

Insolvency & Restructuring - Ireland

Crystallisation of floating charge and liability to pay preferential creditors

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The Irish High Court⁽¹⁾ has held that, under Irish law⁽²⁾, preferential creditors in a winding up must be paid in priority to the claims of the holders of debentures under floating charges which crystallise before the commencement of the winding up.

The case concerned a floating charge which contained a provision entitling the bank to serve a notice converting the floating charge into a fixed charge in respect of any of the charged property in jeopardy, and for automatic crystallisation in circumstances such as possession being taken by debenture holders. The bank served a notice stating that it considered the charged property to be in danger and stated: "we hereby convert the floating charge contained in the debenture into a first fixed charge."

Subsequently, a liquidator was appointed. He applied to court for directions as to whether it was the case that preferential creditors did not have to be paid in light of the crystallisation of the floating charge into a fixed charge prior to liquidation.

This issue had been decided in England and Australia⁽³⁾ (with some dissension and criticism) on the basis that preferential creditors did not have to be paid, and legislative changes⁽⁴⁾ were introduced in those countries to restore entitlements of preferential creditors whenever the charge was a floating charge at the time it was created.

However, the Irish High Court held that the Irish legislative provisions do give priority to preferential debts over the claims of holders of debentures under floating charges which crystallise prior to the commencement of winding up.

Ms Justice Finlay-Geoghegan pointed out that:

- the right of the debenture holder derives from the floating charge created by the company and it is the nature of the right which is changed by crystallisation;
- it is of the essence of a floating charge that it is a charge which will change in nature prior to realisation, with the nature of the security post-crystallisation being a fixed charge; and
- the Irish legislation gives priority in a winding up "over the claims of holders of debentures under any floating charge created by the company" and not over the claims of the holders of any floating charge.

The judge stated:

"It appears to me that the phrase 'holders of debentures under any floating charge created by the company' is deliberately worded, having regard to the potentiality for a floating charge to crystallise and become a fixed charge so as to include persons who hold security of whatever nature, provided it is held under or by reason of a floating charge created by the company. It is the floating charge created by the company which gives the bank the right to make a claim to the assets. It is only the nature of the claim which changes post-crystallisation. The bank's claim to the charged assets remains a claim as the holder of a debenture or security under the floating charge created by the company. Similarly, in my judgment the word 'charge' in the phrase 'property comprised in or subject to that charge' refers to the floating charge created by the company, notwithstanding that by reason of crystallisation, such floating charge may have become fixed on such property prior to the commencement of winding up.

Accordingly, in my judgment, the proper meaning of Section 285(7) is that preferential debts rank in priority to the claim of the bank, as debenture holder, to the funds realised from the assets subject to the floating charge pursuant to Clause 5 of the debenture, irrespective of whether the floating charge crystallised prior to the commencement of the winding up."

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In relation to the concept of automatic crystallisation, although she stated that it was not strictly necessary for her to consider that issue, the judge reviewed the position. She agreed with the analysis and conclusion of Judge Hoffman in the English case of *In Re Brightlife Limited*(5), when he stated:

"It is true that the commercial inconvenience of automatic crystallisation gives rise to a strong presumption that it was not intended by the parties, very clear language will be required. But that does not mean that it is excluded by a rule of law."

As to the argument that the courts should not uphold automatic crystallisation clauses on public policy grounds, the judge stated that, having regard in particular to existing legislative intervention on the rights of chargeholders, it is a matter for the legislature and not the courts to intervene in order to avoid an unfair adverse impact on third-party creditors from contractual arrangements which may be entered into between a debenture holder and a company.

She further stated:

"I am of the view that there is no rule of law which precludes parties to a debenture creating a floating charge agreeing, as a matter of contract, that the floating charge will crystallise upon the happening of an event or a particular step being taken by the chargee. Whether the parties actually achieve their intention is a separate issue... it appears to me... where a debenture expressly provides that a chargee may, by service of a notice, effect a crystallisation of a floating charge over all the assets or specified assets, the mere fact that the debenture so provides does not of itself mean that the service of the notice, has the intended effect (ie, the floating charge crystallises) – this issue must be determined by a construction of the terms of the debenture and the notice served, rather than any subsequent actions by either party."

*If the service of the notice pursuant to Clause 10, in reality had the effect of converting the floating charge over the book debts and stock in trade of the companies into a first fixed charge on such assets, then it must also have effected an equitable assignment of such assets to the Bank. As a consequence, the companies would have lost the ability to deal in or dispose of those assets, save to the extent permitted by the bank. The court appears obliged, in accordance with the judgments in *In Re Keenan Brothers*(6) to determine whether, in reality, such was the effect of the service of the notice, pursuant to Clause 10 having regard to the other provisions of the debenture and the notice served.*

It is not clear to me from the terms of the debenture itself whether the debenture provided that, on service of a notice pursuant to Clause 10, any restrictions come into force on the company's ability to deal with assets which were formally subject to the floating charge but which are now intended to be subject to a fixed charge. The notice served did not contain any such requirement".

The judge pointed out that the above issue did not have to be resolved in the case before her, and stated that if it required resolution in the future, it would have to be further argued and submissions made. She added: "It would probably be necessary to consider further the nature of the assets subject to the floating charge created."

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Endnotes

(1) In *JD Brian Limited and the Companies Acts*, 2011 IEHC 113; Irish High Court, Judge Finlay-Geoghegan.

(2) Section 286(7)(b) (preferential payments in a winding up) of the Companies Act 1963 states:

"so far as the assets of the company available for payment of general creditors are insufficient to meet them, have priority over the claims of holders of debentures under any floating charge created by the company, and be paid accordingly out of any property comprised in or subject to that charge."

(3) *Griffin Hotel Company Limited* [1940] 1 Ch 129 [England] and *Stein v Saywell* [1969] 121 CLR 529 (majority decision of the High Court of Australia).

(4) See Section 40 of the UK Insolvency Act 1986.

(5) *In Re Brightlife Limited* [1987] Ch 200 [England].

(6) *In Re Keenan Brothers* [1985] IR 401, Irish Supreme Court.

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