MALAYSIAN INSTITUTE OF ACCOUNTANTS
ACCOUNTANTS: MANAGERS OF VALUE

IGN R3

INSOLVENCY GUIDANCE NOTE

A Receiver's Responsibility to Preferential Creditors

November 2009

TABLE OF CONTENTS

Paragraphs

FOREWORD

This foreword has been approved by the Council of the Malaysian Institute of Accountants for publication. The Guidance Notes represent what constitutes good practice in stated areas of insolvency.

The Guidance Notes are issued with the view to harmonising the approach of members to questions of insolvency practice. However, the Institute recognises that there may be instances where the circumstances encountered by a practitioner render it inappropriate for the guidance given in a particular Note to be followed.

The Guidance Notes are prepared from the perspective of an insolvency practitioner operating under the laws of and practices in Malaysia. Nevertheless, the Notes are not intended as a definite interpretation of the law, and the Institute disclaims liability for any loss or penalty suffered, or claims sustained, by any member as a consequence of his following the procedures set out in the Guidance Notes.

The Guidance Notes do not form part of the Institute's By-Laws (On Professional Conduct and Ethics) [Revised 1 January 2007].

It is believed that the issuance of the notes will help to improve the quality of insolvency practices. They are not prescriptive in nature. The notes are for guidance only. However, in determining the acts of members in the performance of their respective duties, the Council may take into consideration the recommended practices as contain in these IGNs.

EFFECTIVE DATE

These IGNs are effective for members to observe from the date of issuance and these are set out in each of the IGN proper.

Introduction

1. This Guidance Note has been prepared to summarise what is considered to be the best practice to be adopted by the Receiver of the assets of companies where any of those assets are subject to a floating charge so that the Receiver has legal obligations to creditors whose debts are preferential. Its purpose is to:

   a. ensure that members are familiar with the statutory provisions;

   b. set out best practice with regard to the application of the statutory provisions; and

   c. set out best practice with regard to the provision of information to creditors whose debts are preferential and to responses to enquiries by such creditors.

2. This Guidance Note has been produced in recognition of the likelihood that creditors whose debts are preferential may be concerned about the categorisation of assets as between fixed and floating charges and the manner in which costs incurred during a receivership are charged against the different categories of assets.

Definitions

3. Except where otherwise stated or indicated by the context in which they appear, the following terms have the respective meanings shown for the purposes of this Guidance Note:

   "Act" means the Companies Act 1965.

   "Court" means the Courts in Malaysia.

   "Guidance Note" means the Insolvency Guidance Note ("IGN") as approved by the Council of the Malaysian Institute of Accountants.

   "Receiver" means Receiver, Manager or Receiver and Manager as the case may be and whether appointed by the Court or any other instrument and whether appointed over specific assets or substantial or whole of the assets of the subject Company.

   "Section" means the Section or Sections of the Act.

The Statutory Provisions

4. The rights of creditors whose debts are preferential in a receivership derive from Section 191 of the Act. Where a Receiver is appointed by or on behalf of the holders of any debentures of a company secured by a charge which was a floating charge at the date of the appointment of the Receiver and the company is not at the time in the course of being wound up, its preferential

debts shall be paid out of the assets coming into the hands of the Receiver in priority to any claims for principal or interest in respect of the debentures. Where the Receiver is appointed under both fixed and floating charges, this requirement does not extend to assets coming into the Receiver's hands pursuant to the fixed charge(s). Preferential debts are defined in Section 292 of the Act and should be read together with Section 191.

5. Members should note that the statutory provisions give a right to creditors whose debts are preferential to be paid those debts in priority to the claims of floating charge holders, and the corollary of this right is the obligation of the Receiver to pay them. Failure by a Receiver to pay preferential debts out of available assets is a breach of statutory duty.

6. There are no statutory provisions requiring creditors with preferential debts in a receivership to prove those debts in any formal manner and no statutory obligation is imposed on a Receiver to advertise for claims.

Categorisation of Assets and Allocation of Proceeds

7. In order to ascertain what assets are subject to the statutory rights of creditors whose debts are preferential, it is necessary to distinguish, on a proper interpretation of the charging document(s), which assets are subject to a fixed charge and which are subject to a floating charge. In this statement, this process is referred to as 'categorisation'.

8. The overriding principle, as laid down by the courts, is that it is not of itself sufficient for the charging document to state that an asset is subject to a fixed charge for it to be subject to such a charge. There have been cases where the courts have struck down charges that purported to be fixed and held that they were floating.

9. It is the duty of a Receiver to effect the right categorisation and legal advice should be taken in cases of doubt. In some instances where there is doubt as to the correct categorisation it may be possible to consult preferential creditors and reach agreement with them and the debenture holder. However, if this is not possible and the Receiver, in conjunction with his legal advisers, cannot determine the correct categorisation, it may be necessary to apply to the Court for directions.

10. Members are reminded that the conversion, during receivership, of assets (e.g. stocks) subject at the date of appointment of the Receiver to a floating charge into assets (e.g. book debts) subject to a fixed charge, will not remove them from the pool of assets which is available to pay preferential debts.

11. Section 191 of the Act requires that the preferential debts shall be paid out of the [floating charge] assets coming to the hands of the Receiver in priority to the debenture holder. The effect is that a Receiver is under a liability in tort to the preferential creditors if, having had available assets in hand, he fails to apply them in payment of the preferential debts. Where any action

which he proposes to take could result in a diminution in the amount available to meet preferential debts, the Receiver should give the most serious consideration to the risks of such action.

12. When assets are sold as part of a going concern (or otherwise in parcels comprising both fixed and floating charge assets) the apportionment of the total consideration suggested by the purchaser (for example for his own financial reasons) may not properly reflect the financial interests of the different classes of creditors in the individual assets or categories of assets. In these circumstances, the Receiver should ensure that he will be able to properly discharge his obligations to account to holders of fixed charges on the one hand and creditors interested in assets subject to floating charges on the other.

Apportionment of Costs

13. The amount available to meet preferential debts is the funds realised from the disposal of assets subject to a floating charge net of the costs of realisation. It is dependent, therefore, not only on the correct categorisation of the assets but also on the appropriate allocation of costs incurred in effecting realisations.

14. These costs will normally fall into one of three categories:

    a. liabilities incurred by the company (the Receiver being its agent until winding up) and costs incurred by the Receiver and recoverable by him out of the company's assets under his statutory indemnity (other than those referred to below);

    b. the costs of the Receiver in discharging his statutory duties;

    c. the remuneration and disbursements of the Receiver.

15. Liabilities incurred by the company and the Receiver's reasonable costs are sometimes readily identifiable as applicable to either the fixed charge or floating charge assets, but in other cases may not be so easily allocated between the two categories of assets. Where costs are clearly identifiable as having been incurred in the realisation or collecting in of one or other of the two categories they should be recorded as such in the Receiver's records so that they can be deducted from realisation proceeds in ascertaining the amount available for each class of creditors.

16. It is in the nature of receiverships, and particularly receiverships where trading is continued, that there will be continuation of employment of the company's directors and staff, ongoing occupation of its premises, purchase of supplies for manufacturing and other purposes and much of the other expenditure normally associated with a company's operations. In these circumstances it may be difficult to arrive at an appropriate allocation of costs. Many of the activities in a trading receivership will enhance the realisations of assets in both of the categories

identified above. They may of necessity be incurred before full categorisation has been completed. These factors do not affect the duty of a Receiver to allocate costs appropriately but that allocation will involve the exercise of professional judgment undertaken with a full appreciation that it must be made with independence of mind and with integrity.

17. The key principles for a Receiver in his consideration of the allocation of costs (including any trading losses) are:

    a. the statutory rights of preferential creditors as set out in the Act and the decisions of the courts in cases under that Act and predecessor legislation;

    b. the provisions of the charging document(s);and

    c. the maintenance of a proper balance as between the classes of creditors with whose interests he is required to deal in the light of their legal rights.

18. In order to enable a Receiver to allocate costs on an appropriate basis, contemporaneous records of the dominant reasons for incurring costs should be maintained. These will also assist him in providing explanations as to how he arrived at what he considers to be an appropriate allocation and provide evidence should that allocation be challenged by any of the parties involved.

19. In allocating costs a Receiver should have regard to:

    a. the objectives for which costs were incurred, it being recognised that certain types of costs may properly be allocated to the fixed charge assets in one case and to the floating charge assets in another case, such costs may enhance realizations in both categories. For example, the payment of rent on a leasehold property may be to preserve the value of the lease or to enable manufacturing to continue and work in progress to be completed.

    b. the benefits actually obtained for those financially interested in one or other category of asset in terms of protection of those assets or their value and any augmentation of that value;

    c. whether the benefits to those interested in assets subject to a fixed charge has been enhanced by action which proves to be detrimental to those interested in floating charge assets (for example where trading losses are incurred to protect or enhance the value of property or book debts subject to a fixed charge); and

    d. whether the realisation of the undertaking and assets by means of a going concern sale has resulted in a reduction in the quantum of debts which are preferential due to the transfer of employment contracts.

20. A Receiver will incur costs in complying with his statutory duties. The extent of those duties depends upon the nature of his appointment.

21. The allocation of a Receiver's remuneration and disbursements should be undertaken adopting the same principles as those applicable to costs and he should ensure that he maintains contemporaneous records which will enable him to make an appropriate division of his remuneration and disbursements between the different categories of assets.

Determination of Preferential Debts

22. As stated in paragraphs 2.2 and 2.3 of this Guidance Note, it is a Receiver's obligation to pay preferential debts out of assets available for that purpose and no proof of debt or advertisement for creditors is required.

23. Following initial notification to potential preferential creditors of his appointment and before beginning the process of determining preferential debts, a Receiver should assess whether there are likely to be sufficient floating charge realisations to pay a distribution. Where no payment will be made, it is not necessary to agree preferential claims. However, in such circumstances the Receiver should write to creditors whose claims are preferential explaining why he is unable to make a payment to them.

24. Where there will be a distribution to preferential creditors, the Receiver should assist those creditors, where possible, by providing adequate information to enable them to calculate their claims. In the case of all preferential creditors other than employees, the Receiver is entitled to assume they have full knowledge of their legal entitlements under the Act and should invite them to submit their claims. The Receiver should then check those claims, and accept or reject them as appropriate.

25. In determining the preferential claims of employees, the Receiver is not entitled to regard an individual employee as having full knowledge of his rights and entitlements. Accordingly, the Receiver should obtain information from either the company's records or from the employee before calculating the claim. The employee should be provided with details of the calculation of his claim and any further explanation that he may reasonably require.

26. Members are reminded that section 292 (3) provides that anyone who has advanced money for the purpose of paying wages, salaries or accrued holiday remuneration of any employee is a preferential creditor to the extent that the preferential claim of the employee is reduced by such advance.

Payment of Preferential Debts

27. As soon as practicable after funds become available and the amount of the preferential debts has been ascertained, members should take steps to pay them.

Disclosure to Creditors with Preferential Debts

28. When the funds realised from assets subject to a floating charge are inadequate to pay the preferential debts in full, the Receiver should (unless he has already written to them as suggested in paragraph 27) send those creditors a statement setting out:

    a. the assets which have, in accordance with the charging document, been categorised as subject to the floating charge; and

    b. the costs charged against the proceeds of the realisation of those assets.

29. Any further information which a creditor with a preferential debt reasonably requires should be provided promptly.

Other Matters

30. Difficulties may arise in determining the rights of creditors to have debts paid preferentially in priority to a prior floating charge holder when the Receiver has been appointed under a second or subsequent charge. The law in this area is complex and members should seek legal advice (and if necessary apply to the court for directions) when appointed under such a charge.

[The rest of this page is intentionally left blank]