 2020 from £600,000 to £800,000. In so far as trade creditors are concerned, it could see a revival in retention of title claims.

Borrowers

Personal guarantees from directors may be requested by lenders, increasing borrowers' financial risk and personal liability. Borrowers may also be asked to give representations that their tax is paid up to date and to provide their lender with a regular reports of their tax position. While this may be an administrative burden, it may mean that borrowers will continue to be prudent and keep a closer eye on their financial liabilities.

Lenders

While there may be fewer incentives for lenders to provide finance secured by a floating charge and an unsecured basis, with them looking to take fixed security where possible, lenders will be able to bolster their position in a variety of ways. Lenders may want to strengthen their comfort package by asking for personal guarantees by directors of the company to whom they may lend in addition to asking for tax representations in their finance agreements. It may also encourage asset backed finance where it is possible to take fixed charges, as well as assignments, or invoice discounting.

Restructuring more generally

Restructuring may become more protracted especially where preferential creditor consent or funding is required e.g. company voluntary arrangements and there is a fear that HMRC will be hawkish to trigger insolvencies due to their statutory duty to collect tax. However, it is hoped HMRC will avoid such a hawkish approach and look to the potential greater returns if the company is restructured.

Finance market

The uncertainty created by the partial restoration of Crown preference may mean that finance becomes more expensive and harder to access, not only for financially distressed companies, but also SMEs which tend to have fewer assets over which lenders can take fixed security. The timing of the reversal therefore seems out of step with other government efforts to ensure that businesses have access to funding during the pandemic. Despite this, an upside may be that there will be greater dialogue between lenders and borrowers in the market with increased transparency as to the borrower's financial and tax position.

If you would like to hear more about the effects of the partial restoration of Crown preference please contact our restructuring and insolvency team or your usual Clifford Chance contact.

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