



The return of Crown Preference

What ABL borrowers need to know

Key takeaways

- **Crown Preference is expected to return from April 2020.**
- **The change may have a material impact on borrowing headroom for ABL borrowers because certain HMRC debts will rank ahead of secured lenders' claims in an insolvency.**
- **Borrowers are advised to be front-footed in evaluating the potential impact on their liquidity to support discussions with lenders and identification of mitigations.**

Amendments to the UK's insolvency laws are always followed closely by the Asset Based Lending (ABL) market as the calculation of debt capacity for an ABL borrower is designed to ensure that lenders are able to make a full recovery in a hypothetical liquidation of the borrower's assets. A current 'hot topic' is the expected return of Crown Preference from April next year. The proposed change may have a material impact on hypothetical recoveries to ABL lenders providing finance against a borrower's inventory assets, meaning that borrowing capacity could be significantly reduced for companies with (or contemplating raising) an inventory ABL.

What is crown preference?

Insolvency practitioners are required to apply a strict hierarchy when distributing the liquidation proceeds of assets amongst the creditors of an insolvent company. The planned return to Crown Preference, which was a feature of the insolvency landscape before 2003, would push some of HMRC's debt up the hierarchy from unsecured to preferential creditor.

Crown Preference would cover taxes such as PAYE, employees' NIC and VAT which are payable by employees and customers but are collected by a company and held temporarily on HMRC's behalf, typically being paid over to HMRC monthly or quarterly. In the event of an insolvency, the proposals would see HMRC being treated as a preferential creditor in respect of accrued PAYE, NIC and VAT collected by the company but not yet paid to HMRC.

The potential benefits to the public purse are clear: returns to unsecured creditors in liquidations amount to only 4% of debts owed¹ compared to an almost full recovery as a preferential creditor. However the potential impact of Crown Preference on borrowing capacity under certain ABL facilities could affect the appropriateness and availability of

ABL financing for a wide range of companies, with the greater risk for existing users of ABL being the potential for a reduction in the company's liquidity headroom position.

Why would crown preference affect ABL borrowing capacity?

Preferential creditors have the potential to affect ABL borrowing capacity because they rank ahead of floating charge secured creditors, which includes ABL lenders providing finance secured (typically by way of floating charge) on a company's inventory. ABL lenders therefore make deductions, called 'reserves', when calculating the debt capacity of a company's inventory asset base to allow for the priority settlement of preferential creditor claims ahead of the ABL lender's own debts in the event of a liquidation of those assets.

Creditor preference isn't a new issue to ABL financing: reserves are commonly held in inventory lending arrangements to cover certain preferential creditors prescribed by statute, including amounts ring-fenced for employees and other unsecured creditors of the company. But while statute sets out a clear, capped formula for calculation of these amounts, Crown Preference is not proposed to be capped, and calculation of an appropriate reserve will not be straightforward. Potential claims in respect of VAT, for example, will be a function not only of a company's sales performance but also timing, as a lender's exposure will increase as VAT collections accumulate in the period between settlements made to HMRC. Where settlements are made infrequently (e.g. quarterly), these amounts have the potential to be substantial. Practically speaking, therefore, ABL lenders may need to hold significant reserves to manage the risk of uncertain, uncapped but potentially material preferential claims by HMRC under Crown Preference if a borrower was to become insolvent.



When will crown preference come into effect?

The Government has recently concluded a consultation on its Crown Preference plans, and its proposals would see Crown Preference coming into effect from April 2020. However lenders are already assessing their exposures to borrowers with inventory-heavy facilities, and considering potential additional reserves on the assumption that Crown Preference is more likely than not to be implemented.

Who will be affected?

Inventory financing is common across a range of sectors, including plant hire, retail, food and beverage production, manufacturing and wholesale distribution. Many companies could therefore be affected. Companies most at risk are those whose ABL facilities operate at times with limited headroom, as this headroom would be further eroded by the inclusion of an additional reserve for Crown Preference. All current ABL inventory borrowers, and any company considering taking on an inventory ABL, should therefore consider their historic and forecast PAYE, NIC and VAT liability profiles and the theoretical impact on their debt capacity and headroom if these amounts were to be held as a reserve. Borrowers should also consider the potential merits of agreeing more frequent settlements of relevant amounts to HMRC to enhance visibility over ongoing Crown Preference exposure and reduce the likely scale of any reserve. In some cases, it may also be feasible to place some of the company's inventory under a fixed charge to achieve priority ranking. A clear understanding and articulation of the drivers of

these elements could form the basis of discussions with lenders to agree a flexible approach to setting Crown Preference reserves or reconsidering the security structure of the loan, to deliver an outcome which aligns borrower and lender interests by addressing lender concerns while avoiding over-reserving.

The author, Marc Finer, is a Director in KPMG LLP's Debt Advisory team and a leading specialist in Asset Based Lending. He is the sole debt advisor member of the Steering Committee of the Secured Finance Network Europe (formally Commercial Finance Association Europe) and a regular speaker and panellist at ABL industry events.

If you would like to discuss how Crown Preference might affect your financing arrangements, please get in touch.

Notes

- (1) Protecting your taxes in insolvency, HM Revenue & Customs, <https://www.gov.uk/government/consultations/protecting-your-taxes-in-insolvency>

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