

International Corporate Rescue

Volume 17, Issue 5, 2020

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Published by

Chase Cambria Company (Publishing) Ltd

4 Winifred Close

Barnet, Arkley

Hertfordshire EN5 3LR

United Kingdom

www.chasecambria.com

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A hardcopy subscription is EUR 730 / USD 890 / GBP 520; online: EUR 730 / USD 890 / GBP 520; and hardcopy + online: EUR 840 / USD 1045 / GBP 625. Rates per additional hardcopy or online user are: EUR 165 / USD 220 / GBP 145.

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ISSN: 1572-4638

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Printed in Great Britain by Hobbs the Printers, Southampton

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UK Pensions Restructuring in a Post-COVID Era

Dan Mindel, Managing Director, Lincoln Pensions, London, UK

Synopsis

To say that we are living in unprecedented times is obvious from multiple perspectives. Equally as obvious should be that a 'business as usual approach' is unlikely to be an appropriate response to meet the challenges that we face, in particular in ensuring that people and the businesses that employ them can weather the storm and, where possible, emerge stronger than before.

In this article we consider whether the unique circumstances that we find ourselves in are perhaps an opportunity to adapt long held policies and approaches when restructuring companies with UK Defined Benefit Pension Schemes to meet the needs of the times, embracing an enterprise and rescue culture whilst also protecting and working in the interests of the pension scheme members.

We are all in this together

Whether ultimately there is a 'V', 'U', 'L' or any other shaped recovery for the UK economy it is almost certain that there will be a significant amount of restructuring and insolvency of UK based businesses resulting from the impact of the COVID-19 pandemic.

Unfortunately, that will inevitably mean that some companies will enter into administration or insolvent liquidation and any attached UK defined benefit pension scheme ('DB Scheme') will either enter into the UK Pension Protection Fund (PPF) or, if well enough funded, be able to provide a higher level of benefits to its members, but still below their retirement expectations.

This article, however, will focus on those companies that stand a chance of survival, in particular, businesses that were fundamentally sound before the economic shutdown and can either fully recover or return to something close to that state.

It was with these companies in mind that the UK Government dusted off proposed amendments to the insolvency laws which had been sitting on the shelf and, with some new additions, brought into law in June this year the Corporate Insolvency and Governance Act (CIGA).

It is not the intention of this article to go into detail of the various changes brought in by that Act save where it impacts DB schemes, however the key point

is that the driver for this Act (and indeed much else of what the Government has done recently) was a rapid response to protect businesses and jobs and, in my view, set down a very clear expectation that stakeholders will work together with that spirit of rescue culture at the forefront of what they are doing. This time, and more so than in 2008, we really are all in this together.

The pre-COVID landscape for pensions restructuring

Before examining what this all means for DB Scheme-related restructurings it is worth having a quick re-cap of where things were in early 2020.

In recent years there have been some very high-profile restructurings and insolvencies where there has been a significant DB Scheme attached, including BHS, Arcadia and Carillion to name a few.

It is unusual for a DB Scheme to be a secured creditor or, because of cross-guarantees, be structurally pari-passu to unsecured lending. However, given that they are usually a material liability on the balance sheet they are often able to influence financial restructurings through, for example:

- Having a blocking vote as a large unsecured creditor in Company Voluntary Arrangement (CVA);
- The UK Pensions Regulator (TPR) having existing broad powers to issue Financial Support Directions if a scheme is insufficiently resourced, or Contribution Notices if TPR considers that an action that would cause 'material detriment' to the DB Scheme;
- By virtue of the highly charged political atmosphere that has seen directors, advisors, trustees and TPR itself called to give evidence in front of the Work & Pensions Parliamentary Select Committee examining the reasons behind a high profile corporate failure which has impacted the DB scheme.

The recent experience of high-profile restructurings has also led to the TPR's own 'tougher' approach to regulating pensions as well as publishing in its Annual Funding Statement 2020 that the expectation will be that long term funding targets for DB schemes (ie the point at which the Scheme has little to no dependency

on the credit support (or financial covenant) of the employer) should be reached more rapidly.

In addition, there is proposed legislation in the Pensions Scheme Bill (which is currently awaiting its third and final reading in the House of Commons before it becomes law) which will provide additional powers to TPR; more stringent civil penalties (including fines up to £1m) if actions of the directors (or failures to act) detriment the Scheme; a wider basis upon which to issue Contribution Notices; and criminal liability for certain behaviour with up to seven years' imprisonment. What is more, these sanctions can be brought against a much wider range of targets including directors, shareholders, debt and other investors and advisors.

When all the above factors are combined, you have a real tension in a restructuring environment because, in those scenarios, by their very nature, there is a constraint on available funds and as a result, there is very often a more adversarial relationship between the company and the pension stakeholders, rather than a more consensual or constructive one.

The impact of COVID-19 on the economy, however, may create an opportunity to change the pensions paradigm, with all sides coming together to agree a more realistic and sustainable target for funding schemes and meeting other obligations.

Achieving balance – CIGA and the Pension Schemes Bill

There were many elements to the new CIGA but probably the two most pertinent to DB Schemes were the introduction of the Moratorium and the new Restructuring Plan (or Arrangement), including the ability to cram down creditor classes.

After much concern and intervention from the Department of Work and Pensions and other pensions industry stakeholders (including TPR and the PPF), amendments were made to afford the DB Scheme certain rights and protections that were absent in the first drafts of CIGA, in particular the right to notification of a moratorium and the right of the PPF to assume the rights of the trustees to take actions in respect of the moratorium or vote in any Arrangement.

However, despite it being raised as an issue, neither the moratorium nor the Arrangement are insolvency events (a fact that law-makers considered to be a fundamental point) and therefore neither trigger a PPF assessment period for a DB Scheme nor crystallise a full 'buy-out' liability. This means that, theoretically at least, there is uncertainty as to the value that would be attributed to a DB Scheme claim when voting in an Arrangement. Additionally, even if the Scheme can vote based on the full buy-out liability (which is normally the case in restructurings), and it has majority or blocking vote, it can still be crammed down under the new rules provided what is offered is better than the

alternative outcome (most likely insolvency). Finally, should the DB Scheme be compromised as part of an Arrangement, the Scheme members, seemingly do not have recourse to the PPF and their benefits could end up being lower than they would have received had the Scheme entered the PPF.

Although these issues are rightly of concern to trustees, TPR and the PPF, there are already safeguards in place to ensure that the processes are not abused to deliberately unfairly compromise members' benefits or cause detriment to the DB Scheme in general. In particular it is doubtful that the Court would sanction an Arrangement that crams down pension claims without the consent of the trustees, particularly if it meant that members would receive less than they would be entitled to if the Scheme entered into the PPF. In addition, the Pension Schemes Bill will afford even greater safeguards in this respect and it would certainly be helpful if becomes an Act of Parliament and the relevant provisions are brought into force in the shortest possible time frame.

The emphasis, therefore, should not be on the negatives but rather what was the underlying motivation to get CIGA onto the statute books, in priority over other Bills (including the Pension Schemes Bill) whose own journeys through the system began much earlier.

It is clear from the unprecedented support for people and companies (through furlough schemes, grants to the self-employed, the Coronavirus Business Interruption Loan Scheme and many other examples) that the UK Government is looking to provide the means for companies to recover from the impact of COVID-19 as quickly as possible. The Government cannot achieve this alone and all stakeholders must act in concert to ensure that this happens.

CIGA encapsulates the mood music by providing the breathing space for management of companies to regain control (the new Moratorium, suspension of wrongful trading rules and suspension of the ability for creditors to wind up companies) and plan a route to recovery. The new Arrangement is designed for all significant stakeholders to have their say (through voting in separate classes) as they too will often have their own COVID-related issues to grapple with.

This will of course include DB Schemes, which will be impacted by multiple factors, including the loss of contributions paid by the employer due to loss of cash-flows in the crisis, higher long term liabilities as gilt rates have fallen to close to 0% and corresponding reduction in the value of investments.

The key issue here is that now is the time for all sides to avoid the temptation to take too adversarial an approach and put the survival of the company at the forefront. Of course the DB Scheme needs to make its case and ensure members' benefits are protected, however this should be done on the basis that the existing laws and those in the draft Bill are in place to *protect* DB Schemes from the worst excesses of poor, cavalier or

criminal corporate governance but are not meant to be a stick to beat directors who owe a duty to all creditors and are working hard to find the right balance.

This is not to say that the DB Scheme stakeholders (trustees, PPF, TPR) are inherently set on frustrating the restructuring process – far from it; however the tone set by the Work and Pensions Parliamentary Select Committee at the end of the last decade has put significant pressure on those groups to ‘fight their corner’ to the point where any perceived risk to the DB Scheme is to be mitigated in full. We have seen of course that there will always be risks, even ones that nobody expects (such as the current pandemic) and which wreak huge damage. The reason the PPF was created was to acknowledge risk and provide some relief where the sponsors of DB Schemes fail. But, the PPF does not guarantee all benefits. The intention was not to eliminate all risk. Therefore, to capture the change in emphasis and tone, and focus on rescue, more forbearance and shouldering of risk by DB Schemes (at least in the short term) is required and sufficient runway should be afforded to companies to allow their rescue journey to get firmly off the ground, provided credible turnaround plans and management teams to implement them can be put in place.

The *quid pro quo* for this is for companies to acknowledge the negative impact that the pandemic has had on their covenant and long term survival prospects and acknowledge that this and other COVID-related factors have had on the pension liabilities cannot be ignored, or kicked down the road for another five years or more. It is not acceptable or desirable for companies to expect the DB Scheme to hope that everything will return to ‘normal’ as nobody can say that with full confidence.

Companies will need to be mindful that a prolonged period of ‘starving’ a DB Scheme of funds could put younger members at significant risk of not having sufficient assets available to meet their retirement benefits which could be exacerbated by trustees trying to plug the funding gap through greater and more volatile

investment risk. There will inevitably be limits to what trustees, TPR and indeed the PPF will be willing to accept.

On the basis that ‘we are all in it together’, then all parties are accountable to each other and ‘support’ is a two-way street.

Conclusion

What is apparent, both in the UK and globally, is the immediate need to rebuild business and restore confidence, protecting jobs and ensuring the functioning of the broader macroeconomy.

The times call for unity of approach and there is an air of expectation both from Governments and the public for goodwill, support and respect.

The pandemic has also starkly revealed some deep-seated inequalities in society and there is both a hope and expectation that these will be addressed. This includes the fair treatment of pensioners and workers amongst others and a new social contract whereby those who ‘lean-in’ now to help the recovery will be protected and rewarded in the future. Of course, it may take a leap of faith to rely solely on management to be mindful of society’s expectations which is why this sentiment can be backed up by TPR with its new and existing powers to ensure fair treatment of the DB Scheme both on its own terms and when compared to other stakeholders.

There is inevitable uncertainty about how restructurings involving DB Schemes will unfold in a post-COVID world. However, we can hope, urge and influence parties to not just pursue their rights and interests but also recognise that this is not a zero sum game and that stakeholders can work together to achieve ‘win-win’ outcomes, putting the rescue culture at the forefront and, by sharing the upside of the economic recovery fairly, at the same time look to build a more sustainable future for schemes and members.

Fighting Cryptocurrency Fraud: What's in the English Lawyer's Toolkit?

Jeremy Richmond QC, Barrister, Quadrant Chambers, London, UK, and **Chris Recker**, Senior Associate, Trowers & Hamblins LLP, UK

Synopsis

Cyber criminals reportedly have taken advantage of the COVID-19 pandemic (and lapses in cybersecurity) on a significant scale. We anticipate that knowledge of the developing English and Commonwealth jurisprudence concerning cryptocurrency will become increasingly essential in combatting such fraud. This article: (1) highlights some of the occasions when a litigator may come across cryptocurrency, (2) outlines some of the interim remedies potentially available where cryptocurrency is concerned; and (3) addresses some of the recent authorities in England and some other Commonwealth jurisdictions dealing with the issue of whether cryptoassets can be considered property, and thus subject to a proprietary claim – a question of particular importance in fraud claims within an insolvency context.

When might a lawyer come across cryptocurrency?

Whilst the paradigm case would be one where cryptocurrency has been misappropriated from a client, there are other examples which may be less obvious. For example, an asset may be sold and the proceeds converted into cryptocurrency, or a client may have made a ransom payment in cryptocurrency and want to recover the payment. It is also possible that a client could have innocently purchased cryptocurrency from a fraudster and be caught up in a dispute with the victim/initial owner of the cryptocurrency. Whichever example, it is essential that the modern commercial lawyer dealing with the matter has at least some knowledge of how cryptocurrency is treated as a matter of English law.

What remedies are available to restrain or control the proceeds of fraud?

As practitioners will be aware, a litigator has a wide range of interim remedies available to him or her in fraud cases under CPR 25.1(1) as well as at common

law and in equity. These remedies include: (1) the Freezing Order; (2) the Search Order; (3) the Asset Preservation Order; (4) the Proprietary or Tracing Injunction; (5) orders directing a party to provide information about the location of assets; and (6) Norwich Pharmacal/‘Bankers Trust’ orders. These interim remedies are varied, and often hinge on a particular asset being classed as ‘property.’ When deployed at the right time, a challenging case can be completely resolved in a client’s / victim’s favour by the use of such interim remedies. However, the balance is a fine one: when used incorrectly an interim remedy can become a new battleground (and lead to a diversion of time and resource).

In addition, there are powers in criminal proceedings in the form of (among other things): (1) confiscation orders (under the Proceeds of Crime Act 2002), (2) account freezing and forfeiture orders, (3) unexplained wealth orders (both (2) and (3) under the Criminal Finances Act 2017); and (4) freezing orders (under the Criminal Justice Act 1988). The substance of these powers is beyond the scope of the article. However, one of the main purposes of these remedies is to deprive someone of the benefit of criminal conduct and/or to prevent the dissipation of assets pending trial. For those reasons, they may also have a role to play in cryptocurrency related litigation. We expect that the battle against cryptocurrency related fraud will require the use of multiple remedies (the nature of which will turn on the circumstances of the particular case).

The authorities on cryptocurrencies

The UK Jurisdiction Task Force’s legal statement on the status of cryptoassets and smart contracts of November 2019 (the ‘UKJT Statement’) addressed, among other things, the extent to which cryptocurrency could be considered to be property. The Task Force concluded (among other things) that cryptoassets could be considered ‘property’ within the meaning of section 436 of the Insolvency Act 1986. We set out below short summaries of some of the recent cases in England and certain other Commonwealth jurisdictions that

have addressed this issue and the related question of the remedies available to the victim of cryptocurrency fraud.

1. Vorotyntseva v Money-4 Ltd (T/A Nebus.com) and others [2018] EWHC 2596 (Ch)

Vorotyntseva transferred approximately £1.5m of Ethereum and Bitcoin to Money-4 and its directors (who were also defendants), for the purposes of Money-4 dealing with that cryptocurrency on its new trading platform (on behalf of Vorotyntseva). Vorotyntseva became concerned that those funds had been dissipated and applied for a proprietary and freezing injunction (which was subsequently granted). The defendants were represented at the hearing. The decision indicated that cryptocurrency could be a form of property and be subject to an injunction.

2. Robertson v Persons Unknown (unreported – 2019)

Robertson was the victim of a 'spear phishing attack' which resulted in him transferring 100 Bitcoin (worth approximately £1.2 million at the time) to a fraudster's cryptocurrency wallet. By tracing the transfer on the public Bitcoin blockchain, it became apparent that the fraudster had then transferred 80 of those Bitcoin to another wallet which was operated by Coinbase (a well-known cryptocurrency exchange).

The Commercial Court acknowledged that there was a serious issue to be tried in respect of whether or not the 80 Bitcoin were Robertson's personal property and granted an Asset Preservation Order in respect of those Bitcoin. The Commercial Court also granted a Bankers Trust order, which required Coinbase to disclose certain information about the wallet holder.

3. AA v Persons Unknown [2019] EWHC 3556 (Comm)

A hacker gained unlawful access to the IT system of a Canadian Insurance company and deployed ransomware. The hacker demanded \$1.2m in Bitcoin, as the ransom payment, in exchange for the decryption software and keys.

The Canadian Insurance company was itself insured by an insurer in England. The English insurer appointed a specialist negotiator who agreed a reduction of the ransom directly with the hacker to \$950,000 (in Bitcoin) and facilitated the transfer to the hacker's proposed Bitcoin wallet. Once the Bitcoin had been transferred, the decryption keys were provided so as to 'unlock' the encrypted files and systems.

The English insurer then worked with specialist blockchain tracing experts to 'follow' the transfer of

the Bitcoin. A substantial amount (96 Bitcoin) had been transferred to a wallet operated by the cryptocurrency exchange, Bitfinex (which is itself the trading name of two BVI entities). The English insurer applied for a proprietary injunction against persons unknown and sought disclosure orders against Bitfinex to obtain the relevant KYC documentation provided to Bitfinex by the true controller of the wallet.

The Commercial Court adopted the rationale as set out in the UKJT Statement and confirmed that cryptocurrencies are capable of being subject to an interim proprietary injunction. The Commercial Court ordered that Bitfinex provide information in relation to the potential 'persons unknown' in order to police the injunction.

4. B2C2 Ltd v Quoine Pte Ltd [2020] SGCA(I) 2 (a Singapore case)

B2C2 entered into a contract with Quoine (an automated cryptocurrency exchange) so as to allow it to make trades on their platform. Due to an error, the platform executed a trade (Ethereum to Bitcoin) in favour of B2C2 at 250 times the market rate. The proceeds were credited to B2C2's account on the platform. Quoine reversed the trade (notwithstanding the fact that the underlying contract stated that trades were 'irreversible') because of the error. B2C2 sued Quoine for breach of contract and breach of trust. B2C2 and Quoine both accepted during the course of the proceedings that cryptocurrencies were a species of property. Judgment was given in the High Court on liability in favour of B2C2's claims for breach of contract and breach of trust, with damages to be assessed (at a later hearing) if not agreed.

Quoine appealed against the decision. The Court of Appeal upheld the breach of contract claim, but held that there was no trust over the Bitcoin in B2C2's account. The High Court had considered that a decisive factor in the breach of trust determination was the fact that Quoine segregated and held the cryptocurrency separately (rather than as part of its trading assets). The Court of Appeal considered that the segregation of assets from its customers cannot, of itself, lead to that conclusion. The Court of Appeal did not determine that Bitcoin was 'property,' but acknowledged that 'cryptocurrencies should be capable of assimilation in the general concepts of property.'

5. Ruscoe and Moore v. Cryptopia Limited (in liquidation) [2020] NZHC 728 (a New Zealand case)

Cryptopia was a New Zealand-based cryptocurrency exchange that provided an online platform or exchange to allow users to trade pairs of cryptocurrencies between themselves, with Cryptopia charging fees for trades,

deposits and withdrawals. Its servers were hacked in January 2019 and some NZD 30 million of cryptocurrency stolen. Soon after, its shareholders placed Cryptopia into liquidation by special resolution. The liquidators applied to the Court for directions in order to resolve a dispute between, respectively, Cryptopia's creditors on the one hand, and its account holders on the other. The dispute concerned whether the remaining cryptoassets were 'property' within the meaning of section 2 of the NZ Companies Act 1993; and if so, whether such cryptoassets were held on trust by Cryptopia for the benefit of the account holders or whether they fell to be part of Cryptopia's assets available for distribution to the general body of creditors. The Judge held that the remaining cryptoassets were 'property' within the meaning of the NZ Companies Act 1993 both on the authorities and as a matter of statutory construction. The Judge also found that as a matter of principle the cryptoassets could be held by Cryptopia on trust for the account holders; and found as a matter

of fact that they were so held on trust since each of the three certainties necessary for a trust (intention; subject matter and objects) were met in the case.

Conclusion

Our provisional conclusion is that there will be a continuing trend for the English Courts to find no conceptual problem in treating cryptoassets as property where the facts and circumstances allow. As such, we anticipate that the English Courts will have no problem in providing, and developing, appropriate interim remedies for victims of cryptocurrency related fraud. We also anticipate in light of the recent case law that tracing or following of cryptoassets (or its proceeds) will present no conceptual difficulty for the English Courts in appropriate cases.

Winding-Up in the Post CIGA World

Nicola Allsop, Barrister, Quadrant Chambers, London, UK

Synopsis

The Corporate Insolvency and Governance Act ('CIGA') which came into force on 26 June 2020 represents one of the biggest changes to the insolvency law of England and Wales in two decades.

This Article focuses on the significant changes contained in schedule 10 of CIGA relating to statutory demands and winding-up petitions and the recent decision in *In Re A Company* [2020] EWHC 1551 (Ch). It also touches upon the new procedure as laid down in the Insolvency Practice Direction relating to the Corporate Insolvency and Governance Act 2020 which was published on 3 July 2020.

Important timing points

Before turning to the specific provisions of schedule 10 of CIGA, two general points are noteworthy. First, the changes brought about by schedule 10 are temporary and presently expire on 30 September 2020. However, the Secretary of State has power to extend beyond that date for up to a further six months if necessary. Secondly, practitioners should not assume that because the changes came into force on 26 June 2020 that they apply from that date as the restrictions imposed by schedule 10 have retrospective effect.

The end of the statutory demand?

The effect of paragraph 1(1) of schedule 10 of CIGA is that a winding-up petition cannot be presented on or after 27 April 2020 based upon a statutory demand served between 1 March 2020 and 30 September 2020. This provision is to be regarded as having come into force on 27 April 2020. This prohibition is absolute – there is no carve out for debtor companies unaffected by coronavirus.

It is doubtful that this provision in isolation will have a far-reaching effect. This is because, unlike its equivalent in bankruptcy, the statutory demand has never been a central feature of corporate insolvency law. An unsatisfied statutory demand provides one circumstance in which a company is deemed, under section

123(1) of the Insolvency Act 1986 ('the IA 1986') as unable to pay its debts.

A company will also be deemed unable to pay its debts, if it is proved to the satisfaction of the court that it is insolvent on a cash flow or balance sheet basis: that is, if it is proved to the satisfaction of the court 'that the company is unable to pay its debts as they fall due' (section 123(1)(e) of the IA 1986) or 'that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities' (section 123(2) of the IA 1986).

It remains open to a creditor to send a letter demanding payment of a debt and to present a petition otherwise than in reliance upon a statutory demand. However, the circumstances in which such petition may be presented and a winding-up order made have been significantly curtailed by schedule 10 of CIGA.

Restrictions on winding-up petitions

A creditor may not, between 27 April 2020 and 30 September 2020, petition for the winding up of a company on a ground specified in section 123(1)(a) to (d) of the IA 1986 unless the 'coronavirus test' is satisfied (CIGA schedule 10 para. 2(1)). Similarly, a creditor may not, between 27 April 2020 and 30 September 2020, petition for the winding up of a company on the ground it is insolvent (either on a cash flow or balance sheet basis) unless the 'coronavirus test' is satisfied (CIGA schedule 10, para. 2(2)). Parallel restrictions in respect of the winding up of unregistered companies are contained in paragraph 3 of schedule 10.

So, what is the coronavirus test? The wording is slightly different depending on which ground of the IA 1986 is relied upon, but the substance is the same. The creditor must have reasonable grounds for believing that:

- (a) coronavirus has not had a financial effect on the company, or
- (b) the facts by reference to which the relevant ground applies would have arisen [or the relevant ground would apply] even if coronavirus had not had a financial effect on the company.

Paragraph 21(3) of schedule 10 provides that, ‘coronavirus has a “financial effect” on a company if (and only if) the company’s financial position worsens in consequence of, or for reasons relating to, coronavirus.’

It will be a rare case in which a creditor is able to demonstrate reasonable grounds for believing that coronavirus has not had a financial effect on the company given the breadth of the definition in paragraph 21. It will be easier for a creditor to bring itself within sub-paragraph (b). In this regard, timing is likely to be critical. If the debt arose long before coronavirus took hold, the creditor will have a better prospect of demonstrating that the company was and is insolvent absent coronavirus. The recent decision of ICC Judge Barber in *In Re a company* [2020] EWHC 1551 (Ch), discussed below, sheds some light on how the Court is likely to approach the coronavirus test.

Winding-up petitions: transitional provision

Paragraph 4 of schedule 10 applies where a creditor presents a petition under section 124 of the IA 1986 between 27 April 2020 and 25 June 2020.

If the court to which the petition is presented is satisfied that the creditor presented it in the absence of the coronavirus test being met, the court may make such order as it thinks appropriate to restore the position to what it would have been if the petition had not been presented. The form this order will take is unclear. Presumably at the very least the petition will be dismissed, or perhaps deemed withdrawn if the creditor so indicates. If the company has incurred any costs in defending the petition, it seems likely that the petitioner will be ordered to pay these.

Restrictions on winding-up orders

Paragraph 5 of schedule 10 applies where:

- (a) a creditor presents a winding-up petition under section 124 of the IA 1986 between 27 April 2020 and 30 September 2020;
- (b) the company is deemed unable to pay its debts on a ground specified in section 123(1) or (2) of the IA 1986; and
- (c) it appears to the court that coronavirus had a financial effect on the company before the presentation of the petition (CIGA schedule 1, paragraph 5(1)).

Where those three conditions are met, the court’s power to wind up a company is restricted. It may wind the company up under section 122(1)(f) of the IA 1986 on a ground specified in section 123(1)(a) to (d) of that Act only if satisfied that the facts by reference to which that ground applies would have arisen even if

coronavirus had not had a financial effect on the company (CIGA schedule 1, paragraph 5(2)). It may make a winding-up order on a ground specified in section 123(1)(e) or (2) of the IA 1986 only if satisfied that the ground would apply even if coronavirus had not had a financial effect on the company (CIGA schedule 1, paragraph 5(3)).

The operation of this provision in practice is analysed below in the context of the decision in *In Re a company*.

Winding-up order: transitional provision

Any winding-up order made between 27 April 2020 and 25 June 2020 on the basis that a company is unable to pay its debts is to be regarded as void if it would not have been made because the coronavirus test would not have been satisfied (CIGA schedule 10, paragraph 7).

The wording of this provision suggests that it is intended to have automatic effect. However, one can readily see the benefit, in terms of certainty, of applying to the Court for a declaration that a winding-up order is void. It seems likely such an application will be necessary in any event, to deal with issues such as the status of any transactions entered into by the Liquidator and the Liquidator’s costs. Paragraph 7(4) of schedule 10 provides that, ‘The court may give such directions to the official receiver, liquidator or provisional liquidator as it thinks fit for restoring the company to which the order relates to the position it was in immediately before the petition was presented.’

In Re A Company – an application of the coronavirus test

On 16 June 2020, ICC Judge Barber handed down judgment in *In Re A Company* [2020] EWHC 1551 (Ch), which concerned an application by the company to restrain the advertisement of an extant petition (presented on 13 May 2020 based on a stat demand served on 27 March 2020) and the presentation of a further petition. Although the case was decided before CIGA came into force, it was common ground that the Court should have regard to the provisions of the then Corporate Insolvency and Governance Bill in deciding whether to exercise its discretion to restrain advertisement and presentation. Paragraph 1 of schedule 10 was fatal to the petition as it was founded on a statutory demand served during the relevant period. However, the Court accepted that the petitioner would be able, instead, to rely on a pre-action letter and if necessary, amend the petition to make it clear that it was based on s.123(1)(e) of the IA 1986.

The Court, therefore, considered whether the coronavirus test was met in relation to the presentation of the petition: namely, whether the petitioner

could show that, as at the date of presentation, it had reasonable grounds for believing (a) coronavirus had not had a financial effect on the company, or (b) that s.123(1)(e) would apply even if coronavirus had not had a financial effect on the company.

The petitioner accepted that it could not come within paragraph (a). However, the Court accepted that the petitioner satisfied paragraph (b). Key in the Court's decision was that the loan which gave rise to the petition debt was due for repayment on 22 January 2019 which, as the Court said, was 'long before Covid-19 hit.' Further, rather than repay the loan on the repayment date, the company reached an agreement with the petitioner pursuant to which the company was to make interest payments. The company did not make the interest payments, which suggested ongoing significant cashflow problems. By letters starting in December 2019 and culminating in a formal demand letter dated 24 January 2020, the petitioner enquired and latterly demanded repayment of the debt, which letters were met with silence or holding responses. It was not until 16 April 2020, almost three months following the formal demand for repayment that the company wrote to its creditors, including the petitioner, effectively blaming coronavirus for its financial problems. The Court accepted that the petitioner was entitled to view the April communication as 'something of an opportunistic attempt to jump on the Covid bandwagon.'

That was not the end of the matter, as the Court had to consider whether the petition would be likely to result in a winding-up order, having regard to paragraph 5 of schedule 10. The first two conditions in paragraphs 5(1)(a) and (b) were clearly met: the petition had been presented in the relevant period and the company was deemed unable to pay its debts on a ground specified in section 123(1) of the IA 1986.

In relation to the third condition, the Judge noted that the burden was on the company to demonstrate that coronavirus had had a financial effect on the company. That was clearly intended to be a low threshold; the requirement is simply that 'a' financial effect must be shown: it is not a requirement that the pandemic be shown to be the, or even a, cause of the company's insolvency. Moreover, the language of that provision, which requires only that it should 'appear' to the court that coronavirus had 'a' financial effect on the company before presentation of the petition, is in marked contrast to that employed in paragraph 5(3), where the court is required to be 'satisfied' of given matters. The term 'appears' must be intended to denote a lower threshold than 'satisfied'. Taking all that into account, the Judge held that the evidential burden on the company for these purposes must be to establish a *prima facie* case, rather than to prove the 'financial effect' relied upon on a balance of probabilities.

The evidence before the Court was that the company was not solvent for its day to day operations but relied

on rolling over corporate debt and fund-raising by the issue of equity for its long-term financing. The company said that COVID-19 had prevented both routes to acquiring new financing as international capital markets had frozen. According to the company, it had agreements in principle for significant capital financing, all of which fell away in March 2020 when the coronavirus crisis ensued. Although the Court expressed some reservations regarding the quality of the company's evidence, it was satisfied that the company met the relatively low threshold in paragraph 5(1)(c).

This meant that the test in paragraph 5(3) fell to be applied and that the Court was only able to wind up the company if satisfied that the relevant ground, in that case s.123(1)(e) would apply even if coronavirus had not had a financial effect on the company. The burden was on the petitioner to show that even if the financial effect of coronavirus was ignored, the company would still be insolvent. The petitioner was unable to discharge that burden because the company's re-financing efforts had been hampered by coronavirus.

The facts of *In Re a Company* demonstrate the difficulty of fulfilling the coronavirus test in relation to the making of a winding-up order. Notwithstanding that the evidence was consistent with the company being insolvent pre-COVID, the company's ability to return to solvency had been thwarted by COVID-19.

A new insolvency commencement date

In respect of winding-up petitions under s.124 of the IA 1986 presented between 27 April 2020 and 30 September 2020 which result in a winding-up order, the winding up is deemed to commence on the making of the winding-up order rather than at the time of the presentation of the petition (CIGA, schedule 10, paragraph 9). This amendment is significant because the presentation of a petition would normally lead to the freezing of the company's bank account by reason of section 127 of the IA 1986 and the need to apply for a validation order in the event that the company wished to continue to trade or to dispose of any property. This amendment strips s.127 of any potency and removes the need to apply for a validation order. It also changes the commencement date to the date of the winding-up order for the purpose of antecedent transactions such as preferences and transactions at an undervalue.

The new practice direction

A new insolvency practice direction relating to CIGA 2020 was published on 3 July 2020. This makes significant amendments to the relevant procedure for the hearing and determination of petitions. It is suggested that practitioners read the new PD in full. The following are its key features:

- There will be an initial review of the petition when it is sent to the Court and it will not be accepted for filing unless it contains a statement that the creditor has reasonable grounds for believing that the coronavirus test is satisfied along with a summary of the grounds relied upon by the petitioner.
- The petition will initially be treated as private and should not be advertised until the Court directs.
- Upon being issued, the petition will be listed for a non-attendance pre-trial review with a time estimate of 15 minutes for the first available date after 28 days from its presentation.
- The purpose of the non-attendance pre-trial review is to enable the Court to give directions for a preliminary hearing or, in the event the company does not oppose the petition and the Court is likely to make a winding-up order having regard to the coronavirus test, to list the petition for further hearing in the winding-up list.
- The parties may file evidence in accordance with the time limits specified in the PD to be relied upon at the preliminary hearing.
- At the preliminary hearing, if the Court is not satisfied it is likely it will be able to make a winding-up order having regard to the coronavirus test, it shall dismiss the petition. If the Court is satisfied that it is likely it will be able to make a winding-up order having regard to the coronavirus test, it shall list the petition for hearing in the winding-up list.

Concluding comment

The reforms introduced by CIGA certainly seem to mark the start of a more debtor friendly regime. It remains to be seen just how friendly. One thing is clear at this stage: given the new restrictions introduced by schedule 10 and the steps detailed in the Practice Direction, practitioners can expect that it will take considerably longer for petitions presented during the relevant period to be determined.

An ‘Intelligent’ Lockdown? On the Dutch Response to COVID-19

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Synopsis

This paper provides an overview of the measures taken by the Dutch government in response to the COVID-19 pandemic. It focuses on the measures taken to support impacted businesses (para. 3), and changes in relevant insolvency and company law (para. 4). These include large-scale financial support, and an important new tool to rescue businesses, the ‘WHOA’ or ‘Dutch Scheme’.

1. Introduction

When the COVID-19 epidemic hit the Netherlands in March this year, as in many countries, it was initially met with underestimation and nonchalance. These quickly vanished as the disease spread through the country, and serious measures had to be taken to combat the virus. Although the Netherlands never went into a full, government-enforced lockdown, the proclaimed ‘intelligent lockdown’¹ was in many respects similar to the strict measures adopted elsewhere in Europe. At the height of the crisis, all but essential workers were working from home. Schools, bars and restaurants were closed and all gatherings of people were cancelled. In the meantime, shops have always remained open, with supermarkets, DIY stores and shops selling home-office supplies reporting record turnover despite the required social distancing. In good Dutch tradition, the government measures were hardly enforced, but mostly complied with after direct appeals by the government to the personal responsibility of each. At the time of writing, late August 2020, most measures to curtail the virus have been relaxed, although the emphasis on social distancing remains and large gatherings are still mostly forbidden. Measures may be revived soon, as the number of cases has recently been increasing.²

The measures to combat the virus were expected to have an enormous economic impact. In response, the government quickly announced various economic

support measures, mostly aimed at providing liquidity to heavily impacted businesses. These economic support measures have been announced in three waves, the first measures taken late March and early April, to be succeeded with more detailed measures late May, early June. A third, and smaller wave of support measures has been announced for early October.

The government response mainly consisted of these economic measures, but has also included some amendments to statutory law. Moreover, Dutch case law has sprung a steady source of decisions on how to divide and bear the economic burden of COVID-19. The expected boom of bankruptcies has been held off for now, at the time of writing late August. In this regard, the worst is yet to come as the support measures are scaled down in autumn.

2. Financial stimulus

2.1 Reimbursement for labour costs

As COVID-19 hit the Netherlands in March, the government quickly announced a programme to reimburse companies for labour costs of superfluous employees. Under this ‘Temporary Emergency Bridging Measure to Sustain Employment’ or, in its Dutch acronym NOW,³ the government reimbursed companies up to 90% of the labour costs associated to a downfall in revenue, if that downfall exceeded 20%. Hence a company experiencing a downfall in revenue of 50% could receive a reimbursement of up to 45% of its labour costs.

Companies taking part in this arrangement could not dismiss any employees, under penalty of loss of not only the allocated subsidies for dismissed staff, but also an extra 50% surcharge. Essentially, this programme strived to keep workers for whom no work was available on their company payroll, whilst paying their wages out of government-sponsored unemployment funds.

As of June 2020 this NOW programme has been succeeded by the similar NOW 2.0, which will continue until 1 October 2020. The NOW 2.0 abolished

Notes

- 1 The implications of this term, crafted by the Dutch prime minister Rutte, for his views on other lockdowns are beyond the scope of this paper.
- 2 Beyond this introduction, the measures aimed at combatting the virus itself are outside the scope of this paper.
- 3 In Dutch, it is known as the ‘Tijdelijke Noodmaatregel Overbrugging Werkgelegenheid’

the penalty for dismissing staff whilst receiving reimbursements, and replaced it with requirements regarding consultation with labour unions and measures to promote employability of dismissed workers. Moreover, companies receiving over EUR 125,000 in reimbursements under the NOW 2.0 cannot distribute dividends to shareholders, buy back stocks, or pay bonuses to their management.

The NOW arrangements have widely been applied for. Around 140,000 companies have received support under the first NOW, requesting around EUR 10 billion in total to keep 2.6 mln employees employed. The NOW 2.0 has been surprisingly less popular. Between 6 July and 7 August around 36,000 employers had requested the NOW 2.0, receiving a total of EUR 1.3 billion.

At the beginning of October the NOW 2.0 will be replaced with the NOW 3.0. The nature of the programme remains the same, but the loss of revenue required for application will gradually increase and the offered reimbursement will gradually decrease.

2.2 Fiscal measures

The economic stimulus in response to COVID-19 also came through sweeping fiscal measures. As of late March, any company applying for an extension of payment on their taxes was immediately awarded a three months' extension. This covers most taxes due by companies, including corporate income taxes, VAT and taxes over wages. Also no penalties are incurred for untimely payment and the interest rate for due tax claims has been lowered to 0.01%. If three months' extension is not sufficient, a company can request for further extension under the condition that it does not distribute bonuses or dividends and does not buy back stock. Under the third support package the suspension of tax payments will be scaled down. Suspensions can no longer be requested after 1 October.

Other fiscal measures include special adjustment of previously made preliminary assessments, and the creation of a special tax reserve for companies, essentially allowing companies to fiscally offset expected losses in 2020 with profits made in 2019, thus lowering the tax base and the taxes due over 2019. Local tax authorities,

such as municipalities, have also granted suspension of payments of (some or most of) taxes due to them.

2.3 Government-backed loans and subsidies

In addition to suspending tax collection the Dutch government has provided liquidity to companies through various support programmes.

Existing facilities whereby the government provided guarantees for bank loans were considerably expanded. The guarantees for loans to small and medium sized enterprises (hereafter 'SME's') of up to EUR 1.5 mln were raised to up to 75% of the loan, whilst the premiums for such guarantees were lowered to 2%.⁴ Up to EUR 640 mln in loans can be guaranteed in this way. The guarantees for larger companies, drawing loans between EUR 1.5 mln and 150 mln, were raised to up to 50% of the loan.⁵ In the second wave of support measures, a new guarantee arrangement was set up for companies specifically needing liquidity due to the COVID crisis, guaranteeing up to 80% of the loan, or even 90% in the case of a SME.⁶ For these guarantees for larger loans, up to EUR 10 bln is available.

For companies with no existing bank financing, particularly start-ups and scale-ups, a new programme of new credit lines was set up and financed by the central government. The credit lines were distributed through existing public investment vehicles, the regional development societies⁷ and InvestNL, a national investment fund.⁸

In order to further stimulate the banks to provide loans to ailing businesses the Dutch Central Bank and the Authority for Financial Markets have lowered the capital requirements for large banks by lowering the required systemic buffers. Also, the planned introduction of a floor for mortgage loan risk weighting has been postponed.⁹

The Dutch government took further measures to support small companies that were directly affected by the measures to combat the virus, such as hairdressers and event organisers. Initially the government offered these businesses an almost instant payment of EUR 4,000, provided they had such costs.¹⁰ Later this programme was replaced with the Compensation for Fixed Costs, which covers up to EUR 50,000 in fixed costs

Notes

4 This is the 'Borgstelling Midden- en Kleinbedrijf', or BMKB.

5 This is the 'Garantie Ondernemingsfinanciering', or GO.

6 This is the 'Garantie Ondernemingsfinanciering Corona', or GO-C.

7 The regional development societies (*regionale ontwikkelingsmaatschappijen*) supply the Corona Bridge Loans (*Corona Overbruggingslening*, or COL).

8 The bridge loans programme of InvestNL is the *Tijdelijke Overbruggingskrediet Programma innovatieve Start- en Scale-ups* or TOPSS.

9 Further measures taken at the European level, by the European Central Bank, the European Banking Authority, and more broadly the European Union are outside the scope of this paper. For more on that, see the Dutch chapter of the INSOL International & World Bank Group Global Guide, available at <http://insol-techlibrary.s3.amazonaws.com/311e6f64-d01b-4994-b774-61ac234b7356.pdf?AWSAccessKeyId=AKIAJA2C2IGD2CIW7KIA&Expires=1598881514&Signature=nAznAeyp%2BdAIF%2BcN%2BRok4KSqGt%3D>, written by N.B. Pannevis & L.P. Kortmann

10 This is the Compensation Entrepreneurs in Affected Sectors (*Tegemoetkoming Ondernemers Getroffen Sectoren* or TOGS).

over four months.¹¹ This programme will be extended in September, when the maximum reimbursement will be raised to EUR 90,000.

For self-employed some of the usual requirements for income support under the social benefits programme were temporarily relinquished, additional small loans were made available,¹² and government-backed loans gave extensions.¹³

To keep supplier credit available, the government has announced a re-insurance scheme for credit insurance companies, guaranteeing supplier credit up to EUR 12 bln in total.

Lastly, aid packages were announced for some specific sectors, such as EUR 650 mln in subsidies for the agricultural sector, EUR 120 mln for sports and EUR 300 mln for the cultural sector, which is to be further supplemented in the third wave of support in October. KLM, Dutch Royal Airlines and part of Air France–KLM, received a support package of EUR 3.4 bln in guarantees, loans and equity.

2.4 Private measures

Alongside the governmental response, the private sector also responded. Most notably the main Dutch banks quickly announced an extension of payments of half a year for all their SME customers and larger retail companies. Healthcare insurance companies have agreed to pay healthcare providers at least 65 to 80% of last year's turnover, regardless of the services provided this year. Pension funds have announced a suspension of payment obligations of affected companies on a case-by-case basis.

The organisations representing landlords and tenants of commercial real estate have extensively negotiated to come up with guidelines for suspensions and/or reduction of rent payments. This only resulted in a number of non-binding guidelines, leaving it to individual tenants and landlords to agree on amendments of existing rent agreements where necessary. This has not always gone smoothly and resulted in a growing body of case law on the effect of the unforeseen COVID circumstances on lease agreements. This case law is discussed below in para. 3.4.

3. Response in the law

3.1 The Dutch Scheme

Overall the Dutch legislator did not heed COVID-19 as a call to action. Few changes have been made to the existing company and insolvency law. But the amendments that have been made include a piece of milestone legislation.

As the pandemic hit, the Dutch legislator had already been developing a new restructuring tool for about seven years. COVID-19 seems to have given the final push necessary to adopt this new instrument. It now has the added appeal of helping essentially viable businesses to overcome the effects of COVID-19. The Act on the Confirmation of Private Plans, also known by its Dutch acronym: *WHOA*,¹⁴ and already dubbed 'the Dutch Scheme' is expected to come into force in October or November this year.

The *WHOA* will introduce a restructuring tool modelled on the English Scheme of Arrangement, Chapter 11, and the European Restructuring Directive.¹⁵ Essentially, the *WHOA* entails a plan proceeding, whereby the creditors and/or shareholders vote in classes on a restructuring plan proposed by the debtor, which, after court confirmation becomes binding upon dissenting creditors and/or shareholders.

An envisaged restructuring under the *WHOA* is highly flexible. The debtor can choose which creditors to involve and is free to determine the contents of the plan offered. Little court involvement is required, except for confirmation after voting. If desired, court involvement may however be requested at an earlier stage. In any case, *WHOA* cases are handled by specialised judges.

The debtor may choose between a private procedure, involving only the parties affected by the plan, or an open procedure, which is made public and can be recognised internationally as an insolvency proceeding under the European Insolvency Regulation. In both instances, the confirmation of the plan may include a cross class cram down if the plan adheres to the absolute priority rule.

To guarantee the success of restructuring through *WHOA* plans, the *WHOA* offers the opportunity to take several supporting measures. These may include a temporary ban on ipso facto clauses, a stay on the opening of insolvency proceedings, and a safe harbour from

Notes

11 The programme designated as the Compensation for Fixed Costs (*Tegemoetkoming Vaste Lasten* or *TVL*)

12 Both are part of the Temporary Bridge Arrangement Independent Entrepreneurs, or *Tijdelijke Overbruggingsregeling Zelfstandig Ondernemers*, or *TOZO*.

13 This concerns the *Vroege Fase Financiering, Innovatiekrediet*, and loans made by the governmental finance provider *Qredits*.

14 Full Dutch name: *Wet Homologatie Onderhands Akkoord*

15 Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132

claw back provisions where new money is provided under the plan. If a debtor is not willing to propose a plan, yet creditors deem such a plan necessary, they may request the court to appoint an independent restructuring expert with the power to propose a plan on behalf of the debtor.

The bill introducing the WHOA is, at the time of writing, under consideration by the Dutch Senate. It is expected to come into force in October or November this year.

3.2 Stay of recourse by creditors

Under Dutch law a creditor can successfully request the opening of insolvency proceedings of his debtor if the debtor no longer pays his debts as they fall due. Initially, the Dutch legislator did not alter these requirements for the opening of insolvency proceedings, although courts have applied extra scrutiny to petitions for the opening of bankruptcy proceedings, in order to prevent unnecessary bankruptcies of essentially viable businesses. Together with the governmental support measures, this has resulted in some months during the COVID-19 crisis showing even fewer new bankruptcies than the corresponding months in 2019.

Under a draft bill still in preparation,¹⁶ a company that is essentially viable but is experiencing a liquidity crisis due to the measures to combat COVID-19, may request special protection from the court. Such protection temporarily prevents one or more of its creditors from taking recourse or petitioning for the opening of bankruptcy proceedings. As this draft has not been submitted to Parliament yet, it is unclear if and when it will become law.

3.3 Required meetings

Even for those companies that managed to navigate the Corona crisis economically unscathed, the measures to combat COVID-19 still meant a drastic overhaul of day-to-day operations. Physical meetings were largely banned, including those required under company law, and meetings required for the execution of notarial

deeds, such as meetings necessary for the notarial deed required to vest a mortgage.

This was addressed by a temporary law that retroactively allows many such meetings to be postponed, or to be held by videoconference, even where, for example, the relevant articles of association did not provide for that opportunity.¹⁷ Consequently, this temporary law also allows the boards of companies to postpone the publication of annual accounts. Notarial deeds can be executed through videoconferencing with the notary public.

3.4 Sharing the burden in contract law

One area of law where COVID-19 has not necessarily brought changes, but at least interesting new applications, is in contract law, especially where it concerns unforeseen circumstances. This concept has developed into a legal tool to divide the economic burden caused by COVID-19 between contracting parties.

Dutch case law on this topic has been developing rapidly. In many cases, tenants of restaurants and bars have sought discounts in the rent due to the inoperability of the leased premises. Where such discounts were contractually excluded, judges have regularly bypassed such contractual provisions. The case law, albeit in summary proceedings, shows a clear trend that for lease contracts the COVID-19 epidemic qualifies as an unforeseen circumstance that may set aside previous agreements on rent discounts. Courts increasingly find that tenants and landlords should share the burden, and therefore that tenants who can sufficiently show that the epidemic and governmental measures have heavily impacted their business can claim a discount in rent.¹⁸

In other areas of law, amendment of contracts has scarcely been allowed in the case law. In cases regarding other contracts than rent, the pandemic has not been accepted as an unforeseen circumstance that requires amendment of contracts. This may largely be attributed to the more limited effect COVID-19 had on those specific contracts, most notably M&A deals.¹⁹

Notes

16 The Temporary Payment Deferment Act 2020 or *Tijdelijke Betalingsuitstelwet 2020*.

17 The so-called Temporary Act Covid-19 Justice & Security, (*Tijdelijke wet Covid-19 Justitie & Veiligheid*), where the 'Justice & Security' refers to the department of Justice (and Security), whose areas of law this act concerns.

18 See, among others, District Court (hereafter: DC) Noord-Nederland 27 May 2020, ECLI:NL:RBNNE:2020:1979, DC Gelderland 29 May 2020, ECLI:NL:RBGEL:2020:2768, DC Amsterdam 11 June 2020, ECLI:NL:RBAMS:2020:2914, DC Rotterdam 18 June 2020, ECLI:NL:RBROT:2020:5583, DC The Hague 19 June 2020, ECLI:NL:RBDHA:2020:566, DC Limburg 19 June 2020, ECLI:NL:RBLIM:2020:4399, DC Amsterdam 17 July 2020, ECLI:NL:RBAMS:2020:3494, DC Amsterdam 29 July 2020, ECLI:NL:RBAMS:2020:3730, DC Amsterdam 31 July 2020, ECLI:NL:RBAMS:2020:3756 and DC Noord-Nederland 21 July 2020, ECLI:NL:RBNNE:2020:2540. In the interest of full disclosure, it is noted that the author of this article acted as attorney for the tenant in the last mentioned case.

19 See, amongst others, Netherlands Commercial Court 29 April 2020, ECLI:NL:RBAMS:2020:2406, DC Amsterdam 14 May 2020, ECLI:NL:RBAMS:2020:2644, DC Amsterdam 20 May 2020, ECLI:NL:RBAMS:2020:2647, DC Amsterdam 19 June 2020, ECLI:NL:RBAMS:2020:3091 DC Rotterdam 7 August 2020, ECLI:NL:RBROT:2020:7089.

3.5 Directors' liability

In contrast to some other legal systems, Dutch statutory law does not contain a strict obligation for directors of a company to file for insolvency proceedings whenever particular economic circumstances occur, such as over-indebtedness. Therefore, there was no need to suspend such obligations by emergency legislation.

In practice under Dutch law, the decision to file for insolvency proceedings is often driven by the case law on wrongful trading. At the point where the director can no longer have the company enter into new contracts without the risk of personal liability, the director is often compelled to file for insolvency proceedings as a practical matter. Such personal liability essentially concerns having the company enter into obligations whilst the director knew or ought to have known that the company cannot meet such obligations and that the company will not offer recourse for the incurred damages.²⁰ This norm has not been altered by new statutory laws in response to COVID-19. The exact

application of this norm in times of particularly great uncertainty, when the future is hard to predict for any director, such as during the COVID crisis, is left open to developments under case law.

4. Conclusion

The response of the Dutch government to the pandemic can be characterised as robust on financial measures, yet limited on legal measures. Economically, the government has announced and executed large scale support for many companies. Legally, little amendments have been made with the notable exception of the WHOA, or Dutch Scheme. Years from now, when COVID-19 hopefully is reduced to one of the many viruses that constantly roam around the population with little effect, its main legacy under Dutch law may consist in a body of case law on unforeseen circumstances and the final push needed for a restructuring tool that can measure itself with any jurisdiction.

Notes

20 This is the so called *Beklamel* doctrine, derived from Dutch Supreme Court 6 October 1989, ECLI:NL:HR:1989:AB9521 (*Beklamel*).

The CIGA Moratorium: A Lifeline for UK Companies?

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Synopsis

The new moratorium provisions introduced into UK law by the Corporate Insolvency and Governance Act 2020 ('CIGA') are designed to provide breathing space for viable companies that have been laid-low by the effects of the COVID-19 pandemic to allow them to either trade out of trouble or come up with a rescue plan before creditors take enforcement action.

Commercial lawyers need to be aware of the basics of the new procedure because of the challenges it presents to creditors seeking to enforce debts and because it includes a change of priorities in any subsequent insolvency. This article outlines the key aspects of the new moratorium process.

Introduction

CIGA, which runs to a mammoth 254-pages, was rushed through the United Kingdom's Parliament during the country's lockdown. It came into force on 25 June 2020, and it makes significant amendments to the Insolvency Act 1986 ('IA'). Despite the compressed timetable for Parliamentary approval, the new moratorium provisions meet a problem that has troubled insolvency practitioners in the UK for years: UK law did not provide for a 'debtor in possession' process. Directors of struggling companies often did not have sufficient time to consider rescue options before their plans were disrupted by creditor action.

There were previously two contexts in which a company could obtain protection from creditors: (i) the moratorium available to small, eligible companies pursuing a Company Voluntary Arrangement, further to IA section 1A and Schedule A1, which was not widely used and which has been repealed by CIGA; and (ii) the moratorium further to Schedule B1 of the IA for a company in administration.

The new regime represents a step-change. It is a free-standing process which does not lead to any or any particular insolvency procedure. It prevents creditors from taking enforcement action while a company's directors, overseen by a licensed insolvency practitioner referred to as 'the monitor', seek to save the company as a going concern. It also introduces a change in priorities if the company subsequently enters administration or

liquidation to incentivise counterparties to continue to trade with the company through its moratorium.

Eligibility

A company must be 'eligible' in order to obtain a moratorium under the new regime.

A company is eligible unless it falls within one of 14 excluded categories set out in detail in new Schedule ZA1 of the IA. The excluded categories include: companies subject to or recently subject to a moratorium or insolvency procedure; insurance companies; banks; electronic money institutions; parties to capital market arrangements; and certain overseas companies, which essentially covers any company whose registered or head office is outside the UK and whose functions correspond to any of the other exclusions.

The exclusion of financial services companies is not surprising given that they are subject to their own rules and procedures in respect of insolvency.

The exclusion for companies subject to or recently subject to a moratorium or insolvency procedure applies if on the date of filing the relevant papers at court, a moratorium or other insolvency procedure is already in place, or at any time during the 12 month period ending with the filing date, a moratorium or other insolvency procedure was in force, unless the court orders that a previous moratorium is not to be taken into account (IA Sched ZA1 para 2). However, the exclusion in respect of the 12-month period is suspended temporarily, until 30 September 2020, further to Schedule 4, paras 6-7 of CIGA to account for the impact of the COVID-19 pandemic.

How to obtain a moratorium

A company may obtain a moratorium by either simply filing the relevant documents at court or by making a successful application to the court. There are three routes to a moratorium depending on the company's specific circumstances.

Firstly, if a company is eligible, is not subject to a winding-up petition and is not an overseas company, the directors may obtain a moratorium simply by filing the 'relevant documents' at court: IA s.A3.

Secondly, if a company is eligible but is subject to an outstanding winding-up petition, the directors may apply to court for a moratorium, and the court may order a moratorium only if it is satisfied that it would achieve a better result for the company's creditors as a whole than would be likely if it was wound up without first being subject to a moratorium: IA s.A4.

Thirdly, if a company is eligible, is not subject to an outstanding winding-up petition and is an overseas company, the directors may apply to court for a moratorium: IA s.A5.

All three routes require the directors to produce the 'relevant documents' for the court. The 'relevant documents' are defined in s.A6 of the IA. They include: a notice that the directors want a moratorium and that in their view, the company is or is likely to become unable to pay its debts; a statement from the proposed monitor that he or she is a qualified person, that he or she consents to act as monitor, that the company is eligible; and that in his or her view, it is likely that a moratorium would result in the rescue of the company as a going concern, or until 30 September 2020 that it would do so were it not for any worsening of the company's financial position for reasons relating to the current pandemic: IA sA6(1)(e), and Sched 4 para 7(a) CIGA.

The selection of the proposed monitor is a matter for the company's directors rather than its creditors or one particular creditor. Further, the monitor does not run the business once appointed; he or she must be kept apprised of progress and consider whether the purpose of the moratorium is being met.

The emphasis in CIGA is on saving *the company* as a going concern rather than saving *the business* as a going concern, which is the aim in administration. The distinction may signal that the primary aim of CIGA is to rescue entities rather than simply ensuring creditors get paid. On the other hand, it may simply reflect a drafting anomaly and/or the speed at which the legislation was rushed through Parliament.

Duration of the moratorium

If obtaining a moratorium is simply a paper exercise, the moratorium, including the appointment of the monitor, comes into effect when the relevant documents are filed at court. Otherwise, it comes into effect when the relevant order is made: IA s.A7.

The directors must notify the monitor as soon as reasonably practicable that the moratorium has come into effect, and the monitor must notify Companies House, every company creditor of whose claim the monitor is aware, and if the company is an employer in respect of a pension scheme further to s.126 of the Pensions Act 2004, the Board of the Pension Protection Fund: IA s.A8.

A moratorium lasts for an initial period of 20 business days beginning on the business day after the

moratorium came into effect: IA s.A9. There are three ways in which the period may be extended.

The directors can extend the moratorium for 20 business days after the initial period ends without creditor consent. The directors must file further statements from themselves and the monitor with the court to obtain this type of extension, and the company must have paid its moratorium debts and pre-moratorium debts that are not subject to a payment holiday (see below): IA s.10.

The moratorium can be extended with creditor consent. Creditor consent means a majority by value of secured and unsecured pre-moratorium creditors (CIGA Sched 4, para 28). The moratorium may be extended in this way more than once, but the overall extension cannot be for more than 12 months from the first day of the initial period: IA ss.A11-12.

It can be extended by the court on the application of the directors. The court will consider the interests of pre-moratorium creditors and the likelihood that an extension will result in the rescue of the company as a going concern: IA s.A13.

Effects of the moratorium

One of the defining features of the new moratorium is that it gives the company a payment holiday in respect of certain 'pre-moratorium debts'.

A 'pre-moratorium debt' is defined at IA s.53(1) as follows:

'(a) any debt or other liability to which the company becomes subject before the moratorium comes into force; or (b) any debt or other liability to which the company has become or may become subject during the moratorium by reason of any obligation incurred before the moratorium comes into force.'

It stands in contrast to a 'moratorium debt', which is defined at IA s.A53(2) as:

'(a) any debt or other liability that the company becomes subject to during the moratorium other than by reason of an obligation incurred before the moratorium came into force; or (b) any debt or other liability to which the company has become or may become subject after the end of the moratorium by reason of an obligation incurred during the moratorium.'

There are six exceptions to the payment holiday for pre-moratorium debts. The pre-moratorium debts that a company must continue to pay during the moratorium are as follows:

- The monitor's remuneration or expenses
- Goods or services supplied during the moratorium
- Rent in respect of a period during the moratorium

- Wages or salary arising under a contract of employment
- Redundancy payments
- Liabilities arising under a ‘contract or other instrument involving financial services’, a phrase defined in IA Schedule ZA2.

In addition, the company must continue to pay its moratorium debts.

CIGA provides an incentive for those who continue to extend credit to a company in a moratorium: debtors and pre-moratorium debtors who are not subject to the payment holiday are given priority if the company enters into liquidation or administration within 12 weeks after the end of the moratorium: IA s.174A. Those creditors rank below fixed charge holders, but above the expenses of the subsequent insolvency procedure, floating charge holders and preferential creditors.

As one would expect, a moratorium also restricts the ability of creditors to start insolvency proceedings. Further, floating charge holders are precluded from giving any notice that would cause the floating charge to crystallise, although there are certain financial market exceptions: IA s.A22.

Additionally, a landlord cannot exercise a right of forfeiture; no steps may be taken to enforce security over company property (subject to a number of exceptions); goods subject to hire-purchase may not be repossessed without the court’s permission; and no legal process may be instituted or continued, unless it involves an employment claim, or the court gives permission: s.A21 IA.

Role of the monitor

The monitor is an officer of the court: IA s.34. He or she must monitor the company’s affairs throughout the moratorium to form a view as to whether it remains

likely that the moratorium will result in the rescue of the company as a going concern: IA s.A35.

The monitor must bring the moratorium to an end if, among other matters, he or she thinks that the company is unable to pay any of its moratorium debts that have fallen due, or any of the pre-moratorium debts for which it does not have a payment holiday: IA s.A38.

If a creditor under a moratorium debt or pre-moratorium debt that is not subject to the payment holiday is not paid, its primary recourse therefore appears to be a complaint to the monitor, which in most cases is presumably likely to result in the end of the moratorium.

Creditors, directors or company members may challenge the actions of the monitor and/or the directors (IA ss.42-43), and CIGA creates a number of offences in respect of the behaviour of company officers before a moratorium is obtained and concerning the way in which a moratorium is obtained: IA ss.A46-47.

The end of the moratorium

The moratorium can be brought to an end if the company enters into a consensual debt restructuring or a relevant insolvency procedure, which includes a voluntary arrangement, administration or liquidation. It can also be brought to an end by the monitor or the court, or simply by reason of the time limit for the moratorium expiring.

Conclusion

It will take time to assess whether the UK’s new moratorium provisions genuinely help viable companies survive or whether the effect is more akin to a sticking plaster on a gaping wound. But given that the provisions allow the directors to remain in control in the short term at least, it appears likely that they will become a common feature of UK corporate rescue.

Debt Restructuring: The Developing Role of the Court in Cross Class Cramdowns

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Synopsis

It has long been recognised that there is a need for a mechanism to facilitate a restructuring where a class (or classes) of creditors dissent.¹ The courts have acknowledged that such a mechanism is undoubtedly valuable to promote business rescue.² Chapter 11 of the US Bankruptcy Code has long provided for a cross class cramdown where there are dissenting creditors in certain circumstances.³ In the UK, it seems that the economic effects of the COVID-19 economic slowdown have been undeniably instrumental in persuading the government to finally place business rescue high on their priority list. As a result, apart from the transient measures aimed at containing the economic consequences of COVID-19, the Corporate Insolvency and Governance Bill 2020 ('CIGB') proposes the much-awaited restructuring proposal that allows creation of a plan to rescue a company and facilitate a cross class cramdown of dissenting creditors ('Cross Class Plan'), if certain conditions are met. This was not possible using a single mechanism under the existing insolvency and company law and the previous Scheme of Arrangement mechanism contained in Part 26 (Part 26 only allowed for restructurings where the dissenting creditors were only within a class).

The Cross Class Plan proposals are therefore a welcome development. However, it is likely that the provisions that enable a cross class cramdown will require further court interpretation before the mechanism can be considered mature and a 'ready-to-go' option in the insolvency practitioner's tool kit. Before understanding the court's changed role under the Cross Class Plan provisions, it is important to understand the objective and rationale of the court's role in protecting dissenting creditors in such plans.

Rationale for court involvement

Usually, plans and arrangements are proposed as a part of a broader restructuring process that involve creditors usually being asked by the debtor company to alter their rights and accept a lesser or alternative form of value (such as in debt-for-equity swaps) towards the company. In this situation, should a class (or classes) of creditors not approve such an offer, they find themselves in a peculiar situation; they may exercise their rights and potentially block the implementation of the scheme and/or attempt to extract additional value from the debtor company. Such hold-ups have adverse commercial consequences: they can disrupt not just the scheme but also the larger restructuring process and/or adversely affect the rescue and survival prospects of a business and/or potentially damaging its market value. As a result, legislation allows companies to bring dissenting creditors into line by the threat of an application to the court to sanction a scheme or an arrangement.

The court's overall interest in such matters, from a policy point, seems to stem from the principles of macroeconomics to ensure continuity of business in the state, promote economic growth and genuinely protect rights of creditors that are under threat. So, once the debtor company makes an application for the scheme, the court undertakes various exercises to ensure that the debtor company does not abuse the constraints that are placed on the rights of the creditors to implement a cramdown and misuse the legislation to effect a transfer of wealth between creditors. Correspondingly, the court exercises oversight to ensure that the dissenting creditors, against the backdrop of reasonableness and fair and just treatment of creditors, do not hold-out a restructuring in order to extract monetary benefit for themselves and jeopardise business rescue. Therefore, the court's function and intervention, in this regard, is to balance opposing interests. Consequently, it follows that: the broader the scope of imposition [on creditor

Notes

- 1 Insolvency Service, *A Review of the Corporate Insolvency Framework: a consultation on options for reform*, May 2016
- 2 *Re MyTravelGroup plc* [2004] EWHC 2741 (Ch); [2004] EWCA Civ 1734
- 3 1129(b) of the US Bankruptcy Code

rights], potentially the greater the need for the courts intervention to control potential abuse.⁴

The CIGB

The CIGB, by providing for a cramdown across classes of creditors, introduces impositions on dissenting creditor rights like never before. The proposed legislative provisions also offer flexibility to all stakeholders and a platform that may be utilised by junior or senior creditors to cram up on other creditors across the spectrum whether senior or junior. Furthermore, the overall nature of these provisions essentially removes the ‘hold-up’ advantage that minority creditors could exercise in Part 26 schemes. This is a welcome development as it underlines the priorities of the Cross Class Plan provisions: business revival and rescue. The common denominator between creditors across the spectrum is a better economic outcome. Thus, with this distinction gone, the Cross Class Plan is essentially a tool that can be availed by creditors any where on the spectrum if they can show that a better and competing economic outcome is available to a business to eliminate financial difficulties.

However, greater imposition of rights calls for greater court oversight. The courts are now entrusted with the crucial task of interpreting these provisions in a manner to ensure not only opposing interests are kept in balance and fairness is observed on both ends but also determining complex questions of valuations that will be central to such Cross Class Plans.

The court’s role in relation to two areas in particular will likely require delicate handling:

1. Relevant alternative scenario, and
2. Genuine economic interest and valuation.

The court’s stance towards these issues will be all the more important because unlike the United States where Chapter 11 case law provides detailed statutory guidance as to when a cross-class cramdown is just and fair, in the UK, government guidance on the two key conditions and other areas pertaining to these conditions such as valuation, has largely been absent.

The court’s role

‘Relevant alternative’ and valuation basis

The first condition requires that the court should be satisfied that, if the scheme were to be sanctioned, none of the members of the dissenting class would be any worse off than they would be in the event of the ‘relevant alternative’. The relevant alternative test has been defined in the next sub-section of this provision of the legislation as ‘whatever the court considers would be most likely to occur in relation to the company if the compromise or arrangement were not sanctioned ...’.

In order to make that determination, the court has to consider first what the relevant alternative is, in a situation. The ‘relevant alternative’ test has historically been controversial and for good reason; the ‘relevant alternative’ basically serves as a comparator for the court.

In 2016, it was proposed by the UK Insolvency Service⁵ that, in order to facilitate a full cramdown, to analyse the dissenting class’ position, the relevant alternative should be liquidation. The criticism of this is largely on two lines. First, liquidation in many cases is not the ‘next best’ or ‘only’ alternative that a company has when it is considering a restructuring. Second, if liquidation is the only ‘relevant alternative’, it is problematic from a commercial point of view. In liquidation, a company’s resultant valuation is likely to be lower leading to lower disbursements available for creditors. If the relevant alternative is administration, the company’s valuation is likely to be higher as then the valuation of the company would be as a going concern.

The proposed wording of the ‘relevant alternative’ provision leaves the door open for the court to give a broad and liberal interpretation. It may be that the court, in identifying the ‘relevant alternative’, uses its objective knowledge (neutral market place standpoint) and subjective knowledge of the facts of the case (capital structure, arrangements, cash flow position, debt levels etc.). The court ultimately needs to compare the commercial position of the dissenting creditors in the proposed Cross Class Plan against their position in the ‘relevant alternative’, and for the scheme to be sanctioned, to be satisfied that the position of the dissenting creditors would not be worse off than in the identified ‘relevant alternative’ scenario.

The case for adopting a going concern value is bolstered by the fact that it is the go-to basis as per the EU Restructuring Directive and in most Chapter 11 cramdowns. The English courts have also not completely

Notes

- 4 Jennifer Payne, ‘The Role of the Court in Debt Restructuring’ (20 January 2017). Available at SSRN: <https://ssrn.com/abstract=2902528> or <http://dx.doi.org/10.2139/ssrn.2902528>
- 5 Consultation Paper, May 2016 and see Insolvency Service, ‘Summary of Responses – A Review of the Corporate Insolvency Framework’, September 2016.

rejected alternatives other than liquidation and have usually preferred adopting a subjective approach while determining the valuation basis from the facts of the case.⁶

It is also important to mention that the objective of Part 26A is business rescue and revival. It is a possibility that a court, in applying the rule of purposive interpretation, may interpret the ‘relevant alternative’ scenario in that context and lean more towards a going concern valuation where there is a *prima facie* case.

Therefore, although the addition of the words ‘relevant alternative’ in the CGIB is a welcome development, leaving the task for the court to determine what the relevant alternative is and whether it is appropriate has the potential to be highly litigious. Further, the fact that dissenting creditors would now like to present competing counter-proposals of ‘relevant alternative’ makes it more onerous.

Overall, the silver lining is however that this provision allows the court a great degree of flexibility when considering overall fairness of the commercial impact of a proposed Cross Class Scheme.

‘Genuine economic interest’ and valuation methods

The court’s interpretation of genuine economic interest is relevant in two aspects.

At the class composition stage, a court has to determine the meaning and scope of the term ‘genuine economic interest’ in order to determine which creditors have a say in voting for the proposed Cross Class Plan. This in turn means that the issue of valuation will be likely be addressed at the first hearing before the court comes back to it at the sanction hearing stage.

At this stage, if the court is successfully persuaded that none of the members of a class have a ‘genuine economic interest’ in the company, that class can be excluded from the scheme process.

At the sanction stage, a determination of who holds genuine economic interest is key in gaining the court’s approval for the Cross Class Plan. It is required that the court should be satisfied that the compromise or arrangement has been agreed by a number representing 75% in value of a class of creditors, who would receive a payment, or have a genuine economic interest in the company, in the event of the relevant alternative. The rationale here is simple: this condition recognises the rights of those creditors who would still have an economic interest in the company should the court not sanction the Cross Class Plan i.e. the court looks for approval from those creditors that would be ‘in the money’ not only in the proposed plan but also in the

event of the ‘relevant alternative’. This condition attempts to strike a balance between economic outcomes and creditor interests. It seems that the condition was included to ensure that the approval (of at least 75% in value) comes from not just any class of creditors who would have an economic interest in the Plan but also a class or classes that would have a genuine economic interest in the event of the ‘relevant alternative’ as well.

As a result, this leaves the court with the crucial task of discerning clearly whether certain creditors or members have genuine economic interest in a company and this in turn relies on an effective system of valuation.⁷ Different methods of valuation when applied to the same facts produce different economic outcomes. These outcomes are used in assessing which stakeholders have an economic interest in the company and therefore which ones have the right to be consulted as to the terms of the Cross Class Plan. A higher outcome leads to increased creditor enfranchisement. Conversely, stakeholders who, due to lower outcomes, cannot establish such economic interest in the company at risk of being excluded from the restructuring and bearing a complete loss. Therefore, it can be argued that an effective and correct valuation is necessary for the court for two reasons: one, to completely fulfil its overarching role of oversight to ensure fairness to creditors and the proposed Cross Class Plan and second, ensuring the just and fair application of the two key conditions in legislative provisions.

In *Re Bluebrook*,⁸ two different forms of valuations were put forward by the company and the mezzanine lenders: current market price valuation and future cash flow projection, respectively. At the time, the lenders criticised the current market price valuation on the basis that given the then economic climate, there were fewer transactions occurring in the market and therefore a market price valuation was not reflective of the true potential of the business. As a result, the court should consider the ‘intrinsic value’ of the business and consider the future cash flow projections to be the ideal valuation. Following the lenders valuation, the market value that came out was higher than the market price valuation submitted by the company and therefore they were ‘in the money’ aka had economic interest in the relevant alternative, in that scenario.

However, the court in this case adopted the market price valuation put forward by the company and held that the lenders were ‘out of the money’ and therefore had no right to be consulted as to the terms of the Schemes. The reasoning given by the court suggested a pragmatic interpretation. The court observed that the company’s proposals had produced expert evidence that related to the more practical point of what would a

Notes

6 *Re MyTravelGroup plc* [2004] EWHC 2741 (Ch); [2004] EWCA Civ 1734.

7 Role of the court in debt restructuring; Payne, 2018.

8 *Bluebrook Ltd and others* [2009] EWHC 2114 (Ch).

purchaser pay for this now rather than consider futuristic possibilities of what it might be worth later.

However, the court did not completely dismiss the future projection method. It seems that the reasoning given by the court was based more on the nature and quality of evidence that was presented rather than a judicial analysis. Furthermore, there is a strong argument that current market values of distressed companies tend to be flawed because markets tend systematically to undervalue distressed companies simply because they are distressed.⁹

It therefore seems that the gates for the court to consider future value of a business method to value where the valuation basis is a going concern are potentially open particularly in this post-COVID-19 climate when market conditions are far from ideal and many businesses will struggle to find a buyer.

A noted criticism of the future cash flow projection valuation method is that it enfranchises many creditors who would be 'out of the money' were a business to be valued as a going concern. As mentioned above, given that the courts are more likely to value businesses as a going concern than liquidation, it seems that the court, among other factors, would also take into consideration the economic climate and attempt to reach a middle point between the price that a buyer would pay now and a value based on future cash flow projections.

Finally, it is not impossible that the current economic climate and the new found powers of the court might lead the court to determine the correct valuation method ultimately based upon a battle of the experts at the hearings. Valuation is after all an art and not an exact science.

Notes

9 Kerry O'Rourke, 'Survey: Valuation Uncertainty in Chapter 11 Reorganizations', 2005 *Colum Bus L Rev* 403, 419 (2005).

Interpretation of a Third Party Mortgage under the IBC: The Need to Revisit the *Jaypee* Verdict

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Synopsis

The Insolvency and Bankruptcy Code, 2016 ('IBC' or 'Code') is comprehensive legislation to provide for time-bound resolution of corporate entities facing financial distress.¹ The objective of the Code is to achieve maximisation of the value of assets and availability of credit in the market.² As the Code is at the nascent stage, its interpretation has been surrounded by various naive legal ambiguities and issues. Though the judiciary has surmounted such novel challenges through various measures, the outcome of the judgments in a few cases have invited mixed reactions both from the market as well as the legislature. For instance, on the recommendation of the IBBI working report,³ the law laid down by the Supreme Court ('SC') in the *Ramakrishnan*⁴ case, which disregarded the applicability of a moratorium for personal guarantors to the corporate debtor, was incorporated into the Code through an amendment.⁵ However, the verdict of the National Company Law Appellate Tribunal ('NCLAT') in the matter of *Essar Steel*⁶ dictating equal treatment of both the financial and operational creditors was almost overruled through legislative intervention.⁷

Recently, the SC's verdict in *Anuj Jain (Interim Resolution Professional for Jaypee Infratech Limited) v Axis Bank Etc.*⁸ ('*Jaypee*') to treat the lenders holding 'third party

security'⁹ by mortgage as only 'secured creditors' and not 'financial creditors' has drawn sharp reactions both from the market as well as the legal fraternity. Authors have speculated that the decision may have far-reaching consequences, as other lenders holding third-party securities in the nature of pledge or hypothecation would not be treated as 'financial creditors'.¹⁰ Moreover, it could substantially affect the structuring of financial transactions and evaluation by the lenders.¹¹

In this context, this article seeks to argue that the strict interpretation of the term 'financial debt' under the Code to debar the 'third party security holders' as 'financial creditors' of the corporate debtor has compromised the noble objectives of the Code and had also undermined the relevance of 'third party security' in the financial market. The author thus seeks reconsideration of the SC's verdict in *Jaypee*.

The article is divided into the following parts. Part I of the article mainly deals with the analysis of the *Jaypee* verdict on the specific issue of entitlement of a 'third party security holder' as a 'financial creditor' under the Code. Part II then delves into the aspects regarding the various implications that could arise out of the judgment. Part III establishes that third party security holders must be considered as financial creditors under the Code and finally Part IV lays down the way forward in this regard.

Notes

- 1 Insolvency and Bankruptcy Code, 2016, Preamble.
- 2 *Ibid.*
- 3 Ministry of Corporate Affairs, Government of India, 'Report of the Insolvency Law Committee', para. 5.11. <http://www.mca.gov.in/Ministry/pdf/ReportInsolvencyLawCommittee_12042019.pdf> March 2018.
- 4 *State Bank of India v V. Ramakrishnan & Anr.*, Civil Appeal no. 3595 of 2018 with Civil Appeal no. 4553 of 2018.
- 5 See Insolvency and Bankruptcy Amendment Act, 2018.
- 6 *Standard Chartered Bank v. Satish Kumar Gupta, R.P. of Essar Steel Ltd. & Ors.*, Company Appeal (AT) (Ins.) No. 242 of 2019.
- 7 See Insolvency and Bankruptcy Code (Amendment Ordinance) 2018.
- 8 *Anuj Jain (Interim Resolution Professional for Jaypee Infratech Limited) v Axis Bank etc.*, Civil Appeal nos. 6777-6797 of 2019.
- 9 Andrew Evans, 'A Guide to Third Party Security', <<https://www.fieldfisher.com/en/insights/a-guide-to-third-party-security>> 27 February 2014. 'A third party security is security given by an individual or entity which secures the liability of a third party. If the third party security does not contain any personal obligation to pay on the part of the mortgagor or chargor, it can be treated like a limited recourse guarantee so that the liability of the mortgagor or chargor is limited to the amount which can be realised upon disposal of the third party security.'
- 10 Prateek Kumar, Ashwin Bishnoi and Raveena Rai, 'Mortgage Offered by Subsidiary Under Insolvency to Secure Parent Company's Debt – A Preferential Transaction: Supreme Court', <<https://www.mondaq.com/india/Finance-and-Banking/901020/Mortgage-Offered-By-Subsidiary-Under-Insolvency-To-Secure-Parent-Company-39s-Debt-A-Preferential-Transaction-Supreme-Court?login=true>> 6 March 2020.
- 11 L. Viswanathan and Abhijeet Dash, 'The "Jaypee Judgement" – Assessing its impact on the Indian financing landscape', <<https://corporate.cyrilamarchandblogs.com/2020/03/the-jaypee-judgement-assessing-its-impact-on-the-indian-financing-landscape/>> 12 March 2020.

I. The *Jaypee* verdict regarding the treatment of ‘third party security holders’ as ‘financial creditors’ under the Code

In this case, Jaiprakash Associates Limited (‘JAL’) availed loans from ICICI Bank Ltd. and Axis Bank Ltd. (‘lenders’). The debt was secured through mortgage of the assets belonging to the corporate debtor, i.e. Jaypee Infratech Limited (‘JIL’), the subsidiary company of JAL. Subsequently, when the insolvency proceeding was initiated against JIL, the lenders filed a claim before the Interim Resolution Professional (‘IRP’). However, the claim was rejected by the IRP on the ground that the debt was not directly disbursed to JIL against ‘consideration for the time value of money’¹² so as to constitute a ‘financial debt’ under the Code. Moreover, it was also held that the financial arrangement to provide a third party security in the form of mortgage does not constitute a guarantee pursuant to S. 5(8)(i) read with S. 5(8)(a) of the Code.¹³ The order of the IRP was challenged before the National Company Law Tribunal (‘NCLT’) which reiterated the reasoning of the IRP and rejected the claims of the lenders.¹⁴ Later an appeal was filed before the National Company Law Appellate Tribunal (‘NCLAT’). However, this specific issue was not adjudicated on merit as many appeals were clubbed together and a final order was passed. Hence, the issue was ultimately adjudicated by the SC under its original civil appellate jurisdiction. The SC, on this specific issue, held that the lenders of JAL cannot be considered as ‘financial creditors’ of JIL under the Code. It opined that even if certain assets were mortgaged by JIL to secure the debt for JAL, such arrangement would not entitle its lenders to file a claim against JIL. The underlying rationale behind this decision of the Court is discussed below.

a. Restrictive interpretation of the term ‘financial creditors’ under the Code – application of the ‘means and include’ test

A primary reason for the narrow interpretation of the term ‘financial debt’ by the SC was the usage of

the words ‘means’, ‘and includes’ under S. 5(8) of the Code. The provision stipulates thus

“‘financial debt’ means a debt along with interest, if any, which is disbursed against the consideration for the time value of money *and includes*’ (emphasis added)

The term ‘and includes’ is used under S. 5(8) to cover all kinds of financial arrangements which are enumerated under S. 5(8)(a) to S. 5(8)(i).

On interpreting S. 5(8) of the Code, the SC opined that the use of terms ‘means’ and ‘and includes’ requires a restrictive interpretation of the definition of ‘financial debt’. In this regard, it stated that the usage of the word ‘means’ denotes an exhaustive interpretation.¹⁵ Whereas the usage of ‘and includes’ indicates enlarging the meaning of an expression.¹⁶ However, as per the precedents, when the terms ‘means’ and ‘and includes’ are used together even if disjunctively and not conjunctively, such interpretation needs to be exhaustive and not extensive.¹⁷ It was also of the opinion that the inclusive part of the definition cannot prevent the main provision from receiving its natural meaning.¹⁸

Therefore, in this context, the SC concluded that due to the use of word ‘means’ under S. 5(8), the basic constituent of a ‘financial debt’ is the ‘disbursal of debt’ against ‘consideration for the time value of money’. Thus, where a third party mortgages its assets in favour of the lender for the loan to be sanctioned in favour of the principal debtor, then in such a situation the debt is disbursed to the principal debtor against the consideration for the time value of money and not against the third party.¹⁹

Hence, the SC concluded that mere creation of certain mortgages by JIL in favour of the lenders to secure the loan against JAL would not in itself be sufficient to classify the lenders as financial creditors of JIL.

b. Third party mortgages does not amount to a ‘financial debt’

Pursuant to S. 5(8)(i) read with S. 5(8)(a) to (h) of the Code, any liability towards the guarantee is considered to be a ‘financial debt’ and consequently the lender

Notes

- 12 Cambridge Dictionary, ‘Time Value of Money’ <<https://dictionary.cambridge.org/dictionary/english/time-value-of-money>> March 2020. ‘the principle that money received early from an investment or paid back early on a loan is worth more than if that amount of money were received or paid back at a later time’.
- 13 *ICICI Bank Limited v Mr. Anuj Jain*, Company Petition No. (IB)77/ALD/2017, para. 3.13.
- 14 *Ibid.*, para. 13.
- 15 *Jaypee*, *supra* n. 8, para. 42.
- 16 *Ibid.*
- 17 *Delhi Development Authority v Bhola Nath Sharma (Dead) by LRs & Ors.*, (2011) 2 SCC 54; *Bharat Coop. Bank (Mumbai) Ltd. v Employees Union*, (2007) 4 SCC 685; *N.D.P. Nambodripad v Union of India*, (2007) 4 SCC 502; *Hamdard (Wakf) Laboratories v Labour Commr.* (2007) 5 SCC 281; *Black Diamond Beverages & Anr. v Commercial Tax Office, Central Section, Assessment Wing, Calcutta & Ors.*: (1998) 1 SCC 458.
- 18 *Jaypee*, *supra* n. 8, para. 42.3.
- 19 *Ibid.*, para. 51.

could file a claim as a financial creditor against the corporate debtor who acts as surety to the contract of guarantee. In the context of the said provisions, it was argued by the lenders that the mortgages created by JIL were nonetheless a guarantee as per S. 5(8)(i) read with S. 5(8)(a) of the Code and hence they must be considered as a 'financial creditor' of JIL.²⁰ Emphasis was placed on the previous decision of the Gujarat High Court²¹ and the NCLT (Mumbai)²² wherein principles of guarantee were applied to arrangements involving third party mortgages.

Additionally, by reliance upon various precedents, it was also argued that under S. 58 of the Transfer of Property Act, 1882 ('TOPA') the creation of a mortgage results in a covenant to discharge the liability towards the debt.²³ Further, under the said provision, when a valid mortgage is executed there is always a presumption of the existence of a debt.²⁴ Hence, it was emphasised that when there exists a presumed debt under a mortgage, it would invariably constitute a 'financial debt' within the meaning of S. 5(8) of the Code, even if no amount is directly disbursed to the corporate debtor against the consideration for time value of money.²⁵

However, this contention of the lenders was rejected by the SC. It held that the mortgage created by a third party did not qualify to be a 'financial debt', as S. 5(8) of the Code conspicuously omitted mortgage and required 'disbursement' to the corporate debtor against 'the consideration for the time value of money' as the determinative criteria.²⁶ It was of the opinion that these criteria under S. 5(8) could be not forsaken such that any transaction could stand alone to become a financial debt.²⁷ Further, on the aspect of the presumption of debt under S. 58 of the TOPA, the Court held that:

'if a corporate debtor has given its property in mortgage to secure the debts of a third party, it may lead to a mortgage debt and, therefore, it may fall within the definition of "debt" under Section 3(10) of the Code. However, it would remain a debt alone and

cannot partake the character of a "financial debt" within the meaning of Section 5(8) of the Code.'²⁸

Hence, both the arguments regarding treatment of a third-party mortgage as a guarantee and the presumption of debt arising out of S. 58 of the TOPA were rejected by the SC.

c. Treatment of 'third party security holders' as the 'financial creditors' does not further the objectives of the Code

The other aspect dealt by the SC was whether or not the treatment of 'third party security holders' as the 'financial creditors' advances the objectives of the Code. To this end, the lenders argued that the entitlement of the 'third party security holders' as 'financial creditors' would fulfil the objectives of the Code. It was also pleaded that non-conferment of the 'financial creditors' status to the lenders would lead to serious prejudice against their rights since the resolution plan could take away the security interest without their participation.²⁹ Moreover, as commercial wisdom of the 'Committee of Creditors' ('CoC') cannot be challenged after the approval of the resolution plan,³⁰ the presence of the lenders who are third party security holders is a necessity to fulfil the objectives of the Code.

However, the aforementioned arguments were rejected by the SC for the reason that, in light of its own verdict in *Swiss Ribbons*,³¹ the financial creditors ought to be only those creditors who lend finance to the corporate debtor to operate its business and who from the very inception are involved in the assessment of its viability. The principal aim of such financial creditors is to aspire for the well-being of the corporate debtor. However, if the third party security holders are to be considered as the financial creditors, then the growth or revival of the corporate debtor would be a causality as they would only be interested in realising the value of their security and not the revival and growth of the corporate debtor.³²

Notes

20 *Ibid.*, para. 37.4.

21 *State Bank of India v Smt. Kusum Vallabhdas Thakkar*, 1991 SCCOnline GUJ 14.

22 *SREI Infrastructure Finance Limited v Sterling International Enterprises Ltd.*, M.A. No. 1584/2019 in CP No. 402 of 2018 dated 13 March 2019.

23 *Rajkumari Kaushalya Devi v Bawa Pritam Singh & Anr.* AIR 1960 SC 1030.

24 *Pomal Khanji Govindji & Ors. v. Brajlal Karsandas Purohit & Ors.*, (1989) 1 SCC 458; *Prithvi Nath Singh & Ors. v. Suraj Ahir & Ors.*, (1963) 3 SCR 302; *Dassappa & Ors v. Jogaiah & Ors.*, (1964) ILR 545; *Manik Chand Raut v Baldeo Chaudhary & Ors.*: (1949) SCCOnline Pat 64; *Jaypee*, supra n. 8, para. 37.3.1.

25 *Jaypee*, supra n. 8, para. 37.1.4.

26 *Ibid.*, para. 51.

27 *Ibid.*, para. 43.

28 *Ibid.*, para. 47.2.

29 *Ibid.*, para. 37.3.2.

30 *Ibid.*, *K. Sashidhar v Indian Overseas Bank and Ors.*, 2019 SCC OnLine SC 257.

31 *Swiss Ribbons Private Limited and Anr. v Union of India and Ors.*, (2019) 4 SCC 172.

32 *Jaypee*, supra n. 8, para. 47.1.

II. Implications of the verdict

a. Survival of 'guarantee' vis-à-vis the restrictive interpretation of S. 5(8) of the Code

As per S. 5(8)(i) any liability under a guarantee given to secure any debt enumerated under clauses (a) to (h) of S. 5(8) is considered to be a 'financial debt' in itself under the Code. The narrow interpretation of S. 5(8) by the SC that disbursement of debt against the consideration for time value of money are pre-requisites of a 'financial debt', stands in sharp contradiction with the established common law principles of guarantee. As per the Contract Act, 1872 ('Contract Act'), anything done in favour of the principal debtor is sufficient consideration for the surety.³³ The courts have even laid down that a mere benefit to the principal debtor is sufficient guarantee for the surety.³⁴

In the case of *State Bank of India v Smt. Kusum Vallabhdas Thakkar*,³⁵ ('Thakkar') it was clearly held that when the third party mortgages its assets in favour of the creditor for the loan to be advanced in favour of the principal debtor then in such a scenario it is not necessary that the consideration should flow directly between the third party mortgagor and the creditor. The High Court in this case had applied the principle of guarantee under S. 127 of the Contract Act.

Moreover, in accordance with the traditional rules of interpretation, in cases when a statutory word has a meaning in common law that is widely understood and accepted, courts will adopt the common law meaning.³⁶ For example, the US Supreme Court has noted 'extortion' to be a common law word, and it interpreted that term by reference to its meaning at common law.³⁷

Applying the aforesaid principles, it could be safely inferred that the term 'guarantee' as used under S. 5(8)(i) of the Code should be interpreted in the context of its substance in common law. Applying the common law principle enumerated under S. 127 of the Contract Act, the condition for disbursement of debt for the consideration against the time value of money is not essential as against the surety. Hence, in order to be treated as a 'financial creditor', the creditor cannot be required to disburse the debt against the consideration for the time

value of money, to a corporate debtor, who stands as the surety in a contract.

Unfortunately, the decision in the *Thakkar* case was held to be inapplicable by the SC in the *Jaypee* decision. The SC did not disagree that principles of guarantee could be applied to third party mortgage arrangements.³⁸ However, still it did not classify the lenders of JAL as financial creditors of JIL due to its narrow interpretation of S. 5(8) of the Code.

It is argued that if such narrow interpretation of S. 5(8) of the Code supersedes the principle of guarantee enumerated under S. 127 of the Contract Act, the creditor would be required to disburse the debt against the consideration for the time value of money as against the surety in order to become a 'financial creditor'. However, such interpretation would lead to nullification of the common law principle without any express statutory mandate.

b. Effect on the objectives of the Code

The Banking Law Reforms Committee Report ('BLRC Report') clearly suggested that with the aim to improve ease of doing business in India, the main objective behind enactment of the Code was to guarantee time bound resolution of financial distress in corporate entities.³⁹ To this effect both the legislature and judiciary have played a significant role in ensuring that the time limits enumerated under the Code are strictly followed. The legislature, through an amendment, has dictated the completion of the resolution process to be within 330 days.⁴⁰ In its *Essar Steel* verdict the SC also enunciated that the outer limit of 330 days ought to be followed religiously and be exceeded only in exceptional circumstances.⁴¹ Moreover, the NCLAT has also not agreed to condone the delay in filing appeals beyond the mandate of the Code.⁴²

Additionally, the BLRC Report indicated that the Code was enacted with the aim of ensuring that the distressed firm continues as a going concern, and to avoid the value destruction of the corporate debtor, through sale of assets by the secured lenders under the Securitisation and Reconstruction of the Financial Assets and Enforcement of the Security Interest Act, 2000

Notes

33 Contract Act, 1872, S. 127.

34 Avatar Singh, *Contract and Specific Relief* (11 ed. Easter Book Company, Lucknow) (2013) p. 584; *Prasanjit Mahtha v United Commercial Bank Ltd*, AIR 1979 Pat. 151.

35 *Thakkar*, *supra* n. 21.

36 *Carter v United States*, 530 U.S. 255, 266 (2000).

37 *Ibid.*; *Evans v. United States*, 504 U.S. 255, 261–64 (1992).

38 *Jaypee*, *supra* n. 8, para. 51.

39 Bankruptcy Law Reforms Committee, 'Report of the BLRC Volume I: Rationale and Design', para 3.4.1 <https://ibbi.gov.in/BLRCReport-Vol1_04112015.pdf> 4 November 2015.

40 Insolvency & Bankruptcy (Amendment) Act, 2019, proviso to S. 12.

41 *Committee of Creditors of Essar Steel India Limited Through Authorised Signatory v Satish Kumar Gupta & Ors.*, Civil Appeal no. 8766-67 OF 2019, para. 79.

42 *Jagwani Group of Industries Pvt. Ltd. & Anr v Aryavart Chemicals Pvt. Ltd. & Ors.* Company Appeal (AT) (Ins) No.938 – 939 of 2019.

(‘SARFAESI’).⁴³ To attain this objective of the Code the courts have declared resolution of the corporate debtor to be the norm and liquidation to be an exception.⁴⁴ Recently, in one of its decisions the NCLAT held that even during the stage of liquidation, a scheme of compromise under S. 230 of the Companies Act, 2013 could be furnished to revive the corporate debtor.⁴⁵ Similarly, the SC in the case of *Maharashtra Seamless Ltd.* approved the resolution plan at an amount less than the liquidation value, to further the objective of maintaining the corporate debtor as a going concern.⁴⁶

It is argued that non-treatment of ‘third party security holders’ as ‘financial creditors’ may cause serious prejudice to the aforesaid objectives of the Code. As the Code dictates the just and fair treatment of all the creditors,⁴⁷ a resolution plan seeking to abdicate the security of these security holders, without their participation in the CoC, may face frequent challenges before the NCLT. This would consequently lead to prolonged litigation and would hamper the time bound resolution of the corporate debtor. Further, as the SC has given prominence to the commercial wisdom of CoC,⁴⁸ to the extent that resolution plans have been approved below the liquidation value,⁴⁹ the third party security holders may swiftly initiate the proceedings under SARFAESI to recover the maximum amount through sale of secured assets, instead of waiting for the commencement of the insolvency proceedings. These individual recovery actions will lead to deficiency in the availability of assets and would affect the overall resolution of the corporate debtor. A potential investor will balk at the purchase of a distressed company which will bring with it more liabilities than assets.⁵⁰ Hence, this would ultimately defeat the objective of maintaining the corporate debtor as a going concern and would regrettably lead to more liquidation of the corporate debtor.

c. Relevance of the third party mortgages vis-à-vis the Code and its impact

If the law upholds the legitimate expectations of the transacting parties at the time of the transaction, it provides essential certainty and predictability to the

marketplace.⁵¹ Such predictability allows for more accurate risk measurement and therefore fosters lending and other voluntary transactions at more accurate and presumably lower-risk premiums.⁵²

The rationale behind granting loans against third party security by the lenders is that if the principal debtor fails to pay the debt then the secured asset of the third party could be realised by the creditor. The underlying legitimate expectation behind such a transaction is not limited to the sale of assets by the creditors but also equal protection of their rights under the insolvency law. This is because under common law the third party security arrangements are considered as a guarantee⁵³ and liability towards the guarantee is considered to be a ‘financial debt’ under the Code.⁵⁴ The creditors, while entering into such transactions, are cognisant that in case the corporate debtor, who provides the third party security, faces insolvency then the interest of such creditors would be safeguarded as they would be in a position to negotiate the debt while being a part of the CoC.

It is argued that as third party security arrangements are not considered to be a guarantee under the Code, it would seriously undermine its significance in the financial market. The treatment of third-party security holders as ‘secured creditors’ but not ‘financial creditors’ under the Code would provide more impetus to individual recovery actions rather than collective resolution. This would lead to an increase in the cost of lending and would raise difficulties for the various corporate entities, especially those inter-linked through business operations under a corporate group, to secure debt upon the security of the other.

III.A case for treatment of third party security holders as financial creditors

a. Third party security arrangements are treated as guarantees under common law

As per the Contract Act, a contract of guarantee is a contract to perform the promise, or discharge the

Notes

43 *K. Sashidhar v Indian Overseas Bank*, 2019 SCCOnline SC 257.

44 See *M/S. Innoventive Industries Ltd v ICICI Bank*, Civil Appeal no. 8337-8338 of 2017; *Industrial Services & Ors v Burn Standard Company Ltd. & Anr.*, Company Appeal (AT) (Insolvency) No. 141 of 2018.

45 *Jindal Steel and Power Limited v Arun Kumar Jagatramka & Gujarat NRE Coke Limited*, Company Appeal (AT) No. 221 of 2018.

46 *Maharashtra Seamless Limited v Padmanabhav Venkatesh & Ors.*, Civil Appeal no. 4242 of 2019, para. 28.

47 Insolvency and Bankruptcy Code, 2016, exp. 1 to S. 30.

48 *Sashidhar*, *supra* n. 30.

49 *Maharashtra Seamless*, *supra* n. 46.

50 Douglas G. Baird and Robert K. Rasmussen, ‘The End of Bankruptcy’, 55 *Stan. L. Rev.* 751, 787 (2002).

51 Bob Wessels, Bruce A. Markeel & Jason J. Kilborn, *International Cooperation in Bankruptcy and Insolvency Matters* (Oxford University Press, New York, 2009), para. 20.5.

52 *Ibid.*

53 Kindly refer to part III.a. of this article.

54 Insolvency and Bankruptcy Code, S. 5(8)(i).

liability, of a third person in case of his default.⁵⁵ The person who gives the guarantee is a 'surety' and the person in respect of whom the guarantee is given is called the 'principal debtor'.⁵⁶ The person to whom the guarantee is given is called the 'creditor'.⁵⁷ Under common law the surety can give the guarantee in the form of a mortgage to secure the loan for the principal debtor. These arrangements have been accepted as commercial practice in various jurisdictions. In the UK, various principles of guarantee have been invoked to adjudicate upon the rights and liabilities of the parties involved in third party mortgage arrangements. For instance, the 'principle of variance' has been widely applied by the courts to discharge the surety that mortgaged its own property to secure the loan for the principal debtor. In the case of *Bolton v Salmon*,⁵⁸ it was observed that

'A surety pledges his personal credit by note, covenant, or otherwise, and by the same contract pledges also his goods or charges, or mortgages his lands, as security for the same debt. The alteration of the contract without his consent or without the reservation of rights against him affects his position equally in regard to every part of his contract of suretyship.'⁵⁹

A similar principle was also upheld in the case of *Bolton v Buckenham*.⁶⁰ Further in the case of *Perry v National Provisional Bank of England*,⁶¹ the principle of 'co-extensive liability' under the contract of guarantee was applied when the surety mortgaged its own property to secure the loan for the principal debtor. Moreover, in the USA, the courts have also recognised the right of subrogation⁶² of the third-party mortgagor as against the principal debtor.

In the Indian landscape as well, any security given by a third party against the disbursement of debt to the principal debtor is considered to be a 'guarantee'. Under the provisions of SARFAESI, the security provided by the third party through the pledge of shares or any other mode, is conclusively considered to be a guarantee for the enforcement actions by the secured creditor.⁶³ Apart from the verdict in the *Thakkar* case, the analysis of the various other judgments clearly signify that the third party mortgages can be considered as guarantees.

In the case of *KT Sulochana Nair v Managing Director of Orissa State Financial Corpn*⁶⁴ by applying the principles of suretyship the property mortgaged by a third party was allowed to be realised by the state finance corporation on the default by the industrial concern in the repayment of a loan. Similarly, in the case of *Hukamchand Insurance Co Ltd v Bank of Baroda*,⁶⁵ the defendants as third parties hypothecated their moveable assets, and deposited, by way of mortgage, the title deeds of their immovable properties as security. The court, on application of the general principles of guarantee, held that the creditor could enforce the security without first exhausting its remedies against the principal-debtor.

Therefore, in view of the aforementioned decisions, it is reasonable to assert that the third-party security arrangements are treated as guarantees under common law and these principles have been also applied by the courts in India.

b. Common law needs to be read in the statute if there is no express repeal

As per the common law rules of interpretation, Parliament is not presumed to make any alteration to the common law further or otherwise than the act expressly declares.⁶⁶ The rationale behind such rule of interpretation was aptly summarised by Lord Eeid in *George Wimpey and Co. Ltd. v B.O. A.C.*⁶⁷ as follows:

'It is thought to be in the highest degree improbable that Parliament would depart from the general system of law without expressing its intention with irresistible clearness, and to give any such effect to general words merely because this would be their widest, usual, natural or literal meaning would be to place on them a construction other than that which Parliament must be supposed to have intended. If the arguments on a question of interpretation are fairly evenly balanced, that interpretation should be chosen which involves the least alteration of the existing Law.'

Notes

55 Contract Act, 1872, S. 126.

56 *Ibid.*

57 *Ibid.*

58 *Bolton v Salmon*, [1891] 2 Ch. 48.

59 *Ibid.*, p. 53.

60 *Bolton v Buckenham*, [1891] 1 QB 278.

61 *Perry v National Provisional Bank of England*, [1910] 1 Ch. 464.

62 *Hart v Chase*, 46 Conn. 207 (1878).

63 Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, S. 13 (11).

64 *KT Sulochana Nair v Managing Director of Orissa State Financial Corpn* AIR 1992 Ori 157.

65 *Hukamchand Insurance Co Ltd v Bank of Baroda* AIR 1977; *Eshelby v Federated European Bank Ltd* [1932] 1 KB 423.

66 *Arthur v Bokenham*, 11 Mod. 148; *Greenwood v Greenwood*, 28 Md. 369.

67 *George Wimpey and Co. Ltd. v B.O. A.C.*, 1955 AC 169.

The rules of interpretation further requires that when any question arises as to the meaning or the scope of a statutory enactment, it is a good rule to compare it with the common law and construe the statute with reference to that law.⁶⁸ In the case of the *Trustees of the Port of Bombay v The Premier Automobiles Ltd.*⁶⁹ the Bombay High Court applied the common law rules of interpretation to state that S. 87(2) of the Bombay Port Trust Act, 1879 did not abrogate the common law principle of vicarious liability of the master for the wrong committed by the servant in the course of the employment. It was reiterated in this case that the common law principle can only be abrogated by a statute through 'necessary implication' or 'irresistible clearness'.

In light of the precedents, it is argued that the third-party mortgage arrangement which are considered as 'guarantees' under the common law could be interpreted likewise under S. 5(8)(i) of the Code. The interpretation in favour of the common law is not debarred by the language of S. 5(8) expressly or through necessary implication. A balanced approach between the intent of the legislature and the common law would be to treat the disbursement of debt against the consideration for the time value of money as a prerequisite only as against the principal debtor and not the surety who mortgages his own property.

c. Treatment of 'third-party security holders' as 'financial creditors' shall further the objectives of the Code

An effective insolvency law preserves the estate of the corporate debtor and restricts premature sale of the debtor's assets by the individual creditors.⁷⁰ This reason for such a position is to maintain the affairs of the corporate debtor as a going concern.⁷¹ To avoid unilateral actions by the secured creditors, it has been suggested that a sound bankruptcy process shall always seek to create a platform for negotiation between creditors and external financiers to restructure the liabilities of the corporate debtor.⁷²

One of the primary objectives behind the enactment of the Code was to foster the availability of credit in the market.⁷³ It was emphasised that due to lack of a comprehensive legislation on insolvency, lenders skeptical of low recovery only advanced loans against collateral.⁷⁴ This eventually restricted the circulation of credit to a handful of debtors who had tangible security.⁷⁵

It is argued that the treatment of 'third party security holders' as 'financial creditors' will further the objectives of the Code. Given that the primary focus of the Code is to foster availability of credit in the market, the non-participation of creditors holding third party mortgages in the CoC would discourage lending to a debtor on the security of another. This would inadvertently lead to availability of credit in the market to only those few sections of debtors who possess tangible assets of higher value and are not dependent on others for security.

It is asserted that the treatment of third party security holders as financial creditors under the Code would open avenues for negotiation between the corporate debtor and these creditors. This would lead to a comprehensive resolution of the corporate debtor and would mitigate litigation. It would also curtail unilateral actions to sell the assets of the corporate debtor under distress. In effect, such a position would lead to more debt financing in instruments involving third party security and would fulfil the objective of the Code.

IV. Conclusion

The present article demonstrates that the third party mortgage is regarded as an acceptable commercial practice under common law. The issues arising from these financial arrangements have been adjudicated by applying the common law principle of guarantee. It is submitted that the SC in the *Jaypee* verdict failed to consider the well-established principles of guarantee jurisprudence under common law. The identification of the prerequisites for 'financial debt' to mean the direct disbursement of debt against consideration for the time value of money as against the corporate debtor who is a surety to an agreement, has undermined the common law principle that anything done for the benefit of the principal debtor is sufficient consideration for the surety.

It would have been ideal if the SC had considered the lenders of JAL as the corporate debtors of JIL. The SC could have adopted a balanced approach by interpreting S. 5(8) vis-à-vis S. 5(8)(i) read with S. 5(8)(a) of the Code, in a manner by which disbursement of debt against consideration for the time value of money could be an essential pre-requisite as against the principal debtor but not against the surety. This approach would have

Notes

68 *Scalje v Stovall*, 67 Ala. 237; *Howe v Peckham*, 6 How. Pr. 229.

69 *Trustees of the Port of Bombay v The Premier Automobiles Ltd.*, AIR 1971 Bom. 317.

70 United Nations Commission on International Trade Law, 'Legislative Guide on Insolvency Law', pg. 10 (vol. I United Nations, New York, 2005).

71 BLRC Report, *supra* n. 39, para. 3.5.

72 *Ibid.*, para. 3.2.3.

73 *Ibid.*, para. 3.4.1.

74 *Ibid.*, para. 3.5.

75 *Ibid.*

meant that if the debt amounts to a financial debt under S. 5(8) as against the principal debtor the same would be valid as against the surety and not otherwise. Such an approach would have been in consonance with the established principle of co-extensive liability enumerated under S. 128 of the Contract Act.

However, since such an approach has not been followed, it is asserted that the verdict of the SC in *Jaypee* may have far reaching consequences. In a typical corporate group structure there are inter-corporate finances and business collaborations. There are many situations where sometimes one of the companies may fall short of the collateral and may have recourse to another member of the group for collateral in various forms such as mortgage, pledge, hypothecation, etc. However, the relevance of such facilities would now be undermined owing to the limited protection of the third party security holders under the Code. This would inevitably undermine the noble objective of the Code. Hence, the verdict of the SC in the *Jaypee* decision requires reconsideration in the respectful view of the author.

***Robt. Jones Holdings Ltd v McCullagh* [2019] NZSC 86, [2019] 1 NZLR 641: Diminution of the Asset Pool Available to Creditors not Required for Voidable Transactions under s 292 of the Companies Act 1993 (NZ)**

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Synopsis

The Supreme Court of New Zealand¹ recently held that there is no requirement that an insolvent transaction must result in the diminution of a company's assets in order for the transaction to be voidable by a liquidator. The only requirements are those expressly set out in s 292 of the Companies Act 1993 ('1993 Act'). The Court considered the position under the various predecessors to the 1993 Act and the approaches of the courts of other jurisdictions with comparable provisions (including Australia, Canada and the United Kingdom). The Supreme Court approached the question on appeal as being fundamentally one of statutory interpretation, looking first to the text of s 292 then to the purpose of the provision and the voidable transaction regime. In upholding the decision of the Court of Appeal, the Supreme Court found that the text of s 292 left no room for a common law diminution requirement under previous enactments to survive, and supported this reasoning with an analysis of the broader policy objectives underlying the current legislative regime. The decision provides helpful clarity to insolvency practitioners and counsel as to what must be proven in order for a liquidator to succeed in setting aside an insolvent transaction (and, perhaps more importantly, what need not be proven).

Background

The appeal arose from an application by the liquidators of Northern Crest Investments Ltd² ('Northern Crest') to set aside an alleged voidable insolvent transaction made in the two years prior to the liquidation of Northern Crest.³ Northern Crest was the lessee of a property owned by Robt. Jones Holdings Ltd ('RJH').⁴ After it fell into arrears in its payment of rent, Northern Crest entered into various settlement agreements with RJH. As a result, payments were made to RJH by two related companies of Northern Crest: \$489,183.07 by Columbus Property Marketing Ltd and \$262,758.05 by MSH No 2 Ltd ('MSH2').⁵ However, each payment fell within the relevant two-year period prior to the liquidation of Northern Crest and was therefore potentially voidable by the liquidators.⁶ The High Court and Court of Appeal found that each of the payments was an insolvent transaction that could be set aside by the liquidators, and ordered RJH to pay an amount equal to the payments to the liquidators.⁷ RJH appealed to the Supreme Court. The appeal concerned only the MSH2 payments (treated as one payment for the purposes of the proceeding).⁸

The parties' submissions

The central issue on appeal was whether there is a requirement for the assets of the company in liquidation to be diminished by an insolvent transaction in order

Notes

- 1 The Supreme Court is New Zealand's highest court.
- 2 Previously called Blue Chip Financial Solutions Ltd.
- 3 *Robt. Jones Holdings Ltd v McCullagh* [2019] NZSC 86.
- 4 At [13].
- 5 At [13].
- 6 At [2].
- 7 See *McCullagh v Robt. Jones Holdings Ltd* [2017] NZHC 2182, [2018] NZCCLR 8; *Robt. Jones Holdings Ltd v McCullagh* [2018] NZCA 358.
- 8 The Columbus payments were held to be voidable insolvent transactions by the High Court and Court of Appeal, and RJH did not contest this on appeal to the Supreme Court: *Robt. Jones Holdings Ltd v McCullagh* [2019] NZSC 86 at [14]-[15].

for the transaction to be voidable under s 292.⁹ Section 292 relevantly provides:

292 Insolvent transaction voidable

(1) A transaction by a company is voidable by the liquidator if it –

- (a) is an insolvent transaction; and
- (b) is entered into within the specified period.

(2) An *insolvent transaction* is a transaction by a company that –

- (a) is entered into at a time when the company is unable to pay its due debts; and
- (b) enables another person to receive more towards satisfaction of a debt owed by the company than the person would receive, or would be likely to receive, in the company's liquidation.

[...]

It argued that although no diminution requirement is included in the section itself, such a requirement existed at common law under previous iterations of the voidable transaction provision and continued in existence following the enactment of the 1993 Act. On RJH's view of the case, the effect of the MSH2 payments was that:¹⁰

- (a) MSH2 was deemed to have advanced the sum paid to RJH to Northern Crest;
- (b) MSH2 was deemed to have then paid that sum to RJH on Northern Crest's behalf; and
- (c) the result was that MSH2 was substituted for RJH as a creditor of Northern Crest without any change in the assets available to creditors of Northern Crest.

Accordingly, RJH argued that the payments made by MSH2 to RJH were not voidable by the liquidators of Northern Crest because no diminution occurred.¹¹ In doing so, it argued that the true purpose of s 292 is to protect an insolvent company's creditors against a diminution of the assets available to them, and relied on New Zealand authorities under the predecessors to s 292 and the approach taken by the courts in Australia,

Canada and the United Kingdom in interpreting the equivalent statutory provisions in those jurisdictions.

RJH argued that the Court of Appeal had made a number of errors in finding that there was no diminution requirement under the 1993 Act, namely that:¹²

- (a) it wrongly found that the 1993 Act was a code, and therefore left no room for a common law add-on;
- (b) it wrongly concluded that a diminution requirement would conflict with the policy and purpose of s 292;
- (c) it wrongly relegated diminution to an 'objective' that need not be given effect; and
- (d) it wrongly refused to overrule its earlier decision in *Levin v Market Square Trust*.¹³

Unsurprisingly, the liquidators' argued that there is no diminution requirement and that s 292 requires only that the recipient of the payment receive more than it would have in liquidation. Alternatively, they argued that if the recipient receives more than it would have received in the liquidation, a diminution of the assets available to creditors in the liquidation is deemed to have occurred and the transaction is voidable under s 292.

Supreme Court's analysis

The Supreme Court addressed a number of issues in its consideration of s 292, including:

- (a) the statutory history of New Zealand's voidable transaction provisions;
- (b) the effect (if any) of there being no express removal of the common law diminution requirement;
- (c) the purpose of s 292;
- (d) whether authorities from other jurisdictions assist the interpretation exercise and, if so, what they indicate; and
- (e) the consequences of adopting RJH's approach.

Notes

9 On appeal to the Supreme Court, RJH conceded that the payments constituted transactions by the company even though they were made by a third party: at [5]. RJH had unsuccessfully argued that they did not in the Court of Appeal: see *Robt. Jones Holdings Ltd v McCullagh* [2018] NZCA 358 at [108] and [121].

10 At [9].

11 Another issue would have arisen for determination if RJH was successful on its diminution argument, as the deemed payment from MSH2 could have been characterised as either a loan or a payment of licence fees owed by MSH2 to Northern Crest: if the latter, the diminution argument would be irrelevant as the payment to RJH would have involved the use of an asset of Northern Crest (the licence fee receivable): see *Robt. Jones Holdings Ltd v McCullagh* (SC) at [10], [11].

12 *Robt. Jones Holdings Ltd v McCullagh* (SC) at [35].

13 *Levin v Market Square Trust* [2007] NZCA 135, [2007] 3 NZLR 591. In this case, the Court of Appeal held (at [37]) that 'all a liquidator must show in order to satisfy s 292(2)(b) is that the creditor received a greater payment than he or she would otherwise have received in the liquidation'.

Statutory history

The Supreme Court set out a brief summary of the voidable transaction provisions under New Zealand law, to assist with comprehension of RJH's arguments. New Zealand's early voidable transaction provisions focussed on the intention of the debtor in entering into the transaction. Under this approach, it was the debtor's act of giving the preference that was viewed as wrongful, not the preference itself.¹⁴ This approach was incorporated in various statutory provisions of the late-19th century, and remained in place under the Insolvency Act 1967.¹⁵ The preference provisions of the bankruptcy and insolvency statutes were historically imported into company liquidations, until s 309 of the Companies Act 1955 ('1955 Act') was amended to set out a company-specific preference provision in 1980.¹⁶ The focus of the provision remained on debtor intention.¹⁷

However, this changed with the enactment of the 1993 Act. As observed by the Law Commission in its 1989 report titled *Company Law: Reform and Restatement*, the new provision shifted the emphasis from debtor intention to the effect of the transfer.¹⁸ Alongside this alteration in approach, the 1993 Act was intended to make company law simpler and more intelligible, and 'to provide straightforward and fair procedures for realising and distributing the assets of insolvent companies', as expressly stated in the long title to the 1993 Act.¹⁹

While the focus of s 309 of the 1955 Act was whether the insolvent company making a payment intended to prefer the recipient, s 292 focusses on whether the recipient of the payment did, in fact, receive more than it would have received in a liquidation of the company, regardless of the debtor's intention.²⁰

Status of the common law rule following enactment of s 292

The liquidators did not dispute that a common law requirement for diminution did exist under s 309 of the 1955 Act.²¹ Accordingly, the Supreme Court accepted this as correct for the purpose of argument, but without deciding the point.

RJH argued that as there was nothing in the wording of s 292 to suggest an intention to remove this common law requirement, it must continue to apply.²² The Court disagreed, referring to the change in policy that was made when s 292 was enacted, with the primary focus shifting from the intention of the company making the payment to an assessment of the effect on the recipient of the payment and the debt they are owed.²³ The Court distinguished English authority relied on by RJH as not analogous to the case at hand, and considered that the Court of Appeal had adopted an orthodox approach to statutory interpretation.²⁴ It had identified that there was nothing in the text of s 292 to suggest that there was some additional requirement for diminution of the asset pool, a conclusion with which the Supreme Court agreed.²⁵

Purpose of s 292

RJH argued that the real purpose of s 292 was set out in the earlier decision of the Supreme Court in *Allied Concrete Ltd v Meltzer*, being to 'protect an insolvent company's creditors as a whole against a diminution of the assets available to them resulting from a transaction which confers an inappropriate advantage on one creditor by allowing that creditor to recover more than it would in a liquidation'.²⁶ It argued that the diminution requirement observed under earlier provisions reflected the true purpose of the insolvent transaction provisions, and that the Court of Appeal had erred in 'downgrading' this key purpose to a 'policy objective'.²⁷

However, the Supreme Court noted that the controversy in *Allied Concrete* had centred on a different

Notes

- 14 *Robt. Jones Holdings Ltd v McCullagh* (SC) at [17], citing Paul Heath and Michael Whale (eds) *Heath and Whale on Insolvency* (online ed, Lexis-Nexis) at [24.11].
- 15 At [18]-[22].
- 16 At [23].
- 17 At [24].
- 18 At [27], citing Law Commission *Company Law: Reform and Restatement* (NZLC R9, 1989) at [696].
- 19 At [25].
- 20 At [48].
- 21 At [47].
- 22 At [48].
- 23 At [48].
- 24 At [51]-[52].
- 25 At [52].
- 26 *Allied Concrete Ltd v Meltzer* [2015] NZSC 7, [2016] 1 NZLR 141.
- 27 *Robt. Jones Holdings Ltd v McCullagh* (SC) at [57].

provision (s 296(3)(c), which contains the good faith defence).²⁸ The Court's comments in that case had formed part of a general outline of the policy behind the voidable transaction regime. The Court held that it would be 'drawing a long bow' to suggest that *Allied Concrete* is authority for the proposition that the 'insolvent transaction' definition in s 292(2) contains an unwritten, additional, diminution requirement.²⁹ It would be an oversimplification to say that protecting creditors from a diminution of assets is the objective of the voidable transactions regime: this is one of several objectives.³⁰

Among the policy foundations of the reformed voidable transaction regime under the 1993 Act are creditor equality, creditor deterrence and debtor deterrence. The Court considered that these were materially different to the underpinnings of the former regime under s 309 of the 1955 Act. Further, it placed weight on the fact that the objective of the 1993 reform was to simplify the law and provide streamlined procedures for realising and distributing the assets of a company in liquidation.³¹ Importing an additional common law requirement of the diminution of the pool of assets available to other creditors would hinder this objective. Protection of the asset pool is now only one objective of the voidable transactions regime, and not the most important one.³² This suggested to the Court that while there was a common law diminution requirement under s 309, there is no reason to believe that it continues to apply under s 292.³³

Overseas authorities

Australia

The Supreme Court considered that there was 'undoubted similarity' between the relevant provisions of the Corporations Act 2001 (Cth) and the New Zealand provisions. Further, the New Zealand Law Commission had drawn heavily on an Australian report which provided the background to Australia's insolvency law reform (often referred to as the Harmer Report) in preparing its own report that preceded the enactment of

the 1993 Act.³⁴ While the New Zealand Law Commission had made no explicit statement that its proposed reforms were intended to mimic the Australian law, the Court considered that this indicated at least some intention to draw on the Australian experience. Due to the similarity between the Australian and New Zealand provisions, the Court considered that it was likely to obtain some benefit from the Australian cases that would assist in interpreting s 292.³⁵

The Court noted authority that suggested that there was no diminution requirement under an earlier Australian provision, s 122 of the Bankruptcy Act 1966 (Cth).³⁶ However, it also observed that the decision of the Court of Appeal of Victoria in *VR Dye v Peninsula Hotels Pty Ltd (in liq)* provided clear support for the proposition that the transaction must ultimately reduce the pool of assets available to the company's creditors under the provision currently in force, s 588EA of the Corporations Act 2001 (Cth).³⁷ However, this case concerned prepayments, which are unlikely to be vulnerable under s 292 as they do not involve a debtor-creditor relationship.

The Court also examined the case of *McKern v Minister Administering the Mining Act 1978 (WA)*, in which Nettle JA sitting in the Victorian Court of Appeal commented that in *VR Dye*, the Court had not dealt with the plain meaning of the provision; nor had the Court addressed the indications in the Harmer Report that the new regime was intended to be comprehensive, leaving no room for common law exceptions.³⁸ Nettle JA determined that the approach taken in *VR Dye* was strongly motivated by a concern that prepayments and cash on delivery transactions would otherwise be vulnerable to clawback.³⁹

However, Nettle JA's decision in *McKern* was itself criticised by the Full Federal Court in *Federal Commissioner of Taxation v Kassem*, in which the Full Court considered that *VR Dye* was not manifestly wrong and ought to be followed.⁴⁰ Ultimately the Full Court did not need to determine the point as the payments had been made out of the insolvent company's assets, although it noted that nothing in the relevant provision expressly incorporated a diminution requirement.⁴¹ While the Full Court did not expressly say that there was no

Notes

28 At [58].

29 At [58].

30 At [59].

31 At [66].

32 At [68].

33 At [68].

34 At [73], referring to Australian Law Reform Commission *General Insolvency Inquiry* (ALRC R45, 1988).

35 At [74], [76].

36 At [80], citing *G & M Aldridge Pty Ltd v Walsh* [2001] HCA 27, (2001) 203 CLR 662.

37 At [82], citing *VR Dye v Peninsular Hotels Ltd (in liq.)* [1999] VSCA 60, [1999] 3 VR 201.

38 *McKern v Minister Administering the Mining Act 1978 (WA)* [2010] VSCA 140.

39 *Robt. Jones Holdings Ltd v McCullagh* (SC) at [85], citing *McKern v Minister Administering the Mining Act 1978 (WA)* at [20].

40 At [89].

41 At [90].

diminution requirement under the relevant section, the Supreme Court considered it notable that the Australian court had decided in favour of the liquidator in a case on all fours with *Robt. Jones Holdings*.⁴²

The Court also considered Australian cases which stood for the proposition that a diminution requirement is not required,⁴³ and noted the New South Wales Court of Appeal's decision in *Hosking v Extend N Build Pty Ltd*, which left open the issue as to whether there was a diminution requirement.⁴⁴

Ultimately, the Court discerned that there was a divergence in approaches taken in Australia with respect to whether or not diminution is required.⁴⁵ The Court concluded that there were no consensus on diminution outside of cases involving cash on delivery or prepayment, and that there are no compelling reasons found in the Australian authorities to support the proposition that a diminution requirement should be imported into s 292 of the 1993 Act.⁴⁶

Canada

The Court then turned to consider the Canadian legislation and authorities relied on by RJH. Under s 95 of the federal Bankruptcy and Insolvency Act (Canada), a payment to an arms-length creditor 'with a view to giving that creditor a preference over another creditor' is void,⁴⁷ and a payment having the effect of giving a preference is deemed to have been made with a view to giving a preference unless the contrary is proved.⁴⁸ The Supreme Court found that this imposed an intention requirement, unlike s 292.⁴⁹

RJH argued that the Australian authorities should be considered alongside the decision of the Ontario Supreme Court of Justice in *Re Urbancorp Cumberland 2 GP Inc*.⁵⁰ In *Urbancorp* a similar situation arose where payments were made directly from a related party of the debtor company to a creditor. In his judgment, Myers J held that the transaction was not voidable.⁵¹ Myers J reasoned that '[the unsecured creditors] would suffer

no prejudice that might lead them to race to judgment or otherwise to lose faith in the fairness of the bankruptcy system. Nor would the overall pot of assets or their respective shares of [the company's] assets be diminished'.⁵² The Court held that the transaction was not voidable, as there was not in fact a preference.

RJH submitted that the Canadian jurisprudence is relevant because, like s 292, s 95 makes a bare reference to 'preference' and does not mention diminishment. However, the Court's view was that the Canadian provision was more closely aligned with previous iterations of s 292 of the Act. Section 292 does not actually refer to a 'preference'. Instead, it expressly set out what constitutes an insolvent transaction, being a transaction entered into by the company that enables a person who benefits from it to receive more than the person would in the company's liquidation.⁵³

United Kingdom

RJH argued that there was a diminution element to the test under the equivalent United Kingdom provision.⁵⁴ Unlike s 292, the UK provision still includes an intention requirement.⁵⁵ RJH relied on commentaries on insolvency law in the United Kingdom, which the Supreme Court accepted expressed the view that payments that do not diminish the company's assets are not preferences under s 239 of the Insolvency Act 1986 (UK).⁵⁶ However, the Court noted that these commentaries were not supported by reference to cases where a clawback claim has failed on this basis.

RJH also referred to obiter statements in cases to the effect that the purpose of underlying policy of the voidable preference regime is to protect against diminution, which it said supported its position.⁵⁷ The Court considered that the comments made in those cases were, like those in *Allied Concrete*, made as part of a general description of the voidable transactions regime, rather than in the course of deciding whether a payment was

Notes

42 At [92].

43 See *Sheldrake v Paltaglou* [2006] QCA 52 and *New Cap Reinsurance Corp Ltd (in liq) v All American Life Insurance Co* [2004] NSWSC 366, (2004) 49 ACSR 417, both referred to at [91] of *Robt. Jones Holdings Ltd v McCullagh* (SC).

44 *Hosking v Extend N Build Pty Ltd* [2018] NSWCA 149.

45 *Robt. Jones Holdings Ltd v McCullagh* (SC) at [92].

46 At [93].

47 Bankruptcy and Insolvency Act RSC 1985 c B-3, s 95.

48 Section 95(1)(a).

49 *Robt. Jones Holdings Ltd v McCullagh* (SC) at [96].

50 *Re Urbancorp Cumberland 2 GP Inc* 2017 ONSC 7156, (2017) 54 CBR (6th) 311.

51 *Robt. Jones Holdings Ltd v McCullagh* (SC) at [95].

52 At [100].

53 At [101].

54 Insolvency Act 1986 (UK), s 239(4)(b).

55 *Robt. Jones Holdings Ltd v McCullagh* (SC) at [105].

56 At [105].

57 See *Rubin v Eurofinance SA* [2012] UKSC 46, [2013] 1 AC 236 at [95] and *Re Exchange Travel (Holdings) Ltd (in liq) (No 3)* [1997] 2 BCLC 579 (CA) at 585.

voidable.⁵⁸ They did not provide compelling support for RJH's argument.

Consequences of adopting RJH's approach

In contrast to RJH's submissions, the liquidators raised several points to emphasise the effect of the Court adopting RJH's approach:

- (a) Firstly, the liquidators pointed to the objective of simplicity, which they said would be compromised if RJH's approach was adopted by the Court.⁵⁹ The Court saw considerable force in the liquidators' submission that a bright line test was needed to avoid complexity such as that seen in the *Robt. Jones Holdings* proceeding itself, with prolonged disputes over discovery orders dragging out the proceeding for several years.
- (b) Secondly, the liquidators' emphasised the impact that the adoption of RJH's approach would have on logically similar but more common situations, such as where a creditor is paid by a cheque drawn on an already overdrawn account.⁶⁰ In this scenario, there is no diminution in assets, but the creditor receives a preference. Similarly, with a diminution requirement payments could be partly preferential, for example, if a payment was made from an account in credit that exceeded the credit balance, creating an unsecured overdraft.⁶¹
- (c) Thirdly, the liquidators' highlighted the artificiality of the diminution requirement advanced by RJH.⁶² Had the MSH2 payment been made in two stages, from MSH2 to Northern Crest, then from Northern Crest to RJH, the payment would have been indisputably voidable. Although the economic effect of this situation and what actually occurred (a payment directly from a third party to a creditor, discharging the debt of the insolvent company) is exactly the same, one would be voidable while the other would not. The Court accepted the liquidators' argument that there is no public policy reason for distinguishing the two situations.

The liquidators also drew attention to the fact that ss 292(4B) and 296(3) already contain specific defences,

and that the addition of the diminution requirement would cause preferred creditors to focus on putting liquidators to proof in respect of the effect on the asset pool, rather than on bringing themselves within these defences.⁶³ The Court agreed that RJH's approach would also allow directors to structure payments to ensure that debts guaranteed by them were extinguished in preference to other creditors, and that other 'sharp practices' would also be facilitated.⁶⁴

Comment

The Supreme Court's decision in *Robt. Jones Holdings* will provide welcome clarity as to the requirements for liquidators attempting to claw back preferential payments under s 292. Successful actions have already been reduced following the decision in *Allied Concrete*,⁶⁵ which essentially reduced the good faith defence to an analysis of creditor state of mind.⁶⁶ The decision makes clear that a liquidator is not required to prove any effect on the asset pool available to creditors, making for a much more straightforward process than what was seen in the *Robt. Jones Holdings* case itself.⁶⁷ However, it may create uncertainty of a different kind (as suggested below).

In its decision, the Court took a conventional approach to statutory interpretation, in considering what is on its face a relatively simple provision. The Court first looked to the text of the section, then identified the objective of the 1993 regime as being to simplify the law and provide straightforward procedures for realising and distributing the assets of an insolvent company. Through this lens, the Court determined that no more than what is expressly provided for in the statute is required in order for a liquidator to set aside a voidable insolvent transaction.

The practical effect of the Court's interpretation of s 292 is that significant complexity, time and cost in actions to claw back preferential payments has been avoided, which will be welcome news to insolvency practitioners operating in the New Zealand market. It is now clear that structuring the discharge of a debt so as to occur by way of a payment made indirectly by a third

⁵⁸ *Robt. Jones Holdings Ltd v McCullagh* (SC) at [107].

⁵⁹ At [109].

⁶⁰ At [110].

⁶¹ At [111]-[112].

⁶² At [113].

⁶³ At [114].

⁶⁴ At [115].

⁶⁵ *Allied Concrete Ltd v Meltzer* [2015] NZSC 7, [2016] 1 NZLR 141.

⁶⁶ See M. Kersey, J. Bush and H. Drury, 'New Zealand's Good Faith Defence to Voidable Transactions: Shift in Focus to Creditor's State of Mind' (2015) 12 *International Corporate Rescue* 280.

⁶⁷ The relevant payments were made in September to November 2010, the Supreme Court's decision was delivered on 9 August 2019, and the value of the MSH2 payments was \$262,758.05 (of a total of \$751,941.12 targeted for recovery by the liquidators).

party will not save the payment if the debtor company enters liquidation soon afterwards.

However, the impact of this decision on tripartite / direct payment agreements is as yet unclear. The economic impact of payments in such situations share some similarities with the circumstances seen in *Robt. Jones Holdings*:

- (a) Where a related company discharges a debt on behalf of the soon-to-be (if not already) insolvent debtor, a corresponding debt accrues in favour of the related company. Following *Robt. Jones Holdings*, such payments will be voidable.
- (b) Under a direct payment arrangement, a third party is obliged in its own right to make payment to a creditor. Such arrangements will also invariably result in the debtor company incurring a corresponding liability to the financier.

Prior to the Supreme Court's decision in *Robt. Jones Holdings*, the Court of Appeal had held in *Ebert Construction Ltd v Sanson* that a payment by a third party financier to a construction company for work completed for a property developer made just prior to that company's liquidation was not a payment by the insolvent company.⁶⁸ The primary reason for this finding was that the financier had an independent obligation to make payment to the construction company in its own right pursuant to the direct payment agreement,⁶⁹ which was entered outside of the relevant period for voidable transactions. The Court held that it would be artificial to treat such a payment as being one made 'by the company'.

The future treatment of the *Ebert Construction* decision will be of interest following *Robt. Jones Holdings*, as the Court of Appeal had proceeded on the basis that

diminution was required for a transaction to be voidable under s 292, and this appears to have formed part of the basis for the Court's finding that the payments were not voidable.⁷⁰ Whether the Supreme Court will take a different view of direct payment agreements when the appropriate case arises remains to be seen.

Other issues may foreseeably arise where a third party makes payment in discharge of a company's debt, but expressly disavows any right to recover a corresponding sum from the debtor. In such circumstances, the accounting mechanics that gave rise to the finding in *Robt. Jones Holdings* that the payment was made by Northern Crest would be absent. However, what of the situation where a director who has personally guaranteed company debts causes another entity to engage in such a transaction, with the effect of avoiding the personal liability being called (at least in the interim), while making the debt the problem of another company (for now)? Such practices are hardly beyond the realms of possibility.

Ultimately, the distinction necessary to reconcile *Robt. Jones Holdings* and *Ebert Construction* (at least until the Supreme Court considers the issue) appears to be that, provided there is an independent obligation for a third party to pay a creditor under an agreement entered into outside of the voidable period, such payments will not be voidable (even where they discharge the insolvent debtor's liability to that creditor, and substitute a different creditor in their place). Except in this situation, the Supreme Court has now made it clear that if a debt is discharged by or on behalf of an insolvent company and none of the specific statutory defences apply, the only real question is whether the recipient creditor received more than they would have in the liquidation.

Notes

68 *Ebert Construction Ltd v Sanson* [2017] NZCA 239, (2017) NZCLC 98-058.

69 At [55], [56] and [59].

70 See at [44(c)] and [59]. This case was not addressed by the courts in the *Robt. Jones Holdings Ltd* proceedings.

A Reach Too Far? A Review of the Extra-Territorial Scope of the Court's Powers to Support Office-Holder's Investigations

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Table 1

| Power | Extra-territorial scope? | Authority |
|---|--------------------------|---|
| Public examination (s.133) | Full | <i>In re Seagull Manufacturing Co Ltd</i> ¹ |
| Fraudulent trading (s.213) | Full | <i>Bilta (UK) Ltd v Nazir (No 2)</i> ² |
| Private examination (s.236(2)) | Undecided | |
| Account of dealing and/or books, papers or records (s.236(3)) | Full | <i>Wallace</i> (although divergent High Court authority) ³ |
| Private examination abroad (s.237(3)) | Partial | Express |
| Transactions at an undervalue (s.238) | Full | <i>In re Paramount Airways</i> ⁴ |

Synopsis

This article considers whether, following the case of *Wallace (as liquidator of Carna Meats (UK) Ltd) v Wallace*, the power to summon persons for private examination under section 236(2) of the Insolvency Act 1986⁵ ('the IA') also has full extra-territorial effect. In addressing that open question, it reviews judicial comment to date and the extra-territorial reach of the IA more generally. The current position is found to be incoherent and ripe for review at the highest level, although on the present authorities the s.236(2) power appears likely to be territorially limited.

The current position

Successive cases have found that many of the office-holder's investigatory powers, and the court's supportive powers, were intended by the IA to have

full extra-territorial scope. This reflects the intention of Parliament in 1986 that, given the strong public interest in ensuring that a company's failure is properly investigated including by holding those responsible to account, the office-holder's task ought not be stymied by either papers or persons being located in a foreign jurisdiction. A summary of some of the major powers is given in Table 1.

It is clear from the above that, at least at first glance, the power to order private examination under s.236 would be a significant outlier were it to be territorially limited.

Obiter consideration of the territorial scope of section 236(2)

One might detect a certain degree of judicial relief thus far in cases referring to this issue. In each case, the judge has not ultimately had to determine whether

Notes

1 [1993] Ch 325.

2 [2016] AC 1.

3 [2019] EWHC 2503 (Ch).

4 [1993] Ch 223.

5 S.236(2) states that 'the court may, on the application of the office-holder, summon to appear before it- (a) any officer of the company, (b) any person known or suspected to have in his possession any property of the company or supposed to be indebted to the company, or (c) any person whom the court thinks capable of giving information concerning the promotion, formation, business, dealings, affairs or property of the company.'

Parliament intended section 236(2) of the Insolvency Act 1986 to have full extra-territorial scope.

Most recently, in *Wallace*, Adam Johnson QC, sitting as a judge of the High Court, differentiated the power under s.236(3) and said at §54:

'whatever may be the correct position under section 236(2), I am concerned in this case only with section 236(3), and even if it is correct that the power to issue a summons under section 236(2) should be confined to persons within the jurisdiction, it seems to me that the power to require the production of documents and information is different. It is less invasive, and does not involve the exercise of anything akin to the Court's subpoena power. In the modern world of cross-border business practices, it is natural to construe that power as extending to any of the categories of person identified, whether within or outside the jurisdiction.'

The issue could have fallen for determination by Burton J in 2001 in *Re Casterbridge Properties Ltd (in liq.) Jeeves v Official Receiver*⁶ where the Receiver sought in the alternative an order for private examination of the applicant if the order for public examination under s.133 was set aside. However, having heard full argument on the point, Burton J did not set aside the s.133 order and concluded that he 'need not and [would] not resolve the interesting issue between the parties as to whether there would be jurisdiction to make such an order' (§51).

So how might this 'interesting issue' be determined?

The intended jurisdictional scope of s.236(2) – the position in *Re Tucker*

The scope of a statutory provision will turn on who was within the legislative grasp or intendment of s.263(2) – a principle of statutory interpretation most recently restated by the House of Lords in *Masri v Consolidated Contractors (UK) Ltd and others (no 4)*.⁷ Further, in considering such intendment, absent express enactment or plain implication, English legislation will only apply to British subjects or to foreigners within the jurisdiction: *Ex parte Blain; In re Sawers*.⁸

The main difficulty facing an argument that s.236(2) was not intended to be territorially limited is the earlier House of Lords case *In re Tucker (R.C.) (A Bankrupt), Ex parte Tucker (K.R.)*.⁹ In *Re Tucker*, the trustee in bankruptcy applied for the issue of a summons under s.25

of the Bankruptcy Act 1914 requiring the bankrupt's brother (living in Belgium) to attend court (in England) for examination. It was held that the power was territorially limited.

As it is a principle of construction that absent a different context, a re-enactment is intended to carry the same meaning as its predecessor, it is necessary to revisit this case in some detail, as well as the context to the IA generally, to assess *Re Tucker's* continued impact on s.236.

Section 25 of the Bankruptcy Act 1914 provided that:

'(1) the court may, on the application of the official receiver or trustee, at any time after a receiving order has been made against a debtor, summon before it the debtor or his wife, or any person known or suspected to have in his possession any of the estate or effects belonging to the debtor, or supposed to be indebted to the debtor or any person whom the court may deem capable of giving information respect the debtor, his dealings or property, and the court may require any such person to produce any documents in his custody or power relating to the debtor, his dealings or property. [...]

(6) the court may, if it thinks fit, order that any person who if in England would be liable to be brought before it under this section shall be examined in Scotland or Ireland, or in any other place out of England.'

Dillon LJ noted that at the time s.25 had been enacted, and until 1962 and an amendment to the Bankruptcy Rules, there was no power to serve process in bankruptcy proceedings on any person other than the debtor who was not in England.¹⁰ In 1962, however, the rules were amended such that any process or order of the court could be served on any person who was not in England in such a manner as the court saw fit (rule 86 of the Bankruptcy Rules 1952).

Counsel for the trustee suggested that s.25 ought to apply to a person anywhere in the world, being the natural meaning of the words 'any person'. It was accepted, however, the 'eyebrows might be raised at the notion that Parliament had in 1914 or 1883 given jurisdiction to any bankruptcy court, which might well be a county court, to summon anyone in the world before it to be examined and produce documents'¹¹ and in consequence the trustee conceded that jurisdiction instead extended at least to any British subject anywhere in the world.

Notes

6 [2002] BCC 453.

7 [2010] 1 AC 90.

8 [1879] 12 Ch.D 522.

9 [1990] Ch. 148.

10 *Ibid.*, p. 153 at [H].

11 p. 157.

Dillon LJ held that s.25(1) did not have extra-territorial effect, relying on, as background, (1) the general practice being that the courts of a country only have power to summon before them persons who accept service or are present within the territory; (2) the English court had never had a general power to serve a *subpoena ad testificandum* or *subpoena duces tecum* out of the jurisdiction on a British subject and, conclusively, on the fact that s.25(6) gave the power to order examination out of England of any person who if in England would be liable to be brought before it under this section. Those words, he said, inevitably carried the connotation that if the person is not in England, he is not liable to be brought before the English court under the section.¹²

Before we can consider whether the court would likely be bound by that case in relation to s.236(2), it is necessary to also explore more widely the intended scope and purpose of the IA.

The scope of the IA more widely

Turning to other powers under the IA, *In re Seagull*,¹³ Peter Gibson J had to consider whether s.133 of the IA (public examination) had extra-territorial scope. He remarked that it must be construed ‘in the light of circumstances existing in the mid-1980s when the legislation was enacted. By use of the telephone, telex and fax machines English companies can be managed perfectly well by persons who need not set foot within the jurisdiction’ and that relevant background was the ‘public worry and concern over company failures on a large scale, and the need to safeguard the public against such failures’ (pp. 354). Arguably, he did regard the context as *significantly different* then that present in 1914 or 1883.

Further, and importantly for present purposes, he remarked that the legislative intention had been that ‘there should be a proper and effective investigation through public and private examination’ (p. 356). Leaving open the question as to whether s.236 was intended to be territorially limited, he held that whatever was the case there, s.133 could be distinguished by reason of the absence of any provision corresponding to s.25(6), and that it was ‘plain’ that s.133 applied to ‘any person’ notwithstanding their absence from the jurisdiction.

As I explained above, the issue was also left open in *Re Casterbridge*. In that case, counsel for the Receiver in submitted that there was no justification for any differentiation either between s.236 or s.238 and

s.133, both of which had by that time been held to have extra-territorial scope. In particular, that given the words ‘any person’ in s.238 had been held to mean any person anywhere, a similar construction should be given to those words in s.236. It was further suggested that s.237 was merely facilitative and did not imply a territorial limit to s.236.

Finally, as to the relevance of context when considering legislative intention, it is useful to review the 2009 case of *Masri v Consolidated Contractors International (UK) Ltd and other (No 4)*.¹⁴ There, the House of Lords considered the scope of Part 71 of the Civil Procedure Rules, which relates to the examination of judgment debtors in court. *Re Tucker*, *Re Casterbridge*, and *Re Seagull* were all before the House. In determining that Part 71 did not have extra-territorial scope in relation to officers outside the jurisdiction, Lord Mance held the intention of Part 71 lacked the ‘critical considerations which enabled the Court of Appeal in *In re Seagull* to hold that the presumption of territoriality was displaced.’

Lord Mance reflected that Peter Gibson J in *Re Seagull* had distinguished *Re Tucker* because s.25 related to private examination and a wider class of persons. As to the ‘critical considerations’, Lord Mance referred to Peter Gibson J’s articulation of the public interest in seeing that those responsible for the company’s affairs are subject to investigation, that public examination was necessary to obtain material information for the administration of the estate, to form the basis of reports for submission to the department, and to give publicity for creditors and the community at large.¹⁵

Could the context of the IA and the interpretation of other sections as set out above be sufficient to displace the findings of *Re Tucker* in relation to s.236(2)? To reach a conclusion, it is also important to review the consideration of s.236 specifically.

The scope of the s.236 powers

The scope of s.236 in its entirety appeared to be an issue resolved by David Richards J in *In Re MF Global UK Limited (in special administration) (No. 7)*¹⁶ when he held that *Re Tucker* was an authoritative decision on the lack of extraterritorial effect of s.25 of the Bankruptcy Act 1914 and must be taken to apply equally to the successor sections in the Insolvency Act 1986 (including s.236). That was because, as I set out above, it is a principle of statutory construction that where a statutory provision is re-enacted in substantially the same

Notes

¹² p. 158.

¹³ [1993] Ch. 345.

¹⁴ [2010] 1 AC 90.

¹⁵ p. 139.

¹⁶ [2015] EWHC 2319 (Ch) [2016] Ch 325.

terms, it is intended to carry the same meaning as its predecessor unless the context of the new legislation shows that the meaning must be taken to have changed (§23). Unlike Peter Gibson J in *Re Seagull*, however, he did not appear to have considered at any length the potentially different context surrounding the IA.

However, two subsequent decisions in the High Court in relation to s.236(3), *Norriss* followed by *Wallace*, have both declined to follow *MF Global*, albeit that both have done so by way of finding that because s.236 conveyed a free-standing power in relation to production of documents whereas, in the earlier s.25 of the Bankruptcy Act 1914 that power had merely been ancillary to, and dependent on, the principal power of summons, the structure was materially different. Because of that different structure, the intended scope of the power under s.236(3) fell to be considered separately, and it was natural to construe that power to have extra-territorial effect.

Thus the scope of s.236(2) remains uncertain, and I turn to that now.

Where does this leave s.236(2)?

It is arguable that the power to summon a person for private examination under s.236(2) ought to be considered *sui generis* rather than akin to the Court's subpoena power. As Megarry J said of private examination generally in *Re Rolls Razor Ltd (no 2)*¹⁷, 'the examinees are not in any ordinary sense witnesses, and the ordinary standard of procedure do not apply. There is here an extraordinary and secret mode of obtaining information necessary for the proper conduct of the winding up. The process, borrowed from the law of bankruptcy, can only be described as being *sui generis*.' Given that, it could be said that the starting point is a context much closer to that relating to public examination than to the court's wider powers in relation to witness summons or Part 71.

Additionally, since *Re Tucker*, an increasing weight of authority has held that the words 'any person' in other sections of the IA are intended to bear their literal, natural meaning and refer to any person, anywhere. There is, perhaps, less concern about eyebrow raising than in 1914. The most recent statement to this effect being that of Lord Toulson and Lord Hodge in *Bilta* who said that the words 'any person' did have extra-territorial effect for the same reasons as had been given in relation to those words in *Re Seagull*.

Finally, given the significant overlap between persons falling within the material scope of s.133 and s.236 (e.g. officers of the company) it might seem odd if Parliament had intended that a person residing abroad

can be summoned for public, but not private, examination. In *Re Seagull* this appears have been explained by pointing to the fact s.236 is wider in scope, but set against that it was stated that the legislative intention to ensure proper and effective investigation extended to both public and private investigation.¹⁸

Accordingly, in my view, many of the contextual reasons given by Peter Gibson J ought to also apply to private examination and hence s.236(2) is rather closer to *Re Seagull* than *Masri* in relation to determining Parliament's intention. It is possible that the context is sufficiently different such that the court would not consider itself bound by *Re Tucker* despite the similar wording.

However, even if the court was not bound, could a different intention really be found given the continued presence of the wording in s.237(3) that was held to be so decisive in *Re Tucker*: 'the court may, if it thinks fit, order that any person who if within the jurisdiction of the court would be liable to be summoned to appear before it under section 236 or this section shall be examined ... in a place outside the United Kingdom' (emphasis added)?

As Counsel in *Re Casterbridge* suggested, one view is that the intention of s.237(3) was that it simply gave an express discretionary power to, instead of summoning a person to appear in England, instead order a private examination in the place they are. The advantage of such a construction would be that it would allow for a more consistent interpretation of the words 'any person' throughout the IA and it would arguably give effect to the purposes considered in *Re Seagull* that also apply to private examinations.

Standing against that though, and in my view likely to be decisive, despite the tension with the wider interpretation of the IA, is the plain meaning of the words used in s.237(3). It is hard to see beyond those words implying the same limitation as in *Re Tucker* – i.e. that persons not within the territorial jurisdiction of the court were impliedly considered to be outside of the scope of s.236(2).

On balance, whilst there is doubt, it seems to me that *Wallace* is likely the high-water mark of the court's retreat from *Re Tucker* and that the directly equivalent power to the one considered in that case – to summon for private examination – is likely to remain territorially limited in scope.

Summary

Many of the statutory powers available to support the office-holder's investigation have been found to have extra-territorial scope. Following *Wallace*, it seems

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¹⁷ [1970] Ch 576 at §§591.

¹⁸ p. 356 at [B].

likely s.236(3) will be amongst that group of powers and that the *Norriss – Wallace* line will be preferred in future cases. It is possible that Parliament also intended to extend the scope of private examination under s.236 extra-territorially, and, if so, this would produce a more consistent interpretation of similar wording throughout the IA. However, until the matter is considered at the highest level it may be that the continued retreat from *Re Tucker* will not extend further and a summons for private examination will remain territorially limited.

Implementation of the EU Directive on Restructuring and Insolvency:¹ A Quick and Effective, thereby Cost-Efficient ‘German Scheme’ in the Aftermath of COVID-19²

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Synopsis

The imminent ‘German Scheme’, driven by the ‘EU-Directive on Insolvency and Restructuring’, overlaps with an ongoing review of the German debtor-in-possession insolvency process dubbed ‘rescue umbrella procedure’. Whilst strong industry voices advocate for a swift and pragmatic implementation of the Directive’s preventive restructuring framework to manage the aftermath of COVID-19, others would like to see (variations of) the ‘rescue umbrella’ steering or even ‘hibernating’ troubled German companies through the crisis. Both options should be available and decided on a case-by-case basis. The article demonstrates that the Directive’s objectives: quick, effective and thereby cost-efficient, can be achieved by underpinning the ‘German Scheme’s’ legal framework with tailored, successive restructuring reviews, building into a modular system. These economic reviews match the Directive’s ‘milestones’, likelihood of insolvency, drafting and negotiation of the restructuring plan and the prospects of the restructuring plan to prevent the debtor’s insolvency; the latter to be reviewed by the court without delay when confirming a voted plan, ideally based on the reviews already available. The authors further propose for the expert providing such reviews to be appointed as PIFOR to best achieve the Directive’s objectives.

I. Introduction, summary

1. Moratorium and cram-down procedure – tools currently missing in the German restructuring kit

Germany has always had a strong and successful pre-insolvency, out-of-court restructuring culture and practice. The Directive’s preventive restructuring framework, once implemented in Germany, will build upon and draw on existing, proven restructuring standards, that have evolved over the past 25 years during macroeconomic challenges such as German reunification, the New Economy crisis, the 2008 financial crisis and now the economic aftermath of COVID-19.

However, German restructurings can prematurely lead to formal insolvency proceedings for the lack of decisive statutory tools, i.e. (a) a moratorium (or instruments to defer individual enforcements) and (b) a cram-down procedure where fair and equitable restructurings, instead of formal insolvency, are achieved even when not all stakeholders unanimously support them. The lack of a cram-down option led to highly publicised cases of German companies restructuring under English Schemes of Arrangement in the London High Court.⁴

2. Discussions on the introduction of a ‘German Scheme’ go back before the EU Commission’s preventive restructuring initiatives

The introduction of a ‘German Scheme’ has long been requested (even before the EU Commission’s

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- 1 EU Directive 2019/1023 of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency); in the following ‘Directive’.
- 2 This article is based on an article published on 29 April 2020 in INDat Report, www.indat-report.de, a German journal for restructuring and insolvency.
- 3 Both authors are independent experts in the German Ministry of Justice and for Consumer Protection, Bundesministerium der Justiz und für Verbraucherschutz (BMJV) hearings on the implementation of the Directive.
- 4 These English schemes for German companies span over more than the past ten years, prominent examples were e.g. Apcoa or Rodenstock. For an exhaustive compilation and analysis of such cases see Sax/Swierczok in Flöther/Madaus, Sanierungsrecht, p. 333 ff.

2014 recommendation on preventive restructuring or the Commission's subsequent Capital Markets Union Action Plan of 2015) by German restructuring professionals and has also been under discussion on Government level,⁵ prompted by the abovementioned English schemes for German companies. However, in 2012, when the last major German insolvency reform dubbed 'ESUG' came into force, the legislator introduced not a scheme-type procedure but what was dubbed 'rescue umbrella procedure', Schutzschirmverfahren, a variation of debtor-in-possession, Eigenverwaltung, i.e. a formal insolvency process. The 'rescue umbrella' incentivises the submission of a restructuring plan within a statutory time frame of 3 months and can only be commenced at the request of the debtor who can choose the office-holder (with mere supervisory powers for the office-holder). The 'rescue umbrella' requires the debtor to present a restructuring expert's report to the court confirming that the company is (a) still able to pay its liabilities as and when due but is either balance sheet insolvent or threatened with imminent insolvency; and (b) that the intended rescue does not manifestly lack prospects of success, Sec. 270b para. 1 subs. 3 Insolvency Code (Insolvenzordnung, InsO). 'Rescue umbrellas' have seen considerable use since the onset of the COVID-19 crisis, especially in the hospitality, tourism and retail sectors. Voices in the insolvency and restructuring practice, mostly insolvency practitioners and academics would now like to see (variations of) the Sec. 270b InsO rescue umbrella being used for steering or even 'hibernating'⁶ troubled German companies through the worst of the COVID-19 crisis. One of many ancillary suggestions would be to increase the maximum period of insolvency salaries and wages funding from currently 3 months to 6 months.⁷ It will have to be seen whether the ongoing law reform discussions will lead to a short-/medium-term 'renaissance' of rescue umbrella procedures or whether German professionals will also want to restructure through a lean, new preventive procedure as soon as possible. Ideally, both options should be available, with stakeholders taking decisions on a case-by-case basis.

3. Implementation of Directive overlapping with forthcoming German insolvency law reforms (following Government 'ESUG' review) and Government's coalition treaty requesting for insolvency practitioners to be regulated

The implementation of the Directive (with a deadline of 17 July 2021 that could be extended by one year, Art. 34 para. 1 and para. 2 Directive) is not the only insolvency/restructuring topic on the German legislator's agenda. 'ESUG' was reviewed by a group of academics at the request of the Government, namely the Federal Ministry of Justice and Consumer Protection, BMJV, the results were published in 2018⁸ and the resulting reform issues will overlap with the introduction of the Directive's new preventive restructuring tool. Another topic that may have an impact on the implementation of the Directive (or vice versa) is that the coalition treaty, Koalitionsvertrag, of the current German Government proposes that German insolvency practitioners should be regulated (this potentially intertwining with Art. 26 and Art. 27 of the Directive).

4. Cherry-picking and a modular system of expert restructuring reviews for a swift, effective and cost-efficient German preventive restructuring framework

Germany was not the only EU jurisdiction that saw English Scheme 'migrations', another example were the Netherlands, where a 'Dutch Scheme' is now about to come into force.⁹ The evolution of this 'Dutch Scheme' – which, *inter alia*, combines elements of both a UK Scheme (cram-down) and a Chapter 11 (moratorium) and uses minimal court involvement – was very closely monitored by the German restructuring practice, with much debate on whether, with the London High Court route being unavailable post Brexit, German restructurings would then move to the Netherlands in the absence of a competitive German tool.

In this article the authors demonstrate how the Directive's objectives, i.e.: quick, effective and thereby cost-efficient, can be achieved by underpinning the legal framework of the 'German Scheme' with restructuring

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- 5 See e.g. the 2008 conference held jointly by the Ministry of Economics, Bundeswirtschaftsministerium, and the Federal Ministry of Justice and Consumer Protection, BMJV: 'Sanierung im Vorfeld von Insolvenzverfahren'. For summaries of the conference talks see: Paulus et al., Sanierung im Vorfeld von Insolvenzverfahren – Vorträge der gemeinsamen Tagung des BMWi und des BMJ -, WM 2010, 1337.
- 6 See e.g. 'Die Jungen Unternehmer'/'Mittelstands- und Wirtschaftsunion (MIT)', https://www.junge-unternehmer.eu/fileadmin/junge-unternehmer/kommunikation/pressemitteilungen/200610_Forderungen_Insolvenzrecht.pdf, MIT equally advocates for a swift preventive restructuring framework implementation. The term/concept 'Hibernation' for (small) businesses was coined in a Conference on European Restructuring and Insolvency Law (CERIL) executive statement of 20 March 2020, <https://www.ceril.eu/news/ceril-statement-2020-1>.
- 7 See e.g. statement of 'Gravenbrucher Kreis', an association of leading insolvency practitioners, www.gravenbrucher-kreis.de/2020/03/23/gravenbrucher-kreis-nimmt-stellung-zum-gesetzentwurf-zur-abmilderung-der-folgen-der-covid-19-pandemie/.
- 8 www.bmjv.de/SharedDocs/Artikel/DE/2018/101018_Bericht_ESUG.html?jsessionid=B8F53D7E4A60B1FCEB8756D0BDD85E46.2_cid334.
- 9 Amendment to the Bankruptcy Act to make provision for court confirmation of private plans (Act on the Confirmation of Private Plans), Kamerstukken I, 35 249, nr. A; for an English translation see <https://resor.nl/wp-content/uploads/2020/05/English-Translation-Bill-on-New-Dutch-Scheme.pdf>.

reviews, and in the process building upon each other into a modular system. These restructuring reviews derive from the tried and tested, high standards developed by German restructuring experts over the past 25 years. The proposed modules are tailored to the ‘milestones’ the Directive prescribes for a preventive restructuring, i.e. (a) ‘likelihood of insolvency’, the entry threshold to access the framework, (b) ‘drafting and negotiation of the restructuring plan’ and (c) the ‘prospects of success of the restructuring plan to prevent the debtor’s insolvency, assessment of viability’ in the context of a court confirming a voted restructuring plan.

5. Minimal involvement of the court

Defining the German courts’ role in the process will be crucial for the preventive restructuring tool’s success, not only because it will be completely new to the German restructuring arsenal but also because it will be heavily dependent on economic in addition to (formal) legal considerations. For this reason, the role of the courts has been a focal point of discussion ever since a German preventive restructuring tool was discussed, even before the EU Commission’s respective initiative.

The performance of German insolvency courts and insolvency practitioners in administering formal insolvency procedures currently ranks 4th worldwide, see the annual World Bank study ‘Doing Business’.¹⁰ To maintain the same high standard for the new preventive restructuring tool, it has been widely suggested by German restructuring experts and academia¹¹ that designated courts should be introduced, ideally at the level of Higher Regional Courts,¹² with specialised judges also trained in the economic aspects of preventive restructuring. However, specialisation requires time which is not available in the COVID-19 aftermath. This is one of the reasons why this article sets out how the modular economic expert reviews prepared in the preventive restructuring process and on which the restructuring plan is based could be used directly by the court. For courts ‘to be comfortable’ with such expert reviews the authors also suggest the optional

appointment of the expert preparing them as the Directive’s professional in the field of restructuring, ‘PIFOR’.

6. First experiences with KfW coronavirus aid loans, drawing lessons for a ‘German Scheme’

The article also describes how initial experience with the administration of the German ‘KfW-Coronavirus aid loans for companies’¹³ can be directly applied to economic aspects of the imminent ‘German Scheme’. The economic effects of the COVID-19 crisis present unprecedented challenges to the German restructuring market, which will place a heavy burden on the resources of the judiciary, advisers and office holders in the short to medium term. The preventive restructuring framework set out by the Directive should therefore be implemented swiftly and pragmatically into German law and, as set out above, with as lean a process as possible, especially with regard to court involvement.

II. COVID-19 challenges to the German restructuring practice, calls for a quick and pragmatic implementation of the Directive’s preventive restructuring framework

1. Short, medium and long-term knock-on effects of the German Government’s ‘coronavirus aids’ on the restructuring and insolvency practice

To mitigate the economic effects of the COVID-19 pandemic, German Government has responded with a wide range of measures, a combination of, *inter alia*, adjustments to existing laws¹⁴ such as suspending the statutory German insolvency filing requirements until 30 September 2020, direct Government cash contributions and loans given or guaranteed by KfW.¹⁵ At the time this article went to press, KfW had received applications in relation to ‘coronavirus aid loans’ in the amount of EUR 48.850 million from companies that got into financial difficulties as a result of the COVID-19 crisis.¹⁶ Although these loans have maturities of up to

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10 www.doingbusiness.org/en/data/exploreconomies/germany#.

11 See e.g. statement of ‘Gravenbrucher Kreis’, an association of leading German insolvency practitioners; www.gravenbrucher-kreis.de/2019/07/04/gravenbrucher-kreis-begrüßt-weitere-fachliche-spezialisierung-von-gerichten-in-insolvenz-und-restrukturierungssachen/.

12 Germany currently has more than 180 courts dealing with insolvency matters (‘Insolvenzgerichte’), whose local jurisdiction corresponds with the registered seat or ‘COMI’ of the debtor. Insolvenzgerichte are designated divisions of local courts (‘Amtsgerichte’).

13 KfW: The German Bank for Reconstruction, Kreditanstalt für Wiederaufbau, www.kfw.de/kfw.de-2.html.

14 ‘Act on Mitigation of the Consequences of the COVID 19 Pandemic in Civil, Insolvency and Criminal Procedure Law’ of 27 March 2020, ‘Gesetz zur Abmilderung der Folgen der COVID-19-Pandemie im Zivil-, Insolvenz- und Strafverfahrensrecht’. An English convenience translation of this Act is provided by the German Ministry of Justice and for Consumer Protection (BMJV): www.bmjv.de/SharedDocs/Gesetzgebungsverfahren/Dokumente/Bgbl_Corona-Pandemie_EN.pdf;jsessionid=5F7FADA6B8BC4C56F5B8634D711B BE23.1_cid297?__blob=publicationFile&v=2.

15 For a summary of all such COVID-19 measures see: Schiebe/Zenker, Germany, in: INSOL International/World Bank Group, Global Guide: Measures adopted to support distressed businesses through the COVID-19 crisis, 2020, www.insol.org/library/opendownload/1604.

16 www.kfw.de/KfW-Konzern/Newsroom/Aktuelles/KfW-Corona-Hilfe-2.html, also available in English.

ten years, they lead to additional debt service burdens and to higher debt ratios for COVID-19 troubled companies, where new borrowings are added to existing financing. Unlike consumer loan agreements, the 'Act on Mitigation of the Consequences of the COVID 19 Pandemic in Civil, Insolvency and Criminal Procedure Law' of 27 March 2020¹⁷ does not (yet¹⁸) affect the enforceability of existing corporate loans.

2. Majority of COVID-19-troubled German companies neither 'market exit candidates' nor 'zombie companies' earmarked for formal insolvency procedures

From today's perspective, these COVID-19 troubled companies, which would be viable in 'normal circumstances', are exposed to forward looking factors that are difficult to quantify such as when there will be a return to domestic economic normality and the speed of recovery of the world markets – key issues being international supply chains and the German economy's strong export dependency. Many of these companies which are 'healthy in normal circumstances' may therefore not be able to achieve a complete return to normality in the short term despite – or tragically also because of – current Government support, although they will be successful with their business models in the medium and longer term. Such companies are neither the 'market exit candidates' nor so-called zombie companies (having survived on little to no capital expenditure in recent years) for which insolvency proceedings would be or have been long ago the appropriate remedy, nor should they be hastily restructured with the very effective, but in the circumstances too sharp tools of German insolvency law. Statutory insolvency tools can result in substantial collateral damage. The costs of interim funding of salaries and wages, Insolvenzzgeld, and for the Pension Security Fund, Pensionssicherungsverein, are borne by viable, non-insolvent German companies. These contributions could be disproportionately increased by an inappropriate rise in (large) insolvencies – an effect last seen in the massive 2009 Karstadt/Quelle insolvency. Shareholders, employees and contractual partners would be also penalised for the force majeure which is COVID-19: shareholders by inter alia the subordination in the waterfall of regular insolvency

proceedings and employees or contractual partners by the exercise of special short-notice termination rights by the office holder. For these companies – in need of restructuring, but not (yet) candidates for the sharp instruments of insolvency proceedings – the appropriate statutory restructuring instrument is currently still lacking where consensual solutions cannot be reached.

3. Calls for rapid and pragmatic introduction of the Directive's preventive restructuring framework into German Law

As a consequence of the economic COVID-19 effects, strong voices in the German restructuring industry and academia are therefore calling for the preventive restructuring framework of the Directive to be implemented into German law 'swiftly and pragmatically'.¹⁹ 'Swift' implementation should be doable for the German legislator. BMJV, the Ministry responsible at Government level for the respective draft law, had already invited representatives of the German restructuring and insolvency practice (such as representatives of insolvency practitioners' and restructuring advisers' professional bodies and organisations; independent experts, judges, academics and union representatives) and other interested parties to a hearing in Berlin on 19 March 2020 to present and discuss the status of its implementation work on the preventive restructuring framework. The meeting was cancelled as the COVID-19 pandemic spread. 'Pragmatism' is likely to be the order of the day. Both swiftness and pragmatism have been displayed throughout by both the German Government and Parliament from the outset of fighting the economic impacts of the COVID-19. On 3 June 2020 the German Government coalition partners' committee agreed on a comprehensive economic stimulus and crisis management package, including the introduction of a preventive corporate restructuring framework '*vorinsolvenzliches Restrukturierungsverfahren*'.²⁰

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17 See footnote 14.

18 Art. 240 sec. 3 Abs. 8 EGBGB authorises the Federal Government to include (in particular) micro-enterprises in the scope of the COVID-19 pandemic regulations.

19 See statements Gesellschaft für Restrukturierung – TMA Deutschland e. V. of 13.03. and 18.03.2020; Stephan Madaus (www.stephanmadaus.de/2020/04/04/covid-19-massnahmen-weltweit-ein-ueberblick/), published 04.04.2020; Deutscher Industrie und Handelskammertag (DIHK): Restrukturierungsrichtlinie kann in der Corona-Krise helfen, <https://www.dihk.de/de/aktuelles-und-presse/presseinformationen/unternehmen-sanieren-insolvenzen-vermeiden--24830>.

20 See coalition committee (Koalitionsausschuss) results paper of 3 June 2020 'Corona-Folgen bekämpfen, Wohlstand sichern, Zukunftsfähigkeit stärken' (Combating corona effects, securing prosperity, strengthening sustainability) of 3 June 2020 page 3, point 9, https://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Schlaglichter/Konjunkturpaket/2020-06-03-eckpunktepapier.pdf?__blob=publicationFile&v=8.

III. Expert economic restructuring reviews to be used as building block modules underpinning the preventive restructuring framework

1. Module 1: Likelihood of insolvency

1.1 Definition

'Likelihood of insolvency' Art. 1(1)(a) Directive, is an 'entry control', threshold into the preventive restructuring framework. According to the wording of the Directive, the preventive restructuring framework should be 'available for debtors in financial difficulties when there is a likelihood of insolvency, with a view to preventing the insolvency and ensuring the viability of the debtor' (Article 1(1)(a), Article 4(1) Directive). The Directive leaves the definition of 'likelihood of insolvency' to the national legislators, Article 2(2)(b) of the Directive, with the caveat however that the debtor has not yet become insolvent (recital 24 of the Directive) to prevent misuse.

There is an abundance of suggestions for how this 'likelihood of insolvency' should be defined under German law. The obvious choice would be to use an existing legal concept, i.e. the definition of 'imminent insolvency', sec. 18 InsO, a statutory provision based on which management may file for insolvency, i.e. where filing for insolvency and its restructuring tools is an option for management of a troubled company. The two mandatory statutory filing requirements where management must file for insolvency without undue delay, and at the latest within 3 weeks, are: inability to pay debts as and when due, Sec. 17 InsO and balance sheet insolvency, Sec. 19 InsO. The test for balance sheet insolvency involves a prognostic element regarding the company's likelihood of continuing viability until the end of the next financial (calendar) year, i.e. for max. the next two years. Since 2015 and during the Directive's evolution one of its most discussed aspects from a German perspective was that in German restructurings the Directive's prerequisite 'likelihood of insolvency' would always trigger the balance sheet insolvency filing requirement, thereby ruling out preventive restructuring from the start as the prognostic element of viability would lapse – a Catch-22 situation.²¹ The simplest way of course to solve this problem would be to abolish completely balance sheet insolvency, something that has been heatedly discussed and widely demanded in the German insolvency/restructuring industry even before the Directive's evolution started.

Views on abolishing the test have changed over the past 2 years, with voices that had always advocated maintaining balance sheet insolvency continuing to do so adamantly,²² others following suit or suggesting new approaches. A constructive and thoroughly pragmatic approach would be to support restructurings with a reasonable chance of success by adjusting the current defined prognostic time period required for ruling out balance sheet insolvency to a flexible 'survival prognosis', thereby 'emancipating' likelihood of insolvency from balance sheet insolvency.²³ In this way the prospects of viability when defining likelihood of insolvency could be ignored and instead focus only on liquidity planning. If and when necessary, the forecast period for the liquidity planning could be adjusted. At the same time, the prognosis for viability would of course continue to be positive if it can be assumed that the restructuring will be successful.

1.2 Avoidance of abuse and 'coronavirus aid' parallels

The early determination of 'likelihood of insolvency', which can also be tested in court, is key to prevent abuse of the preventive restructuring framework, i.e. 'healthy debtors' must not encroach on the constitutionally guaranteed property rights of creditors and/or shareholders. A parallel assessment, albeit of course in the opposite direction, can currently be found in the case of 'coronavirus aid', which is only to be granted to those who are demonstrably economically affected by the COVID-19 pandemic or at risk of insolvency and for whom there are reasonable prospects of overcoming the crisis triggered by the COVID-19 pandemic. Economic third-party support – whether from the state or from creditors – must always be justified.

1.3 Levels of proof for 'likelihood of insolvency' and required expert reviews

Here, too, parallels can be drawn to the KfW 'coronavirus aids' and their viability test (under 'reversed sign'). Banks are granting KfW guaranteed loans based on documented proof including that future competitive operating profitability can be achieved on the basis of historical profitability and on the basis that in principle the business model is viable. These tests are designed to prevent abuse.

From the outset KfW coronavirus aids loan application documentation to assess eligibility could be completed quickly (approx. one to two weeks) and

Notes

21 Andersch/Philipp, 'Damoklesschwert Insolvenzverschleppung – Nachweis der positiven Fortbestehensprognose noch vor Finalisierung des Sanierungskonzepts', NZI 2017, 782, 784.

22 Steffan/Poppe in INDat Report 07_2019, S. 32.

23 See e.g. Moritz Brinkmann, 'Die Antragspflicht bei Überschuldung', in Ebke/Seagon/Piekenbrock (Hrsg.): Überschuldung: Quo vadis?, S. 73; or Lars Westpfahl in 'Wesentliche Elemente eines vorinsolvenzlichen Sanierungsregimes für Deutschland', ZRI 4/2020, S. 166.

with rather limited expenditure for all parties involved. The necessary assessment and ‘prognostic yardstick’ is both far removed from mere ‘good feeling’ that could of course not serve as proof in court and from a fully comprehensive expert review complying with both the Institut der Wirtschaftsprüfer in Deutschland e.V. (IDW) ‘Standard IDW S 6’²⁴ and the related minimum case law requirements by the German Federal Court of Justice, Bundesgerichtshof (BGH).²⁵ The ‘prognosis yardstick’ is based on the plausible substantiation (i.e. quickly understandable for third parties within reasonable time) of the (practical) prospects of recovery. This approach (adjusted on a case-by-case basis) can be developed and prepared at pace and thus at minimum cost, and as with the the ‘rescue umbrella’ expert review confirming likely viability²⁶ confirmation, can be verified ex post by the court without additional work incurred and is dubbed ‘IDW S-6-Light Approach’ or step-by-step model.

2. Module 2: The drafting and negotiation of the restructuring plan

2.1 The core of the restructuring plan

The restructuring plan, Art. 8 of the Directive, will be the core of the preventive framework. It must set out in a logical and understandable way why the restructuring plan has a reasonable prospect of preventing the insolvency of the debtor and ensuring the viability of the business, including the necessary pre-conditions for the success of the plan. The restructuring plan must provide for a statement of reasons to this extent. Member States when implementing the Directive can request for the statement of reasons to be provided or validated either by an external expert or by the PIFOR if appointed (Art. 8 para. 1 lit. h).

2.2 Use and further development the high IDW standards for a ‘German Scheme’

The above substantive requirements of the Directive’s restructuring plan are almost identical to those of the established IDW S 2 standard,²⁷ which includes a restructuring concept in accordance with an IDW S 6 standard and additional prerequisites for group situations, for the ‘best-interest-of-creditors-test’ and which sets out the economic and legal implications of restructuring measures. IDW standards have evolved into tried and tested practice standards used throughout the German restructuring practise, have the ‘seal of approval’ of the Federal High Court, BGH, and could be easily adjusted to the new preventive restructuring tool.

2.3 Content of the restructuring plan

The required contents of the restructuring plan also follow the logical considerations that must always be taken into account when drawing up a restructuring plan, in particular the mapping of future cash flows in an integrated business plan (Art. 8 para. 1 lit. Directive), in order to provide a basis for decision-making, especially for the banks who are parties to the restructuring. Whenever German banks are involved as creditors, the drafting of economic restructuring expert reviews, then called ‘Sanierungsgutachten’, are typically required and will have to comply with special regulatory requirements:

- In accordance with the BaFin (Federal Financial Supervisory Authority) MaRisk requirements BTO 1.2.5,²⁸ credit institutions must have a restructuring concept submitted to them if they want to support the restructuring of a crisis company, and
- the European Banking Authority definition²⁹ of borrower default and the ECB regulations on

Notes

- 24 The Institut der Wirtschaftsprüfer in Deutschland e.V. [Institute of Public Auditors in Germany, Incorporated Association] (IDW) is not a ‘recognised professional body’ or institute of chartered accountants, but a privately run organisation established to serve the interests of its members who comprise both individual Wirtschaftsprüfer [German Public Auditors] and Wirtschaftsprüfungsgesellschaften [German Public Audit firms]. IDW Standards (IDW S) contain requirements relevant to services provided by German public auditors other than in respect of audit engagements and accounting matters, which are covered by *IDW Auditing Standards* and *IDW Accounting Principles*, respectively. Examples for IDW Standards would be services provided in insolvency and restructuring with the most relevant being IDW S6, the requirements of an expert restructuring opinions, Sanierungsgutachten, or IDW S2. For further details see IDW’s website (also available in English) www.idw.de.
- 25 The BGH tests compliance with IDW S6 and thereby (indirectly) also defines IDW S6 prerequisites when ruling e.g. on directors’ or advisers’ liabilities for non-compliance with insolvency filing requirements. For details see Andersch/Philipp, Anforderungen an die Erstellung von Sanierungskonzepten – Erste praktische Erfahrungen mit dem neuen Standard IDW S6, Corporate Finance law, 3/2010.
- 26 See I. 2 above.
- 27 The IDW S 2 standard describes the essential requirements of an insolvency plan as set by the Institute of Chartered accountants in Germany. IDW S 2 sets out objectives, types and regulatory background of insolvency plans, procedural prerequisites and timeline pursuant to the German Insolvency Code as well as their recommended structure.
- 28 MaRisk, Annex 1: Annotated text of the Minimum Requirements for Risk Management (MaRisk), Requirements relating to the organisational and operational structure, BTO 1.2.5 Treatment of problem loans, no. 1 and 3.
- 29 See ECB, Addendum to the ECB Guidance to banks on non-performing loans: supervisory expectations for prudential provisioning of non-performing exposures, March 2018, retrievable under www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.npl_addendum_201803.en.pdf (download as at 18 June 2020).

non-performing loans (NPLs) require, in very simple terms, for banks to be able to assess the degree of default risk of credit exposures. Ultimately, this also requires a sound restructuring concept, but at least in the first step a resilient, ideally externally confirmed liquidity planning.

2.4 Time frame

Experience shows that at least three months are required to come up with a useful basis for initial decisions and negotiations, and in the case of particularly complex situations without preparatory work provided by the company and with a lack of data, up to four months. Restructuring expert reviews should therefore be provided by experienced and recognized restructuring professionals, especially in the case of more complex companies and financing structures, in order to ensure the necessary speed whilst fully covering all legally defined minimum contents.

3. Module 3: Prospects of success of the restructuring plan to prevent the debtor's insolvency; assessment of viability

3.1 The prospects of a successful rescue in the restructuring plan

The restructuring plan, when submitted to the court for confirmation, must contain a statement that there is a 'reasonable prospect of preventing the insolvency of the debtor and ensuring the viability of the business' (Art. 8 No. 1 lit. h Directive). The prerequisites of this statements are already requested by the German Federal High Court, BGH, for a conclusive restructuring concept and are also included in the substantive IDW Standard S 6 requirements on comprehensive restructuring concepts. A restructuring plan will only receive the necessary majority voting approval for its implementation if the review prepared by the restructuring expert assesses that the outcome of the company's restructuring is likely to be positive – with a predominant probability and thus unconditionally.

3.2 Viability test

The 'reasonable prospect' is covered in the statement on the ability of the company to restructure in so far as, in addition to a positive prognosis of its viability under insolvency law, it reflects a thorough restructuring of the company, i.e. the restoration of the company's profitability as a prerequisite for sustainable competitiveness. The underlying restructuring concept fully defines the corporate structure on which the plan is based and thus covers the viability review required by the Directive. The expert restructuring review defines

the future shape of the company and 'fills in the gaps' in the hitherto unclear concept of what the future shape of the company to be restructured will be.

4. Cost-efficiency of a modular system of economic expert reviews

The modules just described under 1. to 3., i.e. the economic restructuring reviews building blocks used in the preventive restructuring framework, build on each other – increasingly in their scope. They do so from the outset of the restructuring and result in a step-by-step model in which the liquidity and corporate planning is successively expanded into a comprehensive restructuring plan that meets all legal requirements and information needs by the parties involved. In the interest of cost-efficiency of the preventive framework, this step-by-step approach avoids the creation of unnecessary documents if the preparations and negotiations fail or if they are broken off before a restructuring plan is adopted.

IV. Involvement of the court

1. When should 'likelihood of insolvency' be examined

According to the Directive, the preventive restructuring framework to achieve the two central objectives of swiftness and efficiency should be a flexible procedure, with judicial involvement to be limited to what is necessary and proportionate (Recital 29 of the Directive). The Directive does not necessarily provide for a formal judicial procedure from the outset, i.e. a formal process with a judicial entry threshold. It will be sufficient to involve the court only where the Directive requests such involvement, i.e. in particular for the ordering of a moratorium or individual protection against execution; the appointment of the PIFOR in certain circumstances and confirmation of the adopted restructuring plan in the cases provided for this purpose (Art. 10 of the Directive). This gives the German legislator the possibility – and it is to be hoped that she makes use of this – to achieve a swift and effective procedure. Particularly 'likelihood of insolvency' should be tested in court only if and when the court is approached, i.e. at the very latest when the restructuring plan is confirmed by the court, not at the outset of a formal process. If a likelihood of insolvency test were to be the 'entry test' for a formal process to be reviewed by the court this would slow down the process (and undoubtedly also make it public). When reviewing likelihood of insolvency at a later stage, the court should be allowed or even required to rely on the review of the restructuring expert (see below).

2. *In practice restructuring plans will always be reviewed in court as part of confirming the plan*

According to the Directive, the restructuring plan adopted by the required majority must be confirmed by the court if the restructuring plan impairs dissenting parties, if the restructuring plan provides for new financing or results in the loss of more than 25% of jobs (Art. 10(1) of the Directive). In practice restructuring plans will therefore almost always have to be confirmed by the courts since they will regularly provide for new financing and since the preventive restructuring tool will only be used if it becomes apparent that a consensual solution cannot be achieved, i.e. if opposing (impaired) creditors are to be out-voted. The court then will not only examine compliance with formal criteria, but also economic aspects, as the court ‘may refuse to confirm a restructuring plan if there is no reasonable prospect that the plan would prevent the insolvency of the debtor or ensure the viability of the enterprise’ (Art. 10 para. 3 of the Directive, for the substantive requirements see II.3. above).

3. *The court examining economic considerations and calculations*

3.1 *Avoiding timing uncertainties*

So the court will have to consider the same economic assessments and calculations which had already been made by economic experts in the weeks and months of the preparation and negotiation of the plan prior to the court’s considerations. In typical German restructurings, a time-consuming (and costly) expert opinion obtained by the court at this point in time (bearing in mind that the process pruning up to the successful vote on the plan will typically already have taken three months) will disrupt the restructuring success achieved by the majority of creditors (shareholders), may jeopardise it or even cause it to fail. Most importantly banks will only make necessary internal decisions deriving from the agreed restructuring plan and, above all, will only make further funds available to the company once the court has confirmed the restructuring plan.

3.2 *Also the Directive seeks to avoid a timing vacuum*

The above is also recognized by the Directive (Art. 10 (4) of the Directive, Recital 29): the German legislator must ensure that the decision of the court confirming the restructuring plan as binding ‘is taken in an efficient manner with a view to expeditious treatment of the matter’ and that the involvement of the court is limited to ‘what is necessary and appropriate’. It is

therefore particularly appropriate for Germany (not yet having the infrastructure of designated preventive restructuring courts or judges and expecting a tidal wave of COVID-19 workload) to allow the courts to use the restructuring documentation leading to the restructuring plan as a neutral basis for their decisions. To this extent, restructuring expert reviews must be geared to such later use from the outset, so that the court can dispense with the involvement of a further expert opinion.

V. *Using the modular restructuring reviews as a basis for the court’s decision*

1. *Minimum requirements regarding the suitability and neutrality of the restructuring expert*

The use of the expert restructuring reviews as a basis for a decision by the court requires the suitability of the expert and her neutrality in addition to the clear definition of the necessary minimum requirements of the restructuring review. These aspects must be presented in a way that is transparent and plausible for the court. Therefore, the professional prerequisites for the expert should be defined by law – e.g. in accordance with section 270 b (1) InsO,³⁰ i.e. ‘a tax advisor, auditor or lawyer or a person with comparable qualifications’; or perhaps ‘an expert experienced in corporate restructuring’ – and assured by the expert in his expert review(s). The same applies to the neutrality of the restructuring expert reviews: The restructuring review should contain a legally binding statement by the expert to the extent that (1) the documentation has been prepared by an objective third party, (2) the restructuring concept does not unduly prefer/disadvantage any of the creditors and (3) the expert considers a return to viability through the assumptions made and thereby the success of the restructuring to be predominantly probable.

2. *Practice checklists*

On the basis of these mandatory key points, the court can then decide without delay whether the formal minimum requirements and the confirmation with regard to neutrality and suitability of the restructuring expert are met. At present, the German restructuring practice (especially work out units at banks) already uses checklists for internal quality control in order to check whether such minimum contents are contained in the restructuring expert’s opinion. Such checklists are based on the minimum requirements set out by the Federal Court of Justice, BGH, so this approach can be easily used by courts.

Notes

³⁰ See above I. 2, sec. 270b InsO, the ‘rescue umbrella’.

3. Liability of the restructuring expert as an additional corrective

Expert opinions used by the court will typically be contested by crammed down creditors or by stakeholders unhappy with valuations. A further corrective to ensure a restructuring expert's professionalism and neutrality is the expert's civil and criminal liability for culpably false confirmation of his suitability and neutrality. Although German restructuring experts who provide economic restructuring reviews, namely the essential IDW expert reviews, 'S6 Gutachten',³¹ are very often regulated professionals (lawyers or accountants) this is not always the case, i.e. many of Germany's top professionals in the field of restructuring are not regulated by professional bodies. Here courts will seek an 'equivalent' to such regulation and where liability could prove the necessary corrective. Such liability is – if necessary – verifiable in a separate court proceeding without blocking the restructuring process. Such safeguarding – ultimately vis-à-vis the court – should already result from § 311 para. 3 German Civil Code (BGB) and could be explicitly introduced for preventive restructuring, combined, if necessary, with limitation language analogous to § 323 para. 2 German Commercial Code (HGB).

VI. The restructuring expert in the role of the Professional in the Field of Restructuring (PIFOR)?

1. The Directive no longer defines profiles of the PIFOR exhaustively

The Directive defines the PIFOR to be appointed by the court as a person (or body) who, in particular, performs one or more of the following tasks: (a) assisting the debtor or creditors in the preparation or negotiation of a restructuring plan; (b) monitoring the debtor's activities during the negotiations on a restructuring plan and reporting to a judicial or administrative authority; (c) taking partial control of the debtor's assets or transactions during the negotiations (Art. 2 para. 1 (12) of the Directive).³² This list of profiles is – unlike in the previous draft versions of the Directive – no longer exhaustive, in particular due to the insertion of the wording 'in particular'. Therefore, preparing economic restructuring expert reviews could also be regarded (part of) the profile of a PIFOR and enable the court

– who may later want to base its decisions on same expert reviews – to (co-)decide on the expert at an early stage and to appoint the expert as PIFOR with, in a typical scenario, the same expert also assisting (time- and cost-efficiently) on the drafting and negotiating of the restructuring plan.

2. Restructuring experts have always assumed the role of the moderator and mediator in restructuring processes

Successful restructuring processes are based not only on the preparation and presentation of convincing plans, but often also on the moderation and mediation of the restructuring expert, who uses her special position of trust as well as neutrality and detailed knowledge of the financial and performance-related possibilities of the company to achieve solutions for the conflicting interest groups.

For a future 'German Scheme', especially in larger and complex proceedings, restructuring experts will be regularly called in to provide economic restructuring expert reviews, namely 'IDW S6 Gutachten',³³ if only because banks require them to comply with the BaFin (Federal Financial Supervisory Authority) MaRisk³⁴ requirements. With regard to the 'content of restructuring plans', the Directive stipulates that the plan must contain a justification of the prospects of avoiding insolvency and of the ability to continue as a going concern, including the necessary conditions for the success of the plan³⁵ the Directive allows for this justification to be submitted or confirmed either 'by an external expert' or by the restructuring officer, if one is appointed.

3. Remuneration of the PIFOR, cost and profile/role considerations

Where the PIFOR appointed by the court to assist the debtor or creditors in drawing up or negotiating a restructuring plan also instructs an external expert to produce the economic restructuring expert reviews (and in practice this will happen regularly), this will result in additional costs. Costs are synergistically reduced if the PIFOR and the restructuring expert providing the expert reviews are (partly) identical, performing (partly) identical tasks.

Notes

31 For IDW S6 see III. 1.3 above.

32 For an analysis and innovative suggestions on how the typical profiles of German restructuring experts / insolvency practitioners can be matched to the PIFOR profiles see Fritz in 'Neue Zeitschrift für Insolvenzrecht' (NZI), 2020, p. 49 ff.

33 For IDW S6 see III. 1.3 above.

34 For MaRisk see footnote 27.

35 For details of the business management requirements see III.2. above.

Of the Directive's PIFOR profiles³⁶ German restructuring experts specialising in providing economic restructuring expert reviews, 'Sanierungsgutachter', will typically not (not want to) assume the monitoring and controlling role, in particular not take (partial) control over the debtor's assets or business: in the German insolvency and restructuring market this will be a task typically performed by insolvency practitioners.

The Directive indirectly provides guidance on the fees of the PIFOR in Art. 5 para. 3 lit. c. Only if the majority of creditors apply for the appointment of the PIFOR, will the creditors bear the costs. Alternatively, the costs of the restructuring agent appointed by the court upon debtor's application or ex officio – irrespective of his profile – are borne by the debtor, as is already the case in the restructuring reports requested by banks.

VII. Conclusion

'We will prevent economically sound companies from going bankrupt' said Federal Minister of Economics Peter Altmaier on 13.03.2020 at the outset of the Government COVID-19 aids programme.³⁷ The Minister's statement should become a motto for the German restructuring and insolvency practice: viable companies in need of restructuring should neither in the present extraordinary COVID-19 circumstances nor 'under normal circumstances' be put into insolvency prematurely. Although German insolvency law and

and practice can facilitate very effective and successful restructurings, its tools (e.g. short-term statutory contractual termination rights; insolvency wage funding and Pension Trust contributions borne jointly by – solvent – German companies as a whole) are rigid, the collateral damage caused can be considerable and – in these existential COVID-19 times, with normally healthy companies experiencing exogenic problems – put disproportionate burdens on solvent German companies. It also gives restructured (formerly insolvent) companies, who 'cleared their balance sheets' through insolvency, unfair advantages over their 'supportive' competitors who have borne the collectivised costs. Germany has a successful restructuring practise, however it still depends on 100 % consensus, i.e. lacks a cram-down option and a moratorium (or remedy against individual enforcement). These options should now be quickly introduced as a lean procedure via the implementation of the Directive's preventive restructuring framework. Where creditors' rights are impaired by a cram-down or otherwise in a preventive restructuring, it is essential under German rule of law that the courts must be involved, however this should be limited to a minimum. To this extent, this article suggests the courts should base *inter alia* their fairness assessment of a restructuring plan on the modular expert restructuring reviews s prepared in the course of the restructuring. Such expert reviews must be prepared by recognized experts and they must be neutral, which could also be facilitated by the court appointing the same expert providing the expert reviews as PIFOR.

Notes

³⁶ For these see VI 1. above.

³⁷ www.spiegel.de/politik/deutschland/peter-altmaier-cdu-werden-verhindern-dass-wirtschaftlich-gesunde-unternehmen-in-die-insolvenz-geraten-a-00000000-0002-0001-0000-000169988523.

Recognition and Assistance for PRC Insolvency in Hong Kong

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Synopsis

A recent case in Hong Kong, has demonstrated both the ability and willingness of common law courts to recognise insolvency appointments made by the courts of the People's Republic of China ('PRC'), and to grant appropriate assistance at common law. It is to be hoped that this proven track record will pave the way for easier recognition of common law court appointed liquidators in PRC, where, unlike in common law countries, such recognition is subject to the principle of reciprocity.

Introduction

In *Re CEFC Shanghai International Group Limited (in Liquidation in the Mainland of the People's Republic of China)*¹ ('CEFC Shanghai') Harris J, sitting in the High Court of Hong Kong, granted recognition and assistance to a Chinese company's Mainland administrators appointed by the Chinese court in order to protect the company's assets in Hong Kong.

Recognition

CEFC Shanghai was a PRC company in insolvent liquidation in PRC under the Enterprise Bankruptcy Law, with substantial assets in Hong Kong, namely a HK\$7.2 billion claim against its Hong Kong subsidiary which was in liquidation in Hong Kong (The 'HK Receivable'). Administrators (the PRC equivalent of liquidators) had been appointed by the Shanghai No.3 Intermediate Court. They applied to the Hong Kong Court for recognition and assistance in order to protect the Hong Kong receivable from enforcement by a creditor who had obtained a garnishee order nisi, and who was seeking to take the receivable by having the garnishee order made absolute. The application was supported by a Letter of Request from the Shanghai Court.

This was the first time an application for recognition and assistance had been received from PRC, but not

the first time an application had been received from a Civil Law system.² Accordingly, the outcome of the application was never in any doubt. In accordance with well-established principles, the Court asked itself two questions:

- (a) Are the PRC insolvency proceedings 'collective insolvency proceedings'?
- (b) Are the PRC insolvency proceedings opened in the company's country of incorporation?

The answer to the second question was self-evidently affirmative.

The answer to the first question was also straightforward in that, under the Enterprise Bankruptcy Law of the PRC, the liquidation proceedings include all of the debtor's assets and these are to be distributed on a *pari passu* basis.

Common law assistance

It is well settled that when granting assistance at common law the Hong Kong court does not extend to the foreign liquidators all the powers which would be available to Hong Kong liquidators under the domestic rules.

The three underlying principles governing the scope of the common law power of assistance were identified by Lord Sumption in *Singularis Holdings Ltd v PricewaterhouseCoopers*:³

- (a) The power of assistance exists for the purpose of enabling foreign courts to surmount the problems posed for a world-wide winding up of the company's affairs by the territorial limits of each court's powers. Therefore, the power of assistance is not available to enable foreign officeholders to do something which they could not do even under the law by which they were appointed.
- (b) The power of assistance is available only when it is necessary for the performance of the foreign officeholder's functions.

Notes

1 [2020] HKCFI 167 (13 January 2020).

2 See 'Recognition of Foreign Insolvency in Hong Kong' (Japan Life Co. Ltd (application by Mr. Kaoru Takmatsu)) [2019] Vol.16 ICR Issue 5.

3 [2014] UKPC 36.

- (c) An order granting assistance must be consistent with the substantive law and public policy of the assisting court.

In Hong Kong, there is a standard-form recognition order containing a suite of the usual powers which will be granted by way of assistance, and this includes a stay on proceedings against the company in Hong Kong.

Encouragement to PRC courts

Harris J took the opportunity to set out these principles in more detail than otherwise strictly necessary because this was the first case of a recognition and assistance request from PRC Administrators in Hong Kong. He was keen to stress that the principles which govern common law recognition and assistance do not require reciprocity to be demonstrated, unlike in the case for recognition of foreign judgments and court orders in the PRC, and also to highlight what is known or understood in relation to PRC decisions which have involved some element of recognition. He referred to Article 5 of the Enterprise Bankruptcy Law which provides:

‘The bankruptcy proceedings initiated in accordance with the provisions of this Law shall have an effect on the debtor’s property beyond the territory of the People’s Republic of China.

Where an application or request is made to the people’s court for recognition or enforcement of a legally effective judgment or written order of a bankruptcy case made by a foreign court, in which the debtor’s property within the territory of the People’s Republic of China is involved, the people’s court shall, in accordance with the international treaties concluded or acceded to by the People’s Republic of China or with the principle of reciprocity, examine the judgment or written order and make an order to recognize and enforce it, provided that the said judgment or written order does not contradict the basic principles of the law of the People’s Republic of China, nor violates State sovereignty, security and social and public interests of country, and nor infringes upon the lawful rights and interests of the creditor within the territory of the People’s Republic of China.’

As far as is known this is not a provision which has yet been applied by the PRC court to recognise a foreign liquidator, but as Harris J pointed out, the power is clearly there in PRC law and the provision envisages that recognition should be granted. He did observe in this connection that although in the present case it

was appropriate to grant recognition and assistance in conventional terms ‘The extent to which greater assistance should be provided to Mainland administrators in the future will have to be decided on a case by case basis and the development of recognition is likely to be influenced by the extent to which the court is satisfied that the Mainland, like Hong Kong, promotes a unitary approach to transnational insolvencies.’

This judgment is a clear encouragement to the PRC courts to grant recognition to Hong Kong liquidators in the future, the Hong Kong court having taken the first step and granted recognition and assistance in this case.

No priority for Judgment Creditor with garnishee order nisi

Although the recognition and assistance aspect of this judgment was straightforward, Harris J also tackled the potentially more difficult question of whether having regard to the fact that a judgment creditor had obtained a garnishee order nisi in respect of the HK Receivable prior to the commencement PRC liquidation, the judgment creditor should be permitted to obtain a garnishee order absolute, or whether the garnishee proceedings should be stayed so that the HK Receivable would be dealt with in the insolvency.

In *Galbraith v Grimshaw*,⁴ a case of personal bankruptcy, the House of Lords held that where an English garnishee order nisi was obtained before a Scottish bankruptcy, the judgment creditor prevailed over the Scottish trustee in bankruptcy. It did so on the basis that the English rules of relation-back did not apply to a Scottish bankruptcy, and the Scottish rules of relation-back are not recognised by the English court. Harris J observed that this analysis is inconsistent with contemporary cross-border insolvency law, and is inapplicable to modern cross-border insolvency assistance. It was a case to be confined to its own facts and as authority only for the limited principle that local courts do not recognise foreign rules of relation-back. Fairness between creditors requires that insolvency proceedings have universal application so that all creditors are entitled to prove against one estate so that there is no advantage to be gained from being in a jurisdiction with more of the assets or fewer creditors.

Harris J followed the approach of Brereton J, sitting in the Supreme Court of New South Wales in *ML Ubase Holdings v Trigem Computer*,⁵ where the court refused to make a garnishee order absolute even though it had been obtained prior to a Korean insolvency in respect of which recognition and assistance was sought in the New South Wales court. By so doing he adopted an

Notes

⁴ [1910] AC 508 (HL).

⁵ [2007] NSWSC 859.

approach which was consistent with the position of a Hong Kong company in liquidation.⁶ It was plainly the appropriate approach, and any other decision would have produced an anomaly.

Conclusion

This judgment serves as a useful reminder that the common law principles of recognition and assistance in respect of the insolvency of foreign companies apply irrespective of the jurisdiction of the court which appointed the insolvency practitioner. They apply equally to civil law and common law jurisdictions and are independent of reciprocity. Nevertheless it is to be hoped that this judgment will pave the way for greater recognition and assistance in PRC of common law appointed liquidators, especially those appointed by the Hong Kong court.

Notes

6 *Credit Lyonnais v SK Global Hong Kong Ltd.* [2003] HKC 104.

COVID-19 and India's Blanket Suspension of IBC: Total is Fatal?

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Synopsis

The COVID-19 pandemic has brought the entire world to an unprecedented halt, having not only enormous human cost but also seriously affecting business and the economy. As a part of India's measures to mitigate this upheaval, the Indian President promulgated the Insolvency and Bankruptcy Code Ordinance, 2020 providing for a blanket suspension of insolvency proceedings. This article provides a summary of the ordinance while comprehensively analysing its plausible lacunas. Further, a comparative analysis has been made to conclude that the Indian government ought to have followed the measures taken by other jurisdictions such as the UK, the US and China.

Introduction

In the wake of more than two months of unprecedented business inactivity and consequential economic distress, the government of India introduced the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2020 ('Ordinance') providing relief to corporate debtors from COVID-19-related debt occurring on or after 25 March 2020 and suspending fresh insolvency proceedings for a period of up to one year.¹ The measures entail the introduction of Section 10A of the Insolvency and Bankruptcy Code ('IBC' or the 'Code') which would render Sections 7, 9 and 10 as inoperative, thereby barring financial creditors, operational creditors and the defaulting party from applying to National Company Law Tribunal ('NCLT') for Corporate Insolvency

Resolution Process ('CIRP'). An explanation to Section 10A clarifies that it will not apply to defaults committed before 25 March 2020.

Rationale

The Ordinance is based on the premise that COVID-19 as an external force has severely affected the cashflow of businesses, thereby reinforcing the need to prevent them from being dragged into insolvency or acquired at abysmal valuations through adversarial actions of creditors.² The government intends to give these cash-starved firms a breathing space so that they can revive their businesses in a supposedly friendly environment and continue to exist in the long run.³

Further, the Ordinance synchronises well with the government's offer of collateral-free loans to already vulnerable MSMEs.⁴ While these loans, as a source of interim finance, would enable the enterprises to meet costs of buying raw materials and recover business, the suspension of insolvency proceedings would allow them to work under a protective shield, devoid of any risk of facing liquidation.⁵ Also, these measures may considerably relax the overburdened NCLT and prevent the system from choking with insolvency cases.⁶

Why counter-productive?

Although on a brief perusal the Ordinance seems to reflect the government's pro-business stance and looks promising in the normative sphere, a closer look

Notes

- 1 IBC (Amendment) Ordinance No. 9 of 2020.
- 2 Krishnavia Dutt, 'Is IBC Suspension Antithetical To Pandemic Protection?' *Mondaq* (8 June 2020) <https://www.mondaq.com/india/insolvency/bankruptcy/949734/is-ibc-suspension-antithetical-to-pandemic-protection> accessed 11 June 2020.
- 3 'IBC suspension during Covid-19 will give firms breathing space: Experts' *Business Standard* (8 June 2020) https://www.business-standard.com/article/companies/ibc-suspension-during-covid-19-will-give-firms-breathing-space-experts-120060801140_1.html accessed 11 June 2020.
- 4 Pranbihanga Borpuzari, 'Covid-19 relief: Government announces Rs 3-lakh crore collateral-free automatic loans for MSMEs' *Economic Times* (15 May 2020) <https://economictimes.indiatimes.com/small-biz/sme-sector/covid-19-relief-government-announces-rs-3-lakh-crore-collateral-free-automatic-loans-for-msmes/articleshow/75710137.cms?from=mdr> accessed 11 June 2020.
- 5 Hemant Kothari, 'Suspension of IBC: It's a half-baked solution to ease financial stress' *Money Control* (19 May 2020) <https://www.moneycontrol.com/news/economy/policy/suspension-of-ibc-its-a-half-baked-solution-to-ease-financial-stress-5285481.html> accessed 13 June 2020.
- 6 Mukesh Bhutani and Kriti Upadhyaya, 'IBC Suspension: Reforms That Can Fill The Gap' *BloombergQuint* (26 May 2020) <https://www.bloombergquint.com/opinion/ibc-suspension-filling-the-gap> accessed 13 June 2020.

reveals various unaddressed challenges in its practical implementation.⁷

Absence of a moratorium

The Code provides a robust and secure mechanism for debt resolution and optimisation of the assets of a corporate debtor which then helps in balancing the interests of all the stakeholders. For this, Section 14 provides for the imposition of a moratorium, once an application for CIRP is admitted.⁸ This prohibits the creditor from initiating a suit or continuing an existing suit, transferring or alienating by the corporate debtor any of its assets, and recovery of any property-in-possession of the corporate debtor by a third party. Such prohibition, therefore, acts as a protective space for the resolution of the debtor and ensures the smooth functioning of the entire process.⁹

However, since the admission of a CIRP application is a prerequisite for declaring a moratorium, the protective space will cease to exist after the suspension, putting the stressed assets at risk.¹⁰ Arguably, this may also lead to a surge in filing of frivolous recovery applications, which in turn will run counter to the objective of de-clogging NCLT.

Availability of other means of recovering money

Another lacuna that could plague the government's measures is the availability of other means of recovering money. Given the suspension of IBC, lenders may invoke the provisions contained under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ('SARFAESI'), and the Companies Act, 2013 or initiate bank-led resolutions.¹¹

SARFAESI is a powerful tool in the hands of secured creditors to encash the collateral security on account

of the emergence of non-performing assets.¹² Unlike court-regulated procedure of the Code, it enables banks and other financial institutions to take possession of the security, sell it, or take over the management of the debtor company with minimal court intervention. Therefore, in the absence of the Code, parties may resort to misusing this provision.¹³ Besides, creditors may decide to resort to compromises and arrangements with the debtor company under the Companies Act, 2013. Such a restructuring mechanism helps a company rearrange its debt obligations to increase the company's productivity and profitability.¹⁴

Additionally, there exist bank-led resolutions such as RBI's Prudential Framework for Resolution of Stressed Assets formed with the purpose of early recognition, reporting and time-bound resolution of stressed assets.¹⁵ While this mechanism is only available to RBI-regulated creditors, it provides an opportunity to attempt resolution at the bank level itself.

Disregard to the fate of creditors

The Ordinance indisputably gives a big jolt to the balance sheet of the financial and operational creditors.¹⁶ With an increased threshold of default already in place, the government's decision to impune debtors from COVID-19-related debts indefinitely not only adds to the miseries of creditors but reflects the poor balancing of their interests as against the corporate debtors.¹⁷

At this juncture, one may argue that creditors may avoid this by opting for alternate modes of recovery (such as SARFAESI, bank-led resolutions, etc.). However, this argument doesn't hold good in its entirety because of the various preconditions attached to the invocation of such alternatives. For instance, only secured creditors can have recourse to SARFAESI, thereby thwarting a large pool of unsecured lenders from recovering their money.¹⁸ Similarly, only financial

Notes

- 7 Ruchika Chitravanshi, 'Firms red-flag pitfalls of IBC suspension; law's future unsure' *Business Standard* (21 May 2020) https://www.business-standard.com/article/companies/firms-red-flag-pitfalls-of-ibc-suspension-law-s-future-unsure-say-experts-120052101701_1.html accessed 13 June 2020.
- 8 *IBC 2016*, s.14.
- 9 *Ibid.*
- 10 Shruti Singh, 'When IBC is Suspended – What Happens Next' *Lexology* (28 May 2020) <https://www.lexology.com/library/detail.aspx?g=5f940925-5394-4805-a653-11f26581262d> accessed 13 June 2020.
- 11 *Ibid.*
- 12 George SK and Zisha Rizvi, 'Life of Debt: India's SARFAESI Act on Non Performing Assets' *Lexology* (4 August 2016) <https://www.lexology.com/library/detail.aspx?g=115f5ba0-d1ec-471c-83d9-fd86f95cd5cb> accessed 17 June 2020.
- 13 *Ibid.*
- 14 The Companies Act, 2013, ss. 230-232.
- 15 Shayan Ghosh and Gopika Gopakumar, 'RBI relaxes stressed asset norms' *Livemint* (8 June 2019) <https://www.livemint.com/industry/banking/rbi-relaxes-stressed-asset-norms-1559934009703.html> accessed 17 June 2020.
- 16 Banikinkar Pattanayak and Ankur Milshra, 'Banks to bleed as no new IBC cases for a year, relief for MSMEs and covid debt' *Financial Express* (18 May 2020) <https://www.financialexpress.com/industry/banking-finance/banks-to-bleed-as-no-new-ibc-cases-for-a-year-relief-for-msmes-and-covid-debt/1962108/> accessed 17 June 2020.
- 17 *Ibid.*
- 18 *Trishul Developers Vs L & T Housing Finance Limited*, WP No. 22137 of 2019 <https://indiankanoon.org/doc/180529928/> accessed 17 June 2020.

creditors can initiate bank-led resolutions leading to a sharp deterioration of the financial health of the operational creditors. Therefore, the measures certainly fail to provide for the financial difficulties faced by the lenders, apart from forcing them to invoke less reliable resolution mechanisms.¹⁹

What may follow is an increase in litigation by debtors on account of claiming exemptions for COVID-19-related debt. If unsuccessful, they may seek to invoke the defence of force majeure to avoid payment of their borrowings. Additionally, unscrupulous debtors may use these measures as a means of dilatory tactics, all of which may hamper the recovery prospects of creditors.²⁰

Deviation from structured revival by Committee of Creditors

The Code provides for constituting a Committee of Creditors (COC) which is solely responsible for performing various tasks connected to CIRP including but not limited to the appointment of the Resolution Professional and approval of a Resolution Plan.²¹ In other words, the COC plays a vital role in controlling and protecting distressed assets from being disposed of or devalued.²² However, with the measures having the effect of shifting this control back to the sick and vulnerable debtor, it seems that the government has followed an over-optimistic approach and assumed that businesses will prosper and prevent loss of assets in post-COVID-19 times.²³ In doing so, it has failed to take account of issues such as lack of working capital, ill-functioning of logistics and poor cashflow of sick establishments which would render it difficult for them to generate sustainable revenue and make payments.

No timely exit of sick establishments

The Code enables a debtor to voluntarily initiate insolvency proceedings and ensure value preservation of assets.²⁴ However, since corporate debtors have been blocked from self-filing to restructure debt, the

suspension defeats the objective of the timely exit of sick establishments from the market, ultimately forcing them to run the show without the available means.²⁵ This may lead to a significant devaluation of their assets and an increase in the filing of insolvency cases in post-COVID-19 times.

What 'ought' to be done – taking a lead from other jurisdictions

Having analysed the Ordinance, it becomes relevant to understand the measures taken by other major economies such as China, the UK and the US. Notably, these jurisdictions have placed greater emphasis on providing monetary relief and strengthening the existing insolvency laws, in sharp contrast to the blanket suspension directed by the Indian government.

China's selective relief policy

The Chinese Supreme People's Court ('SPC') has issued comprehensive guidelines for handling insolvency cases, requiring adjudicating authorities to emphasise factors attributable to COVID-19 before admitting an application.²⁶ For instance, in cases where the court finds that a debtor was operating efficiently and had sound cashflow before the pandemic, it is necessarily required to examine whether the pandemic was the root cause of the debtor's financial distress and if so, it will take into account the ability of the debtor to continuously operate and survive. Furthermore, the guidelines provide for active negotiations between creditors and debtors. The aforesaid exercises are purported to avoid bankruptcy proceedings against such debtors that could prosper in the absence of the pandemic.²⁷

The Indian government ought to have followed a similar policy aimed at affording some leverage to debtors severely hit by the pandemic while reserving the right of creditors to initiate insolvency proceedings against unscrupulous debtors, which in turn could prevent exploitation of the payment holiday.

Notes

19 Joel Rebello, 'Complete IBC suspension for defaults may hurt creditors' *Economic Times* (7 June 2020) <https://m.economictimes.com/industry/banking/finance/banking/complete-ibc-suspension-for-defaults-may-hurt-creditors/articleshow/76248542.cms> accessed 19 June 2020.

20 Ibid.

21 IBC, 2016, s.21.

22 Charanya Lakshmikumaran, 'Evolution of the committee of creditors' authority' *India Business Law Journal* (10 October 2019) <https://www.vantageasia.com/committee-creditors-authority-evolution/> accessed on 19 June 2020.

23 Ibid.

24 IBC, 2016, s.10.

25 Ibid.

26 'Supreme People's Court's New Policy on Cross-border Commercial Issues and Covid-19' *Supreme People's Court Monitor* (19 June 2020) <https://supremepeoplescourtmonitor.com/2020/06/19/supreme-peoples-courts-new-policy-on-cross-border-commercial-issues-and-covid-19/> accessed 21 June 2020.

27 Maarten Roos and Molly Luo, 'SPC issues Guiding Opinions on handling civil disputes involving COVID-19' *Mondaq* (22 May 2020) <https://www.mondaq.com/china/litigation-contracts-and-force-majeure/938434/spc-issues-guiding-opinions-on-handling-civil-disputes-involving-covid-19> accessed 21 June 2020.

US Paycheck Protection Program

The US has brought relatively few changes to its insolvency regime and primarily relied on providing economic stimulus to businesses to combat the wrecked economy. Accordingly, it introduced the Coronavirus Aid, Relief, and Economic Security ('CARES') Act, 2020 to inject roughly USD 2 trillion into the economy and provide additional financing options to businesses and mitigate risks.

The government plans to bail out distressed companies and support small-scale businesses in two separate tranches of USD 500 billion and USD 670 billion respectively.²⁸ For this, the Small Business Administration ('SBA') has implemented a Paycheck Protection Program ('PPP') which would provide small businesses with funds to pay up to eight weeks of payroll costs including benefits.²⁹ Further, the SBA will forgive loans if all employees are kept on the payroll for eight weeks and the money is used for payroll, rent, mortgage interest or utilities. Besides, under the CARES Act, the threshold allowing businesses to take advantage of streamlined bankruptcy protection has been raised from approximately USD 2,725,625 to USD 7,500,000.³⁰

UK's new moratorium and restructuring policy

The UK government has introduced the Corporate Insolvency and Governance Act (the 'Act'), to provide new moratorium rules and a fresh restructuring plan, as a part of various permanent changes to its Insolvency Act, 1986.

The Act enables a distressed company to obtain benefit of the moratorium for a period of up to 40 days (extendable up to one year subject to court's approval) by filing a notice that the directors wish to obtain a moratorium and a statement by the monitor that it is 'likely that' the moratorium will result in the rescue of the company as a going concern.³¹ During this period, the directors would retain control over the

management while working under the supervision of the monitor. Also, the debtor company would be relieved of all pre-moratorium debts and legal processes, giving it time to map out a rescue plan. Notably, the Indian government could easily give effect to such a mechanism by relaxing the provisions of Section 29A of IBC which bars promoters from participating in the resolution process.³²

Further, the reforms also provide for a cross-class calm down provision in the form of a restructuring framework similar to pre-packs, allowing the debtor to propose a restructuring plan. The plan is submitted to the court which directs the convening of a meeting of creditors to vote on the plan. It is then required to be approved by 75 percent of the creditors to have a binding effect on all the creditors and stakeholders.³³ Given the adversities brought about by the pandemic, such a mechanism allows cost-effective and less disruptive revival of the debtor's business as against the rigorous and lengthy traditional procedure. With that said, it is high time that the Indian legislature introduces pre-packs as a fast track resolution process under IBC.³⁴

Conclusion

Though the Ordinance providing for a blanket ban on insolvency proceedings might lend some breathing space to revive businesses, it devoids the parties of a structured framework and various benefits accorded by the Code. Arguably, it is not free from lacunas and exemplifies a hasty decision, leaving room for unscrupulous parties to take undue advantage at the cost of already overburdened balance sheets of their counterparts. Further, unlike other jurisdictions, it fails to provide for selective relief and effective debt restructuring alternatives to the Code which may result in devaluation of distressed assets and their consequential liquidation. Thus, the government has indeed failed to adequately address the ongoing adversity and instead opened the floodgates for endless litigation.

Notes

28 'The CARES Act Provides Assistance to Small Businesses' <https://home.treasury.gov/policy-issues/cares/assistance-for-small-businesses> accessed 28 June 2020.

29 Ibid.

30 'Current Economic Relief Opportunities for US Small Businesses Impacted by the COVID-19 Outbreak in the CARES Act' *The National Law Review* (March 26, 2020) <https://www.natlawreview.com/article/current-economic-relief-opportunities-us-small-businesses-impacted-covid-19-outbreak> accessed 28 June 2020.

31 Barney Smedley, 'UK Corporate Insolvency And Governance Act: Moratorium' *DLA Piper* (30 June 2020) <https://www.dlapiper.com/en/uk/insights/publications/2020/06/uk-corporate-insolvency-and-governance-bill/> accessed 30 June 2020.

32 IBC, 2016, s. 29A.

33 Steven Wood, 'Corporate Insolvency and Governance Act 2020 – New restructuring procedure' *ICAS* (26 June 2020) <https://www.icas.com/professional-resources/coronavirus/latest-updates/corporate-insolvency-and-governance-bill/corporate-insolvency-and-governance-bill-new-restructuring-procedure> accessed 30 June 2020.

34 Aparna Ravi, 'Introducing Pre-packs in India – A Useful Tool in Times of COVID-19?' (25 May 2020) *OBLB* <https://www.law.ox.ac.uk/business-law-blog/blog/2020/05/introducing-pre-packs-india-useful-tool-times-covid-19> accessed 30 June 2020.

Recognition and Enforcement of Foreign Insolvency Orders in the US: Comity Still Works¹

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Synopsis

US courts have a long history of granting comity and enforcing orders of foreign courts. Since the enactment of chapter 15 – the incorporation of the Model Law into the US Bankruptcy Code – foreign representatives generally have sought chapter 15 relief to obtain recognition and enforcement of an order in a foreign insolvency proceeding in the US. The decision in *EMA Garp*,² however, is a reminder that comity is alive and well, and that chapter 15 may not be required to enforce foreign orders in the US.

From comity, to Bankruptcy Code section 304, to chapter 15

Prior to the enactment of the Bankruptcy Code in 1978, ‘comity’ was the sole standard by which a foreign

insolvency proceeding could be recognised by a court in the United States.³ International comity permits a court of one nation to acknowledge the legislative, executive, or judicial acts of another nation, recognising twin duties the court must balance: due respect for foreign proceedings, as well as safeguarding the rights and obligations of persons owed the protection of law.⁴ Through comity, United States courts generally recognised orders of foreign courts so long as (a) the foreign court had jurisdiction over the relevant parties and (b) the proceeding comported with United States notions of due process.⁵ Although the pre-1978 jurisprudence generally favoured recognition, there was enough uncertainty and lack of uniformity⁶ that Congress enacted section 304 to create a basic framework to address cross-border insolvencies.

Bankruptcy Code section 304⁷ provided a foreign representative with a statutory basis to protect assets located within the territorial jurisdiction of the United

Notes

- 1 The views expressed herein are solely those of Ms Zerjal, and not necessarily the views of Arnold & Porter or any of its attorneys.
- 2 *EMA Garp Fund v Banro Corp.*, 2019 U.S. Dist. LEXIS 27387, *2-7 (S.D.N.Y. Feb. 21, 2019), *aff'd*, 783 F. App'x 82 (2d Cir. 2019).
- 3 Comity has been defined as ‘recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to the international duty and convenience, and to the rights of its own citizens or of other persons who are under the protections of its laws.’ *Hilton v Guyot*, 159 U.S. 113, 163-64 (1895).
- 4 *See*, *JP Morgan Chase Bank v Altos Hornos de Mexico, S.A. de C.V.*, 412 F.3d 418, 423 (2d Cir. 2005).
- 5 *See, e.g.*, *In re Waite*, 99 N.Y. 433, 448 (1885); *In re Clarkson Co. v Shaheen*, 544 F.2d 624, 629-30 (2d Cir. 1976); *In re Culmer*, 25 B.R. 621, 629 (Bankr. S.D.N.Y. 1982) (‘[F]oreign-based rights should be enforced unless the judicial enforcement of such a [right] would be the approval of a transaction which is inherently vicious, wicked or immoral, and shocking to the prevailing moral sense.’) (citing *Confeld v Investors Overseas Servs., Ltd.*, 471 F. Supp. 1255 (S.D.N.Y. 1979)) (internal quotations omitted).
- 6 *Compare In re Banque de Financement, S.A.*, Civil No. 75 B 764 (Bankr. S.D.N.Y. 1976), *rev'd* 568 F.2d 911 (2d Cir. 1977) (dismissing U.S. bankruptcy petition of foreign bank so that preferential attachments of U.S. creditors could be protected (*i.e.*, territoriality doctrine)) with *In re Israel-British Bank (London) Ltd.*, No. 74-B-1322 (Bankr. S.D.N.Y. 1978) (ordering transfer of assets in the U.S. to English liquidators for the benefit of all creditors (*i.e.*, universality doctrine)).
- 7 Section 304 of the Bankruptcy Code (repealed in 2005), in its entirety, provided as follows:
 - (a) A case ancillary to a foreign proceeding is commenced by the filing with the bankruptcy court of a petition under this section by a foreign representative.
 - (b) Subject to the provisions of subsection (c) of this section, if a party in interest does not timely controvert the petition, or after trial, the court may –
 - (1) enjoin the commencement or continuation of –
 - (A) any action against –
 - (i) a debtor with respect to property involved in such foreign proceeding; or
 - (ii) such property; or
 - (B) the enforcement of any judgment against the debtor with respect to such property, or any act or the commencement or continuation of any judicial proceeding to create or enforce a lien against the property of such estate;
 - (2) order turnover of the property of such estate, or the proceeds of such property, to such foreign representative; or
 - (3) order other appropriate relief.
 - (c) In determining whether to grant relief under subsection (b) of this section, the court shall be guided by what will best assure an economical and expeditious administration of such estate, consistent with –

States.⁸ Filing for protection under section 304 created an ancillary proceeding within the United States – *i.e.*, in aid of the insolvency proceeding pending in the foreign representative's country, and did not initiate a full, plenary bankruptcy action within the United States. A foreign representative could generally seek (i) an injunction against the commencement, continuation, or enforcement of any action, judgment, or lien against the property of the debtor's estate (which was accomplished by satisfying the standards for a temporary restraining order and later preliminary and final injunctions); or (ii) an order for the turnover of estate property to the foreign representative for distribution in the foreign proceeding. Section 304, however, had certain limitations and uncertainty regarding additional relief the court could grant.⁹ It also was not the exclusive remedy for foreign debtors as a foreign representative could still request that the US court recognise the foreign proceeding as a matter of international comity, without seeking relief under section 304.¹⁰

It became increasingly evident that a unified approach to cross-border insolvencies in a global economy was necessary. Accordingly, in 2005, Congress repealed section 304 and replaced it with chapter 15, which incorporates the UNCITRAL Model Law on Cross-Border Insolvency promulgated in 1997. Bankruptcy Code section 1509(b) provides that, upon recognition of a foreign proceeding, the foreign representative may apply directly to another US court for appropriate relief, which 'shall be accompanied by a certified copy of an order granting recognition' under chapter 15, and such US Court 'shall grant comity or cooperation.' This provision reflects the intention that chapter 15 be the exclusive way for foreign debtors to seek assistance in the US.

EMA Garp

Banro Corp. ('Banro'), a Canadian company, commenced a reorganisation proceeding in the Ontario Supreme Court of Justice under Canada's Companies' Creditors Arrangement Act (the 'CCA'). The Canadian court issued an order confirming the plan on 27 March 2018. The plan entailed a debt-for-equity swap that extinguished Banro's existing equity, and it included releases for both the Banro debtors and their directors and officers.¹¹ Banro did not seek a chapter 15 recognition of its CCA proceeding.

Meanwhile, on 5 March 2018, certain equity holders filed a complaint in the US district court, alleging false and misleading statements, as well as material omissions of fact, in communications from Banro and its former CEO to Banro's shareholders.¹² Plaintiffs conceded they were aware of the CCA proceeding, but rather than participating, decided to commence the action while the CCA proceeding was still pending.¹³ Defendants moved to dismiss the action on the basis of comity, because the action was filed during the CCA proceeding.¹⁴

District Court and Second Circuit: comity is alive and well

The district court granted the motion to dismiss.¹⁵ In reaching its conclusion, the district court expressly stated that Banro was under no obligation to file anything in US courts, including a recognition proceeding, to obtain international comity.¹⁶ In determining whether to grant comity, the district court analysed whether the CCA proceeding satisfied the fundamental standards of procedural fairness for a foreign bankruptcy

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- (1) just treatment of all holders of claims against or interests in such estate;
- (2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding;
- (3) prevention of preferential or fraudulent dispositions of property of such estate;
- (4) distribution of proceeds of such estate substantially in accordance with the order prescribed by this title;
- (5) comity; and
- (6) if appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns.'

Former 11 U.S.C. § 304.

- 8 Section 304 'provide[d] for the first time a bankruptcy remedy, in addition to comity, for dealing with issues related to foreign insolvencies.' *Iida v Kitahara (In re Iida)*, 377 B.R. 243, 254 (B.A.P. 9th Cir. 2007). The fundamental purpose of Section 304 was to 'provide a statutory mechanism through which United States courts may defer to and facilitate foreign insolvency proceedings.' *In re Treco*, 240 F.3d 148, 156 (2d Cir. 2001).
- 9 *In re Treco*, 240 F.3d 148, 156 (2d Cir. 2001) ('[W]e note at the outset that we are not bound by the decisions affording comity to Bahamian bankruptcy proceedings in *In re Culmer* and *In re Hackett*, not only because bankruptcy court decisions are not binding on us, but also because § 304(c) calls for a case-specific exercise of discretion in light of all of the circumstances.')
- 10 *See, e.g., Remington Rand Corporation—Delaware v Business Sys. Inc.*, 830 F.2d 1260, 1267–68 (3d Cir. 1987) (section 304 'expresse[d] Congressional recognition of an American policy favoring comity for foreign bankruptcy proceedings ... [and was] not the exclusive source of comity').
- 11 *EMA Garp Fund v Banro Corp.*, 2019 U.S. Dist. LEXIS 27387 at *2-7.
- 12 *Id.* at *1.
- 13 *Id.* at *6.
- 14 *Id.* at **8, 11.
- 15 *Id.* at *24.
- 16 *Id.* at 16.

proceeding established in *Allstate Life Insurance Company v Linger Group Limited*,¹⁷ namely:

- (1) whether creditors of the same class are treated equally in the distribution of assets;
- (2) whether the liquidators are considered fiduciaries and are held accountable to the court;
- (3) whether creditors have the right to submit claims which, if denied, can be submitted to a bankruptcy court for adjudication;
- (4) whether the liquidators are required to give notice to the debtors' potential claimants;
- (5) whether there are provisions for creditors' meetings;
- (6) whether a foreign country's insolvency laws favour its own citizens;
- (7) whether all assets are marshalled before one body for centralised distribution; and
- (8) whether there are provisions for an automatic stay and for the lifting of such stays to facilitate the centralisation of claims.¹⁸

Agreeing with Banro that the CCAA satisfied this standards, the district court ultimately noted plaintiffs *chose* not to participate in the CCAA proceedings, although the final hearing was even adjourned to provide them with additional time to review and object to the reorganisation plan, which plaintiffs declined to do.¹⁹ The district court also observed plaintiffs effectively engaged in forum-shopping by electing to file an action in the US court in lieu of participating in the CCAA proceeding, where they could have litigated their claim fully and fairly.²⁰ Finally, dismissing the complaint would not

violate US public policy because deference to the Canadian proceeding was necessary to prevent 'disgruntled members of an out-of-the-money constituency from circumventing and contravening the procedures and rulings of the court overseeing the process in which all other creditors and claimants are participating.'²¹

Notably, the district court also granted comity to third-party releases in the CCAA reorganisation plan. In dismissing the claims against Banro's former CEO, the district court emphasised that permitting such claims would directly contravene the CCAA reorganisation plan, which released those claims.²²

Outlook

The *EMA Garp* decision is a reminder that chapter 15 is not required to enforce an order from a foreign insolvency proceeding in the US. Indeed, not all cases with connections to, or assets in, the US may require chapter 15 recognition. Banro's stock was traded on the New York Stock Exchange, but the company had no significant property in the US, and opted not to seek chapter 15 recognition and relief. The absence of significant property in the US, however, should not necessarily mean chapter 15 recognition is not needed. If there is a risk of litigation against a foreign debtor in the US, such risk can be prevented by a chapter 15 filing because the automatic stay granted upon recognition stays any such action against the foreign debtor. The foreign debtor, therefore, should assess whether precluding any potential litigation with a chapter 15 filing may be more beneficial than having to defend against litigation, if it is commenced.

Notes

17 994 F.2d 996 (2d Cir. 1993).

18 *Id.* at 999.

19 *EMA Garp Fund v Banro Corp.*, 2019 U.S. Dist. LEXIS 27387, *17.

20 *Id.*

21 *Id.* at *19 (internal citations omitted).

22 *Id.* at 22.

Hong Kong's Economic Challenges and Renewed Interest in a Corporate Rescue Scheme

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Hong Kong recorded the first recession in the July to September period of 2019. This was the first for the territory in a decade.¹ The US-China trade war that began in 2018 took a toll on Hong Kong's exports a year later.² Adding to this, heightened political tensions and social unrest with large scale protests prompted by the introduction of the extradition bill earlier last year, Hong Kong's economy had suffered from considerable contraction.³ Then with the outbreak of COVID-19 around February this year a further plummet in tourist numbers and in the following months the introduction of border controls compounded to the territory's economic woes.⁴

The combination of the trade-war, socio-political tensions, and COVID-19 measures all spelled bad news for three out of the four economic pillars (tourism, logistics, trade and finance) of Hong Kong. Unfortunately these three sectors are unlikely to recover anytime soon. Tourism had in the past decade relied primarily on the Mainland Chinese visitors. Whilst COVID-19 border controls will eventually come off, socio-political tensions are unlikely to subside anytime soon.⁵ Mainland tourists will be very wary travelling across the border for leisure. Trade and logistics recovery is looking grim as there is no end in sight for the trade war.⁶ Even if

the President Trump is not re-elected in November, the negative perceptions about the Mainland is more than likely to persist amongst Americans.

Three more factors shall be adding to Hong Kong's economic future. First is the emergence of a split in the economy into 'yellow' and 'blue'.⁷ The former are shops and businesses that support the socio-political movement, and the latter are who are pro-government. There are some evidence to support this separation is hurting the economy by stunting Mainland Chinese tourists away.⁸

The second is the impending enactment of a security law by the Standing Committee of National People's Congress on the Mainland, by-passing the Legislative Council in Hong Kong. This is expected to have an impact on the fourth pillar of the territory's economy – the financial services. Commentaries on its affect varies from one end of the spectrum to the other. The optimists including the territory's finance chief who claimed that the removal of preferential treatment of Hong Kong by the US in reaction to the security law will have 'little impact'.⁹ He expressed confidence in financial market to adapt.¹⁰ Another commentator also agreed that the proposed security law would have little impact because Mainland Chinese capital flows and

Notes

- 1 BBC News, 'Hong Kong in First Recession for a Decade amid Protests' <<https://www.bbc.com/news/business-50431614>> 1 June 2020.
- 2 Denise Tsang, 'Hong Kong exports fall 5.7 per cent as US-China trade war bites' <<https://www.scmp.com/news/hong-kong/hong-kong-economy/article/3024374/hong-kong-exports-fall-5-7-cent-us-china-trade-war>> 3 June 2020.
- 3 Kenneth Rapoza, 'Latest Data Shows Protests Sucking The Life Out Of Hong Kong Economy' <<https://www.forbes.com/sites/kenrapoza/2020/01/03/latest-data-shows-protests-sucking-the-life-out-of-hong-kong-economy/#39d2015444f9>> 3 June 2020.
- 4 Tong Cheung, 'Coronavirus crisis to hit economies worldwide, Hong Kong finance chief warns, citing downgraded analyst forecasts' <<https://www.scmp.com/news/hong-kong/hong-kong-economy/article/3074134/coronavirus-crisis-hit-economies-worldwide-hong>> 3 June 2020.
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- 7 Cannix Yau, 'What happens to Hong Kong's economy when businesses are split by protests into 'blue' vs 'yellow'? <<https://www.scmp.com/print/news/hong-kong/hong-kong-economy/article/3045737/what-happens-hong-kongs-economy-when-businesses>> 4 June 2020.
- 8 Kanis Leung, 'Hong Kong protesters plan mini 'golden week' hijack to boost yellow businesses as city reels from economic impact of coronavirus' <<https://www.scmp.com/news/hong-kong/hong-kong-economy/article/3082194/hong-kong-protesters-plan-mini-golden-week-hijack>> 4 June 2020.
- 9 Chan Ho-him, 'Hong Kong Finance Chief Paul Chan says City had nothing to Fear from Donald Trump Sanctions over national security law' <<https://www.scmp.com/news/hong-kong/politics/article/3086821/hong-kong-finance-chief-paul-chan-says-city-has-nothing>> 5 June 2020.
- 10 Ibid.

investments into Hong Kong would continue.¹¹ The pessimists highlighted that if the US would to apply sanctions on the territory if China went ahead with the national security law, it is likely that the professional and financial services sectors would take a hit.¹²

Third, the pandemic has thus far created a 'deep recession' on a global level.¹³ This would clearly affect Hong Kong's economic recovery. Personal bankruptcies in 2019 rose by 9 percent year on year to 8151.¹⁴ And company winding-up petitions jumped to 14 percent to 419.¹⁵ With the travel bans due to the COVID-19 many companies, particularly the food and beverage and retail sectors are expected to seek debt restructure in order to survive.¹⁶ However, there is no expectation of a quick recovery post-COVID due to the depressed local and international demand, and so individual bankruptcies and corporate winding-up as well as liquidation are anticipated to mount this year into the next.

Earlier in March a news article about Hong Kong revisiting a Chapter 11 style corporate rescue bill to be introduced later this year has re-surfaced.¹⁷ According to this report, 'A key part of the proposal may include giving debtors a six-month moratorium from hostile acts, such as winding-up or liquidation proceedings, while they work on rehabilitation plans or find white knights, according to people involved in the discussions.'¹⁸ The Hong Kong government's motivation from this report states that, 'The move underlines the government's efforts to prevent a wider implosion in corporate failures after gross domestic product economy shrank last year for the first time since the

global financial crisis. Anti-government protests and the coronavirus outbreak have now brought many pillars of the economy to their knees.'¹⁹

However this is not the first attempt, in fact it can be considered the fourth attempt.²⁰ Whilst it would offer companies and creditors a good option to look for white knights or restructure its debt to stave off liquidation, it is too little. Given the huge and unprecedented economic challenge noted in the above, this corporate rescue scheme needs to offer greater legal safeguards for all stakeholders, especially the employees and creditors to prevent the scheme from becoming a debt scheduling mechanism to delay liquidation. Also to ensure corporate rescue to work in Hong Kong, employees and creditors should be given more opportunities to work out a viable plan with management and major shareholders via a formal mechanism with the aid of professionals because it is in every stakeholders' interests to avoid more companies in Hong Kong from going under.

One can only hope that a corporate rescue scheme shall be finally enacted. It shall be the fourth attempt. More importantly, having a moratorium in place is not a silver bullet for corporate turnarounds. It is when all key stakeholders are committed to a corporate rescue plan through negotiated agreements and willingness to compromise for the greater good for such scheme to work. This is where traditional Chinese culture of meditation can help. Perhaps, it is time for Hong Kong to look at its cultural roots to support modern regulatory mechanisms for the good of all parties concerned.

Notes

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- 12 Holly Chik, 'Hong Kong's Flagship Industries including Finance to Suffer First from United States Sanction Threat, Minister Warns' <<https://www.scmp.com/news/hong-kong/hong-kong-economy/article/3086733/hong-kongs-flagship-industries-including-finance>> 5 June 2020.
- 13 Kenneth Rogoff, 'The COVID-19 recession could be far worse than 2008 – here's why' <<https://www.weforum.org/agenda/2020/04/mapping-covid19-recession/>> 5 June 2020.
- 14 Enoch Yiu, 'Worse than Financial Crisis, Deadlier than Sars: Coronavirus to Push Hong Kong Bankruptcies to Decade High' <<https://www.scmp.com/business/companies/article/3052020/worse-financial-crisis-deadlier-sars-coronavirus-push-hong-kong>> 5 June 2020.
- 15 Ibid.
- 16 Ibid.
- 17 Enoch Yiu, 'Hong Kong Resurrects Chapter 11-style Corporate Rescue Bill after a 24-year Hiatus as Singapore Powers ahead with Reforms' <<https://www.scmp.com/business/banking-finance/article/3074733/hong-kong-resurrects-chapter-11-style-corporate-rescue>> 5 June 2020.
- 18 Ibid.
- 19 Ibid.
- 20 For more on the three earlier attempts see – Ted Tyler and Angus Young, 'Provisional Supervision in Hong Kong: Third Time Lucky?' (2011) 8 *International Corporate Rescue*, 19-25.

Decision of the European Court of Justice in *Riel*, dated 18 November 2019 – C 47/18

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Synopsis

In its decision in *Riel*, dated 18 November 2019 – C 47/18 the European Court of Justice ('ECJ') discusses three central questions regarding European insolvency law. The first question is an all-time classic – the distinction between the scope of the Regulation No 1346/2000¹ (European Insolvency Regulation, 'EIR 2000') and Regulation No 1215/2012² ('Brussels Recast Regulation'). The second question concerns the relationship of (parallel) main and secondary insolvency proceedings towards each other and the handling of emerging conflicts of competences. Regarding the third question, the ECJ enters new judicial territory and deals with the requirements for the lodgement of (insolvency) claims of creditors in the light of Art. 41 of the EIR 2000 for the first time.

A. Facts

The director of the state treasury of the Republic of Poland responsible for country roads and highways ('Plaintiff') authorised the Alpine Bau GmbH located in Austria ('Debtor') to execute several road construction projects in Poland. In the middle of the year 2013, restructuring proceedings were opened in Austria over the estate of the Debtor, which were later reclassified as bankruptcy proceedings – main insolvency proceedings according to the EIR 2000. In this context, Mr Riel was appointed as insolvency administrator over the estate of the Debtor. Shortly thereafter, secondary insolvency proceedings over the estate of the Debtor were opened in Poland.

The Plaintiff logged precisely estimated claims to the insolvency table of the Debtor in the Austrian main insolvency proceedings as well as in the Polish secondary insolvency proceedings. These claims were disputed (as a whole) in both insolvency proceedings. Therefore, in

the middle of the year 2015, the Plaintiff brought an action for a declaratory judgment before the competent court in Poland concerning the determination of the existence of his claims in the Polish secondary insolvency proceedings. At the end of the year 2016, he also filed an action for a declaratory judgment pursuant to sec. 110 of the Austrian Law on Insolvency (*Insolvenzordnung*, 'öStIO') at the Commercial Court of Vienna concerning the determination of the existence of his claims in the Austrian main insolvency proceedings. At the same time the Plaintiff applied for a stay of the Austrian declaratory judgment proceedings according to Art. 29 and 30 of the Brussels Recast Regulation until a binding decision of the Polish court in its determination proceedings. Art. 29 para. 1 of the Brussels Recast Regulation states that where proceedings involving the same cause of action and between the same parties are brought in the courts of different Member States, any court other than the court first seized shall of its own motion stay its proceedings until such time as the jurisdiction of the court first seized is established.

The stay requested by the Plaintiff was not granted by the Commercial Court of Vienna. The Plaintiff appealed against that decision to the Higher Regional Court of Vienna, which postponed the Austrian declaratory judgment proceedings and decided to refer the following questions to the ECJ for a preliminary ruling:

1. Is Art. 1 para. 2 lit. b) of the EIR 2000 to be interpreted as meaning that an action for a declaration of the existence of a claim under Austrian law concerns insolvency for the purposes of that provision and is, therefore, excluded from the material scope of that regulation?
2. (only if the first question is answered in the affirmative):
Is Art. 29 para. 1 of the Brussels Recast Regulation to be applied analogously to related actions falling within the scope of the EIR 2000?

Notes

1 Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings.
2 Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (recast).

3. Is Art. 41 of the EIR 2000 to be interpreted as meaning that the requirement to indicate the ‘nature of the claim, the date on which it arose and its amount’ is satisfied where, in the lodgement of his claim, the creditor situated in a Member State other than the State of the opening of proceedings:
- a) describes the claim simply by assigning a specific amount to it without stating the date on which that claim arose;
 - b) does not state the date on which the claim arose in the declaration itself, but such a date may be inferred from the annexes submitted with the declaration of claim (for example, based on the date stated on invoices submitted)?

B. Decision of the ECJ

I. With reference to some of its previous rulings dealing with the distinction between the scope of the EIR 2000 and the Brussels Recast Regulation, the ECJ confirms that the Austrian action for a declaratory judgment raised by the Plaintiff is excluded from the scope of the Brussels Recast Regulation and is covered by the scope of the EIR 2000. The crucial aspect for the distinction between both regulations is, whether the action in question has its ‘legal basis’ within insolvency proceedings, i.e. the special regulations for insolvency proceedings, or within general civil- and/or commercial regulations. In the case at hand, the Austrian determination action was based on sec. 110 östIO. The regulatory location of the section within the östIO as well as its factual/personal scope shows that the Austrian determination action has its foundation in the Austrian insolvency proceedings and is closely connected to them.

II. Regarding the second question the ECJ clarifies, that Art. 29 of the Brussels Recast Regulation is not to be applied analogously to related actions falling within the scope of the EIR 2000. This is already a result of the strict distinction between the scopes of the Brussels Recast Regulation and the EIR 2000 as well as the legislative will/intent laying therein. This intent of the EU legislator would be undermined by an analogous application. In addition, such an application would disregard the parallel scheme of main and secondary insolvency proceedings under the EIR 2000. It would undermine the effectiveness of the relevant provisions, thus hampering their practical use. Conflicts between main and secondary insolvency proceedings are

bridged under the EIR 2000 by way of cooperation and information duties and expressly not by process barriers as foreseen in Art. 29 and 30 of the Brussels Recast Regulation.

III. The last question concerning the lodgement of claims is answered as follows by the ECJ: A creditor in an insolvency proceedings may lodge his (insolvency) claim without formally indicating the date on which the claim arose, if (i) the law of the Member State within the territory of which those insolvency proceedings were initiated so permits and (ii) the date may be inferred from the supporting documents referred to in Art. 41 of the EIR 2000.

Art. 41 of the EIR 2000 states the maximum requirements regarding the lodgement of a (insolvency) claim to the insolvency table which the applicable national laws of a Member State cannot further increase. Moreover, Art. 4 para. 2 lit. h) of the EIR 2000 clearly states, that for the admission, verification and the determination of a claim the law of the Member State in which the insolvency proceedings were opened is applicable.

C. Context of the case

I. The distinction between the scopes of the Brussels Recast Regulation and the EIR 2000 (as well as its successor, the ‘EIR 2015’³) is meanwhile ‘judicial routine’ for the ECJ. Thus, every action that (i) would not have been raised with the intended goal without the opening of insolvency proceedings and that (ii) directly serves the purpose of the insolvency proceedings, can be regarded as of insolvency nature, falling within the scope of the EIR 2000/2015.⁴

In this regard, the ECJ’s criteria of the ‘legal basis’ of the action must not be taken to literally. The ECJ does not refer to the legal basis of the claim itself (e.g. a performance claim from a sales contract). With legal basis the ECJ means the regulatory and judicial (insolvency) framework under which a claim is or may be enforced in an insolvency proceedings.⁵

In Germany for example, the action for a declaratory judgement (*Feststellungsklage*) pursuant to secc. 179 para. 1, 180 para. 1 of the German Insolvency Code is therefore covered by the scope of the EIR 2000/2015.⁶

II. The ECJ accurately dismisses the analogous application of Art. 29 of the Brussels Recast Regulation with respect to the EIR. There is already no required

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3 Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast).

4 P. Mankowski, ‘Klage auf Feststellung des Bestehens einer Forderung unter der EuInsVO’ [2019] 21 NZI 861, 864.

5 C.G. Paulus, ‘Zu den Anforderungen an eine Forderungsanmeldung im Hauptinsolvenzverfahren hinsichtlich des Entstehungszeitpunktes der Forderung (“Riel”)’ [2019] 20 EWiR 627, 628.

6 P. Mankowski, ‘Klage auf Feststellung des Bestehens einer Forderung unter der EuInsVO’ [2019] 21 NZI 861, 864; J. Schmidt, ‘Neues zur Annexzuständigkeit und Forderungsanmeldung: Das EuGH Urteil in der Rs. Riel’ [2019] 48 ZInsO 2449.

regulatory gap that may be filled by an analogy. This results, as noticed correctly by the ECJ, from the underlying concept of parallelism of main and secondary insolvency proceedings under the EIR 2000. This parallelism is further concretised in Art. 32 para. 1 of the EIR 2000 which was (unfortunately) not mentioned by the ECJ in its ruling. According to this provision, multiple lodgements of the same claim by one creditor in main insolvency proceedings and every secondary insolvency proceedings are possible. Thinking it through, this must consequently apply to actions for declaratory judgment, too. The possibility of two or more contrary judgments in this case is already taken into account by the system of the EIR 2000. However, other mechanisms, especially rules of cooperation (see Art. 31 of the EIR 2000) or the accounting rule in Art. 20 para. 2 of the EIR 2000 are (significantly) reducing or compensating such possibility of contrary judgements.⁷

III. Finally, also the statements of the ECJ regarding Art. 41 para. 1 of the EIR 2000 are convincing. If the law of the Member State, in which insolvency proceedings were opened, foresees lower requirements for the lodgement of claims than Art. 41 para. 1 of the EIR 2000, these lower requirements have preference.⁸

Consequently, if the law of the Member State, in which insolvency proceedings were opened, does not require the disclosure of the date on which the claim arose and/or the attachments listed in Art. 41 of the EIR 2000, the creditor may lodge his claims without these information. The misleading statement of the ECJ ‘and that [the] date may be inferred from the supporting documents referred to in Article 41’ does not contradict that conclusion.⁹

Moreover, the above finding/conclusion is also applicable to the EIR 2015. Art. 55 para. 2 lit. b) of the EIR 2015 opens the possibility to use a (European) standard form for the lodgement of (insolvency) claims

in which the disclosure of the date on which the claim arose is required. However, the use of the standard form is optional and not mandatory (see Art. 55 para. 1 of the EIR 2015 ‘... may ...’). In addition, Art. 55 of the EIR 2015 – as well as Art. 41 of the EIR 2000 – both have the objective to ease and not to hamper the lodgement of claims for (foreign) creditors. Consequently, a claim can be lodged without the disclosure of the date on which it arose under the new EIR 2015, if the law of the Member State, in which the insolvency proceedings were opened, does not require such disclosure.¹⁰

D. Practical impact

Because of the – in parts – very different insolvency regimes within the Member States, it is to be expected that the ECJ will also in future cases have to deal with the distinction between the scope of the EIR 2000/2015 and the Brussels Recast Regulation.

Regarding the relationship between main and secondary insolvency proceedings under the EIR 2000/2015 it is worth mentioning, that the European legislator, during the reform of EIR, did not meet various calls for an introduction of a provision similar to Art. 29 para. 1 of the Brussels Recast Regulation into the EIR 2000/2015.¹¹ Against this background and in the light of the present ECJ ruling, this whole issue may now be off the table.

Finally, as far as the decision deals with the lodgement of (insolvency) claims, it provides substantial legal certainty and clarity. The requirements stipulated in the EIR 2000 are maximum requirements. This must also apply to the new EIR 2015. Consequently, it is left to the Member States whether they deviate from those maximum requirements by demanding lower standards due to their national rules or not.¹²

Notes

7 J. Schmidt, ‘Neues zur Annexzuständigkeit und Forderungsanmeldung: Das EuGH Urteil in der Rs. Riel’ [2019] 48 ZInsO 2449.

8 P. Mankowski, ‘Klage auf Feststellung des Bestehens einer Forderung unter der EuInsVO’ [2019] 21 NZI 861, 864.

9 J. Schmidt, ‘Neues zur Annexzuständigkeit und Forderungsanmeldung: Das EuGH Urteil in der Rs. Riel’ [2019] 48 ZInsO 2450.

10 J. Schmidt, ‘Neues zur Annexzuständigkeit und Forderungsanmeldung: Das EuGH Urteil in der Rs. Riel’ [2019] 48 ZInsO 2450; *contra*: P. Mankowski, ‘Klage auf Feststellung des Bestehens einer Forderung unter der EuInsVO’ [2019] 21 NZI 861, 864; *left open*: C.G. Paulus, ‘Zu den Anforderungen an eine Forderungsanmeldung im Hauptinsolvenzverfahren hinsichtlich des Entstehungszeitpunktes der Forderung (“Riel”)’ [2019] 20 EWiR 627.

11 J. Schmidt, ‘Neues zur Annexzuständigkeit und Forderungsanmeldung: Das EuGH Urteil in der Rs. Riel’ [2019] 48 ZInsO 2450.

12 This case not is based on A. Swierczok, ‘Anforderungen an eine wirksame Forderungsanmeldung nach Art. 41 EuInsVO 2000’, [2020] jurisPR-InsR Anm. 1.

Re Carluccio's Ltd (in administration) [2020] EWHC 886 (Ch)

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Synopsis

In response to the coronavirus pandemic, the government announced a measure of particular significance for companies in administration. This was the Coronavirus Job Retention Scheme ('the Scheme'), by which the government undertook to underwrite, in large part, the payment by private companies of employee wages, in an effort to reduce the scale of any redundancies resulting from the crisis.

The decision of Snowden J in *Re Carluccio's (in administration)* [2020] EWHC 886 (Ch) ('*Re Carluccio's*'), heard from 6 to 9 April 2020, was the first decision to consider how the use by companies in administration of the Scheme might be reconciled with the statutory regime set out in Schedule B1 to the Insolvency Act 1986 ('Schedule B1'). In *Re Carluccio's*, Snowden J carefully considered the circumstances in which administrators would be treated as 'adopting' employment contracts of the workforce. The judgment provides the clarification that an administrator's act of applying to the Scheme in respect of certain employees, or of paying the wages of certain employees to be furloughed under the Scheme, would cause those employment contracts to be 'adopted' under paragraph 99 of Schedule B1. That, in turn, would provide a proper basis for paying employee salaries out of the company's estate in priority to other creditors, consistently with the requirements of the Insolvency Act 1986, as and when the Scheme funds were paid to the company.

Snowden J's analysis provided the foundation for the further consideration of these issues in *Re Debenhams Retail Limited (in administration)* [2020] EWHC 921 (Ch), heard before Trower J on 15 April 2020, and heard on appeal ([2020] EWCA Civ 600) on 22 April 2020 ('*Re Debenhams*').

Background

The application was brought by the administrators as a matter of some urgency. The availability of the Scheme to the company was a critical consideration. The evidence was that the company had no money with which to pay the existing wages of its employees, and so if the Scheme were not open to the company, the workforce would be made redundant (at [3]). This concerned

the administrators because in order to 'mothball' the business, with a view to a prospective sale in order to achieve a better result for creditors than would result from an immediate winding up, the company would need to retain its workforce.

The company could, however, afford to pay employee wages, and retain the workforce, to the extent of the financial assistance provided by the Scheme, where the employees' employment contracts were varied to that end. Otherwise, the administrators would, economically, have had no option but to terminate the employment of the workforce (at [13]).

The administrators were conscious of the 14-day 'safe period', during which the administrators' actions would not be treated as contributing to the adoption of employment contracts. The adoption of those contracts would mean that they qualified for payment as expenses, having 'super-priority', before even the administrators' own remuneration. The administrators' assessment was that the adoption of the original (unvaried) employment contracts would be economically unsustainable for the company, and in this scenario the administrators were concerned about becoming personally liable in respect of the original employment contracts. To avoid this risk, the administrators would be forced to make the workforce redundant.

With this in mind, the administrators had invited employees by letter to consent to the variation of their employment contracts on terms that dovetailed with the available funding provided under the Scheme. The company would only be able to pay employees as and when it received funds from the government under the Scheme. Almost all employees agreed to this variation. A small number of employees either refused to consent to the variation, accepting that they would be made redundant, or failed to respond to the letter.

As a preliminary matter, Snowden J considered that those contracts were validly varied where the employees expressly agreed to the variation (at [45]). It could not be inferred from a failure to respond that the employees concerned had consented to the variation, however Snowden J limited his conclusion on this point to the particular circumstances of the case before him (at [54]).

Snowden J explained that the Scheme did not change the applicable law, and based on the available guidance published online concerning the Scheme (the

'Scheme Guidance'), its structure had not been publicly explained in any great detail (at [15]). The central question became how, if at all, applicable insolvency legislation could accommodate payments under the new Scheme as it had been proposed.

The urgency with which the application had been brought, and the absence of any joined representative employees, or representatives of the government, led Snowden J to question whether it was appropriate to give directions at all (at [7]). However, the administrators did not have the luxury of time, and in the extraordinary circumstances, Snowden J considered that the courts should work constructively and innovatively to respond to the crisis, wherever possible (at [8]-[9]).

Structure and scope of the Scheme

A first question concerned the scope of application of the Scheme as announced by the Chancellor of the Exchequer on 20 March 2020. While the Scheme was principally directed at companies which were not in an insolvency process, the Scheme Guidance referred to the possibility of the Scheme being open to an administration where, for instance, there was a 'reasonable likelihood of rehiring the workers'. That phrase was apt to include, Snowden J considered, a sale of the business and assets of the business. The court therefore accepted that the Scheme was available to the company (at [23]).

This then gave rise to a problem. How could the Scheme operate in the course of an insolvency process? There were techniques open to the government to ensure that money lent or provided to the company would never form part of its estate. The judge noted that the funds could be held on trust as earmarked for particular purposes, referring to *Barclays Bank v Quistclose Investments Limited* [1970] AC 567. But the Scheme as announced contemplated that funds would be paid to the company as income. Those monies would therefore constitute assets of the company in administration, and the applicable provisions, including Schedule B1, would therefore be engaged (at [33]). The consequence was that the administrators would have to justify the payment of employee wages, in priority to other claims against the company, by reference to relevant provisions of insolvency legislation (at [36]).

The basis in insolvency legislation for the priority payment of wages

The two candidate provisions for enabling payments to employees in these circumstances, in priority to the payment of the company's unsecured creditors, were paragraphs 66 and 99 of Schedule B1.

The first was paragraph 66 of Schedule B1, which sets out a general basis for allowing payments outside the normal order of priorities where an administrator

'thinks it likely to assist achievement of the purpose of administration'.

The other candidate was paragraph 99, which dealt with charges and liabilities upon an administrator's vacation of office. Snowden J identified that the adoption of a contract of employment under paragraph 99(5) would mean that any salary due would be payable out of the assets held by the administrators, even in priority to the administrators' own remuneration, which already has priority over the claims of other creditors (at [39]).

Which provision should apply? Paragraph 66, Snowden J observed, was drafted in wide terms, and used for payments other than in accordance with the normal order of priorities. Nevertheless, the judge considered that paragraph 99 was the more apt provision here, being specifically designed to deal with the obligations of administrators to pay wages and salary in an administration. The general provision had to give way to the specific provision (at [56]).

The above analysis would be revisited in the High Court and the Court of Appeal in *Re Debenhams*. In the Court of Appeal, David Richards LJ opined that paragraph 66 of Schedule B1 was the more obvious source of authority, given that paragraph 99 is stated to operate only where a person ceases to be an administrator (at [67]). This was not an essential part of Snowden J's decision in *Re Carluccio's*. But as Trower J had noted at first instance in *Re Debenhams*, it was possible to view paragraph 99 not only as the source of the obligation to pay employee wages as a super-priority expense, but, by extension, as authority for an administrator's ability to do so before leaving office (at [39]-[41]).

Paramount and the 'adoption' of employment contracts

Snowden J then turned to the leading authority on the 'adoption' of employment contracts in the context of paragraph 99(5), which was the decision of the House of Lords in *Powdrill v Watson & Anor (Paramount Airways Ltd)* [1995] 2 AC 394 ('*Paramount*') (at [57]-[68]). In that case, the administrators had continued to pay the wages of pilots while they continued to seek a buyer over the course of four months. The administrators asserted, however, that the contracts of employment of the pilots would not be adopted. The efforts to find a buyer ultimately failed, the pilots' employment was terminated, and the pilots claimed that their employment contracts had been adopted, entitling them to the super-priority payment of their contractual salary and other employment-related benefits.

Lord Browne-Wilkinson had explained (at 440-441) that new provisions had been introduced into the Insolvency Act 1986 to correct the mischief revealed by *Nicoll v Cutts* [1985] BCLC 322, the effect of which was that an employee who had rendered services during a

receivership or administration was unable to recover any payment for their work where the employment contract was not adopted. Parliament's response, however, had the practical consequence that office-holders had only a short window within which to decide whether to adopt contracts of employment (which risked exposing the administrators to large personal liabilities) or avoiding the risk altogether by making employees redundant.

Snowden J then recorded Lord Browne-Wilkinson's comments that the mere continuation of employment did not inexorably lead to the conclusion that the contract of employment had been adopted. Rather, 'adoption' connoted some conduct by the administrator or receiver which amounted to an election to treat the continued contract of employment as giving rise to a separate liability in the administration or receivership (*Paramount*, at 448-449). A second element of Lord Browne-Wilkinson's speech was his conclusion that, as Snowden J put it: '*adoption was an all-or-nothing concept*' (at [67]). Either the whole employment contract was adopted, or there was no adoption at all.

The question then turned to how those dicta applied to the furlough arrangements under the Scheme.

Rejection of the 'no services' argument

The Scheme did not contemplate that employees would provide services to the insolvent company. In fact, on the contrary, the terms of the furlough prevented employees from rendering services to their employer. Since the purpose of paragraph 99(5) of Schedule B1 was to address the mischief identified in *Nicoll v Cutts*, where services rendered went unremunerated, and given that the furlough arrangements did not give rise to that mischief, it was argued that, therefore, the paragraph had no application. The employees' contracts could not be 'adopted' where no services were to be provided by them.

Snowden J rejected this argument. Parliament deployed the concept of 'adoption' for remedying the mischief of *Nicoll v Cutts*, and did not limit super-priority to cases in which services had actually been rendered (at [71]).

There were, in addition, other reasons why the 'no-services' argument should fail. Even in normal circumstances, Snowden J continued, there were other situations in which it would be appropriate, and commercially important, for an administrator to continue to pay an employee's wages, despite the employee not providing any services. This could be the case where retention of an employee's status as such was valuable, whether in keeping them from a competitor, or retaining the value of a business in advance of a prospective sale. It would be wrong in those circumstances to hold that an employee was not entitled to wages or salary (at [72]).

When would contracts of employment be adopted under the Scheme?

In the circumstances of the coronavirus pandemic, Snowden J emphasised that paragraph 99(5) of Schedule B1 should, if possible, be interpreted to allow the Scheme to take effect, and support both the rescue culture and efforts to address the crisis.

In this respect, Snowden J considered further Lord Browne-Wilkinson's statement in *Paramount* that the mere continuation of a contract did not necessarily lead to its adoption. Some positive conduct was required by the administrator in order to treat salaries as ranking as separate liabilities in the administration. In the light of those comments, 'continuing' the employment contracts after the expiry of the 14-day grace period in paragraph 99(5), by failing to terminate them, did not mean that those contracts had been adopted automatically (at [84]). Snowden J approved the later decision of Laddie J in *Re Antal International Ltd* [2003] 2 BCLC 406, where the employment contracts in question were only discovered by the administrators once the 14-day grace period had expired, and on learning of their existence, the employment contracts were terminated. Those contracts had simply been 'continued' in the meantime, and were not automatically adopted by virtue of the failure to terminate. Snowden J endorsed that conclusion (at [88]).

For an 'adoption' to take place, Snowden J held that the administrators would need to carry out an act that was only explicable on the basis that they were electing to treat the varied contract as giving rise to liabilities which would qualify for super-priority.

In the context of the Scheme, it was sufficient to make an application under the Scheme in respect of any employees to be retained. A payment of the employees' wages under their varied contracts of employment would also qualify. Snowden J added that where any monies that became unexpectedly available to the company were applied to the payment of the wages of furloughed employees, prior to the receipt of funds from the Scheme, this would amount to an adoption of the varied contract. These were actions that were only explicable on the basis that the administrators were electing to treat the varied employment contract as giving rise to liabilities which qualified for super-priority (at [91]).

Snowden J therefore considered that the employment contracts, as varied in order to dovetail with the receipt of funds under the Scheme, could be adopted so as to permit super-priority payments in respect of wages. This meant that payments could properly be made to employees from the company's estate, consistently with insolvency legislation, as and when the funds were received under the Scheme.

The judge's conclusion also meant that the administrators did not have to take the precaution of dismissing employees who did not respond to the invitation to

vary their terms of employment. After the expiry of the 14-day grace period, those employment contracts would not be automatically adopted, but would simply 'continue' instead.

This Time It's Personal: Grand Court of the Cayman Islands Recognises Minority Shareholder Rights to Bring a Direct Personal Claim

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Synopsis

The Grand Court of the Cayman Islands recently handed down an important decision on the right of minority shareholders to object to an issue of shares which has the effect of diluting their position in a company. The Honourable Mr Justice Segal held that, contrary to the earlier decision of Mr Justice Kawaley in the matter of *Gao v China Biologic Products Holdings, Inc.* (unreported, FSD 157/2018, 10 December 2018 ('*Gao*')), a minority shareholder does have standing to bring a personal claim against the company in respect of such a share issue, and is not necessarily limited to bringing a derivative claim.

Background

Tianrui (International) Holding Company Limited v China Shanshui Cement Group Limited (unreported, FSD 161/2018, 6 April 2018) concerns a long running takeover battle for a significant cement producer in the People's Republic of China. The cement producer (the 'Company') is the subject of a winding up petition and the defendant in a related proceeding. Both proceedings were brought by a significant shareholder in the Company (the 'Petitioner'). The Company is the subject of a winding up petition on the just and equitable ground (the 'Petition proceeding'). It is also the defendant in a related proceeding in which the Petitioner alleges that the Company's decision to issue a significant number of convertible bonds and then convert them to shares constituted an improper exercise of the director's powers (the 'Writ proceeding').

In August and September 2018 the Company issued over \$500 million in convertible bonds to a number of subscribers, which were subsequently converted to shares in October 2018. The issue of the convertible bonds was not disclosed to shareholders or the market until after the Company had entered into the relevant

subscription agreements. The shares that were issued to give effect to the conversion were equivalent to approximately 24% of the total shares previously on issue. The Petitioner argues that these transactions were entered into for an improper purpose, and are the result of the controllers of the Company (the Petitioner's rivals in the takeover battle) attempting to cement their control by diluting the Petitioner's holding in the company. In particular, the Petitioner argues that the effect of the share issue was to dilute its shareholding in the Company from approximately 28%, at which point it had the power to block special resolutions of the Company, to approximately 21% at which it would not.

In August 2019 the Company filed summonses to either stay one or both of the Writ proceeding and Petition proceeding, or to strike out one or both of the Writ proceeding and the Petition proceeding on a number of bases.¹ One of the grounds on which the Company sought to strike out the Writ proceeding was that, as a minority shareholder and for the reasons explained in *Gao*, the Petitioner did not have standing to bring a claim regarding the dilutive share issue. The Company contended that, as the claim properly related to breaches by the board of the fiduciary duties they owed to the Company, the proper plaintiff was the Company itself and the Petitioner could only have brought a derivative claim.

On 6 April 2020 the Honourable Justice Segal handed down a decision in respect of both the Petition proceeding and the Writ proceeding.

The decision – does a shareholder have a personal right to sue?

Mr Justice Segal identified the question he was required to determine as:

'Can a shareholder bring a personal claim against the company where the directors allot shares for

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¹ In circumstances where the Company had previously sought to strike out the Petition proceeding as an abuse of process. The Court of Appeal's judgment in respect of the reinstatement of the Petition is *In the matter of China Shanshui Cement Group Limited* [2019] (1) CILR 481.

the improper purpose of diluting the shareholding of a minority shareholder from above to below 25% where it is alleged that the directors were acting in concert (and were part of a conspiracy with) the majority shareholders in order to achieve that dilution?’

Justice Segal considered there was also a related question:

‘Can the majority shareholders ratify the allotment and the breach in such circumstances and if they can do so, does ratification preclude the shareholders’ personal claim?’

In *Gao*, a minority shareholder (Mr Gao) had brought a writ action against a company in respect of the exercise by its board of directors of the power to allot and issue shares. The Honourable Mr Justice Kawaley struck out the writ on the basis that individual minority shareholders have no standing to pursue personal claims against a company for an improperly motivated allotment of shares which dilutes their voting rights. In reaching this decision, Kawaley J rejected the suggestion that a shareholder had a personal right of action arising from the improper issue of shares, concluding that to the extent any authorities could be read as supporting the existence of such a right, they were distinguishable or ought not be applied as the relevant statements were *obiter dicta*.

In reviewing the earlier decision of Kawaley J, the Honourable Mr Justice Segal undertook a detailed consideration of the relevant authorities and concluded that authoritative dicta in the cases and principle supported the view that the Petitioner had standing to bring its claim against the Company in a personal capacity; see *Re Sherborne Park Residents Co* [1987] BCLC 82, *Howard Smith v Ampol* [1974] AC 821, *Residues Treatment and Trading Co Ltd v Southern Resources* [1988] 6 ACLC 1160 (*‘Residues’*), *Peskin v Anderson* [2001] 1 BCLC 372 and *Eclairs Group Ltd v JKK Oil and Gas plc* [2016] 3 All ER 641.

While his Lordship was hesitant to disagree with the decision of Mr Justice Kawaley in *Gao*, he ultimately accepted the existence of a shareholder’s enforceable personal right, pointing in particular to the compelling and persuasive reasoning found in *In re Sherbourne Park* and *Peskin*, the significance of which had been dismissed in *Gao*. In particular, he noted that:

1. In *Gao*, Mr Justice Kawaley considered the key question to be whether minority shareholders have direct claims against the *directors*, and applied the (correct) principle that, absent special circumstances, directors owe their duties to the company,

not to individual shareholders. However, the real question in that case and again here, was not whether and when directors owe duties directly to shareholders, but whether the Petitioner could bring a claim against the Company itself (as distinct from its directors) arising from breach of the statutory contract between the Company and the shareholder.

2. It is well understood that improper conduct of directors of a company is only voidable where it is not *ultra vires* (in which case it would be void). As such, the directors’ conduct constitutes an act of the company itself unless and until the act is set aside. Accordingly, once the power has been improperly exercised, the company is in breach of the articles (and its statutory contract with its shareholders). On this basis, the Company’s decision to issue shares gave rise to a personal right to bring a claim against the Company for its conduct.
3. This position was *a fortiori* where the shareholders who have suffered from the improper allotment have control rights, including negative control rights (such as the Petitioner’s ability to block special resolutions), which would be affected by the allotment.
4. On the question of ratification of the decision to issue the convertible bonds, Justice Segal held that it follows from the characterisation of the claim as being based on a personal right of the shareholder that, as a matter of principle, ratification by the majority of shareholders was not available. This was on the basis that ratification only relates to causes of action brought by the company. Even if ratification were available on principle, his Lordship held that it was strongly arguable that it would not apply in cases of a fraud on the minority coming within the exception to the rule in *Foss v Harbottle*, as this case was (as the Petitioner’s claim is that the share allotment was part of a conspiracy involving both the company’s directors and its majority shareholders).

Relevance of decision

This decision protects the position of minority shareholders who may be disadvantaged by an improper share allotment by making clear that they have standing to sue the company in their personal capacity and are not limited to bringing a derivative claim on behalf of a company against its directors in search of relief.

CASE REVIEW SECTION

Re Akkurate Ltd (in Liquidation) [2020] EWHC 1433 (Ch)

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Synopsis

The High Court decision in *Re Akkurate Ltd (In Liquidation)*¹ (*Re Akkurate*) provides clarity on recent conflicting authorities of the High Court as to whether an order for the production of documents under s.236(3) of the Insolvency Act 1986 (the 'Act') has extraterritorial effect solely on the basis of domestic insolvency law.

In *Re Akkurate*, Sir Geoffrey Vos C (the 'Chancellor') granted an application made by liquidators requiring the respondent companies to produce certain documents in their possession relating to the company in liquidation in circumstances where the companies were incorporated and operated from Italy. In doing so, while the Court found that the power to require the production of documents under s.236(3) did not have extraterritorial effect in its own right, it held that European Council Regulation 1346/2000, where it applies, can and does extend the territoriality of purely domestic insolvency provisions. This, in turn, permitted the Court to make orders under s.236(3) against EU resident parties.

The law

Section 236 of the Act is a key investigatory tool available to insolvency office-holders to apply to Court to obtain information in respect of the company to which they have been appointed. In broad terms, s.236 is intended to assist office-holders in carrying out their functions and provides relevantly as follows:

- 2) The court may, on the application of the office-holder, summon to appear before it –
 - a) any officer of the company;
 - b) any person known or suspected to have in his possession any property of the company or supposed to be indebted to the company; or
 - c) any person whom the court thinks capable of giving information concerning the promotion, formation, business, dealings, affairs or property of the company.

- 3) The court may require any such person as is mentioned in sub-section 2(a) to (c) to submit to the court an account of his dealings with the company or to produce any books, papers or other records in his possession or under his control relating to the company or the matters mentioned in paragraph (c) of the sub-section.

Section 237 of the Act sets out the Court's enforcement powers under s.236. The terms of s.237(3) (and its similarity to s.25(6) of the Bankruptcy Act 1914 (the 'Bankruptcy Act')) were key to the Court's determination in *Re Akkurate* and stipulate as follows:

- 3) The court may, if it thinks fit, order that any person who if within the jurisdiction of the court would be liable to be summoned to appear before it under section 236 or this section shall be examined in any part of the United Kingdom where he may for the time being be, or in a place outside the United Kingdom.

Background

Akkurate Ltd ('Akkurate') had been the subject of a compulsory liquidation order on 18 May 2015. Having settled misfeasance proceedings against one of Akkurate's directors regarding pre-liquidation matters, the joint liquidators applied under s.236(3) for sight of documents in the possession of two companies based in Italy (together, the 'Companies'). The liquidators did so to enable them to decide whether to bring further proceedings in Italy in relation to post-winding up events, namely, the potential unlawful use of Akkurate's trademarks between 1 April 2015 and 31 December 2016 without payment.

The issues which the Court was required to decide were:

- i. Does s.236(3) and/or the EU Insolvency Proceedings Regulation 1346/2000² (the 'EUIR') give the Court jurisdiction to make the orders sought?
- ii. If so, how should the Court exercise its discretion?

Notes

¹ [2020] EWHC 1433 (Ch).

² Council Regulation (EC) 1346/2000 of 29 May 2000 on Insolvency Proceedings. The Original EU Regulation applied because the company's compulsory liquidation had begun on 18 May 2015.

Decision

The Court acknowledged that much confusion had been caused by the ‘trilogy of inconsistent cases’ concerning s.236(3), all of which had considered the previous decision of the Court of Appeal in *Re Tucker (a bankrupt)*³ (*‘Re Tucker’*). Prior to engaging on a careful and detailed examination of the authorities, the Court clarified that the current legal position had to be determined by a strict application of the doctrine of precedent. A thorough examination of the authorities led the Chancellor to conclude that *Re Tucker* was binding authority on the Court for the proposition that s.236(3) does not have extraterritorial effect. However, the Chancellor went on to hold that the jurisprudence of the European Court of Justice has made clear that the EUIR can and does extend the territoriality of purely domestic insolvency provisions and so conferred extraterritorial jurisdiction on the Court to make an order under s.236 in this case.

Consideration of Re Tucker and the ‘trilogy of inconsistent cases’

Re Tucker concerned an application by the trustee in bankruptcy under s.25 of the Bankruptcy Act requiring the bankrupt’s brother who was resident in Belgium to attend Court and produce documents. The importance of the decision in *Re Tucker* is that the legislative powers granted under s.25 are similar to those granted to an office-holder under s.236(3) in that they both allow the Court to summon specified persons and require those persons to produce documents. In particular, s.25(6) is in materially the same terms as s.237(3).

In *Re Tucker*, the Court of Appeal held that on its true construction, s.25 did not have extraterritorial effect to permit it to summon the bankrupt’s brother before it. Central to the conclusion reached by Dillon LJ on behalf of the Court was the Court’s interpretation of s.25(6), which Dillon LJ described in his judgment as inevitably carrying ‘... the connotation that if the person is not in England he is not liable to be brought before the English court under the section’.

In *Re MF Global UK Limited (in special administration) (No. 7) (‘MF Global’)*,⁴ David Richards J held that s.237(3) was a re-enactment of s.25(6) and where this occurred, it is a principle of construction that the re-enactment is intended to carry the same meaning as its predecessor. The principle is particularly in point if the earlier decision had been the subject of authoritative decision (as has been the case in *Re Tucker*). David Richards J continued that in those circumstances, it

is presumed that, if substantially the same words are used in the new provision, Parliament did not intend to change the meaning as held by the Court. David Richards J therefore decided that he was bound by the decision in *Re Tucker* to hold that s.236 did not have extraterritorial effect (which resulted in his declining to order a French company to produce documents in relation to an administration in England). In *Re Omni Trustees (No 2)*⁵ (*‘Re Omni’*), the Court made an order for a Hong Kong resident to produce documents in relation to a liquidation in England. In making that order, HHJ Hodge QC found that there was a material difference in the structure between s.25 and s.236. The Court found that the power to order the production of documents under s.25 was ancillary to, and dependent on, the principal power to summon a respondent to appear before the Court, whereas this was not the way s.236 was structured. In contrast, HHJ Hodge QC found that the structure of s.236 conferred a freestanding power, independent of the power to summon a person to appear before the Court for examination, to submit to the Court an account of dealings and to produce books, papers and records. HHJ Hodge QC further distinguished *Re Tucker* on the basis that it had been concerned with the question of whether someone can be compelled to come to the jurisdiction to be examined on oath and to produce documents, whereas, the case before him had only concerned the production of documents.

In *Wallace (as liquidator of Carna Meats (UK) Ltd) v Wallace*⁶ (*‘Wallace’*), the Court disagreed with MF Global and instead adopted the analysis of HHJ Hodge QC in *Re Omni* to find that the power to require the production of documents under s.236(3) is: (i) a standalone power, independent of the power to summon a person to appear before the Court under s.236(2) and (ii) different to the power to require attendance before the Court in that it is less invasive and does not involve the exercise of anything akin to the Court’s subpoena power. The Court therefore made an order requiring the former bookkeeper of the company to produce documents, books and records in his possession relating to the company, even though he was resident in the Republic of Ireland.

Conclusion on the authorities

Having considered the authorities, the Chancellor concluded that it was not open to the Court to decline to follow *Re Tucker*. This was because the Court of Appeal’s interpretation of s.25 was binding and applied equally to successor sections of the Act, unless the context of

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³ [1990] Ch. 148.

⁴ [2015] EWHC 2319 (Ch).

⁵ [2015] EWHC 2697 (Ch).

⁶ [2019] EWHC 2503 (Ch).

the new legislation clearly showed otherwise. In this regard, the Chancellor noted the material similarity between both the terms and the powers contained in the two legislative provisions and concluded that:

‘It would, in the absence of compellingly different context, be surprising if almost the same wordings were to be construed as having different meanings in different statutes covering the same subject matter, namely private insolvency examinations’.

The Chancellor also placed weight on the fact that *Re Tucker* had been considered in both the Court of Appeal and the House of Lords without disapproval. With respect to the decisions in *Re Omni* and *Wallace*, the Chancellor respectfully disagreed with the reasoning of the Court in those cases and concluded that *MF Global* was to be preferred. In particular, the Chancellor did not agree that the different statutory structure of s.236 as opposed to s.25 could provide a basis upon which *Re Tucker* could be distinguished, noting that ‘the modernisation of the language and the division between sub-sections cannot be seen as a substantive change’.

Can the EUIR otherwise give extra-territorial effect?

The answer to this question was clear. The Chancellor held that the jurisprudence of the European Court of Justice made clear that the EUIR can and does extend the territorial scope of purely domestic insolvency provisions. In this regard, the Chancellor noted Lord Sumption’s judgment in *Bilta (UK) Ltd v. Nazir (No 2)*⁷ that ‘[t]he English court, when winding up an English company, claims worldwide jurisdiction over its assets and their proper distribution’,⁸ and that jurisdiction is recognised within the European Union by articles 3 and 16 of the EUIR. The Chancellor further noted that in *Seagon v Deko Marty Belgium NV*,⁹ the European Court of Justice held that article 3(1) of the EUIR conferred ‘international jurisdiction on the member state within the territory of which insolvency proceedings were opened in order to hear and determine actions which derive directly from those proceedings and which are closely connected to them’.¹⁰

The Court held that the inevitable consequence of these cases was that proceedings under s.236(3) constituted proceedings which derive directly from the insolvency proceedings and which are closely connected to them. It was therefore clear that the EUIR confers extra-territorial jurisdiction on the English court to make orders against EU resident parties under s.236.

How should the Court exercise its discretion under s.236?

With regard to the question of how the Court should exercise its discretion to make such an order, a careful balancing of factors was required – on the one hand, the reasonable requirements for the liquidators to see the documents in order to be able to carry out their functions, on the other, the need to avoid making an order which is wholly unreasonable, unnecessary or oppressive to the person concerned. Applying this to the present case, the Chancellor held that the liquidators were entitled to certain documents, but redrafted the order sought by narrowing the categories of documents requested, specifically taking into account that the Companies were based in Italy and were not company insiders.

Comment

While this decision is to be welcomed as clarifying the position in respect of conflicting judgments relating to the jurisdictional ambit of s.236, it may pose a concern for office-holders who had been bolstered by the decision in *Wallace* and who may currently be faced with the task of seeking information from non-EU residents. In particular, the Chancellor’s disagreement that the contemporary commercial environment should provide a basis upon which the reasoning in *Re Tucker* could be distinguished may discourage proposed applicants from seeking relief.

Further, despite the Chancellor’s comments that he formed his judgment ‘irrespective of [his] views as to whether [*Re Tucker*] was correctly decided’,¹¹ his thorough examination of the authorities and reinforcement of the strict application of the doctrine of precedent mean that it will be very difficult for any High Court Judge to be persuaded by arguments that the decision should be distinguished. Indeed, the Chancellor indicated that even the Court of Appeal should be bound by *Re Tucker* meaning that a decision of the Supreme Court would be required in order to say that it was not applicable to the construction of s.236.

One can see why there may be a tendency to argue that it is logical for s.236 to have extraterritorial effect, particularly in circumstances where the jurisdictional reach of other provisions of the Act such as s.213 and s.238 have been so extended and where an order under s.236 arguably might assist office-holders in deciding whether to bring an application under either of those

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7 [2016] AC 1 (Supreme Court).

8 *Ibid.* at [109].

9 Case C-339/07 [2009] 1 WLR 2168.

10 *Ibid.* at [21].

11 *Re Akkurate Ltd (In Liquidation)* [2020] EWHC 1433 (Ch) at [47].

sections. In that scenario, the jurisdictional question could be addressed in determining whether a respondent is sufficiently connected with the jurisdiction for it to be just and proper to make an order despite the foreign element.

For now, however, it seems that we will have to wait for the next instalment – whether that be an appeal in *Re Akkurate*, or separate proceedings in which the jurisdictional ambit of s.236 is once again revisited.

Sevilleja v Marex Financial Ltd [2020] UKSC 31

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Synopsis

The Supreme Court has recently considered the so-called 'reflective loss' principle, which in certain circumstances prevents shareholders from bringing claims against third parties, and has narrowed the scope of that principle considerably. Following this decision, the principle will apply in only very limited instances, namely to bar actions that are: (i) brought by a shareholder against a third party, (ii) in respect of loss which the shareholder has suffered in that capacity in the form of a diminution in share value or distributions, (iii) where that loss is the consequence of loss sustained by the company, and (iv) in respect of which the company has a cause of action against the wrongdoer.

Facts

Mr Sevilleja was the owner and controller of two companies incorporated in the British Virgin Islands. Marex brought proceedings against those companies in the Commercial Court of England and Wales for amounts it alleged were owed to it under contracts it had entered into with the companies. At first instance, Marex obtained judgment against the companies for more than USD 5.5 million, and was also later awarded costs.

Shortly after the parties received a confidential draft of the first instance judgment but before the judgment was formally handed down and the orders for payment were made, Mr Sevilleja procured the transfer of more than USD 9.5 million from accounts held in the companies' names. Marex argued that the object of the transfers was to ensure that Marex did not receive payment of the judgment debt.

The two companies were subsequently placed into insolvent voluntary liquidation with alleged debts exceeding USD 30 million owed to Mr Sevilleja and entities associated with him. Marex was the only non-insider creditor. Marex alleged that the liquidator effectively acted under Mr Sevilleja's control and thus had taken no steps to investigate Marex's claims or the companies' missing funds.

As a result, Marex sued Mr Sevilleja in the English courts for damages in tort for (i) inducing or procuring the violation of Marex's rights under the first instance judgment and orders, and (ii) intentionally causing

Marex to suffer loss by unlawful means. Marex sought damages corresponding to (i) the amount of the judgment debt plus interest and costs (less amounts recovered in related US proceedings), and (ii) costs incurred by Marex in its attempts to obtain payment. Marex was given permission to serve the proceedings on Mr Sevilleja out of the jurisdiction.

The High Court

Mr Sevilleja applied to the High Court (Knowles J) to set aside the order granting Marex permission to serve proceedings outside the jurisdiction, on the basis that Marex did not have a good arguable case against him because the losses which Marex sought to recover were reflective of loss suffered by the companies, which had concurrent claims against Mr Sevilleja, and so could not be claimed by Marex (the so-called 'reflective loss' principle). Knowles J rejected that argument, holding that Marex had a good arguable case that its claim was *not* precluded by the reflective loss principle: [2017] EWHC 918 (Comm).

The Court of Appeal

Mr Sevilleja subsequently appealed to the Court of Appeal (Lewison, Lindblom and Flaux LJ): [2018] EWCA Civ 1468. It fell to the Court of Appeal to determine the proper ambit of the rule against reflective loss and whether that rule applied to claims by unsecured creditors such as Marex.

Flaux LJ, giving the main judgment, allowed Mr Sevilleja's appeal in part, on the basis that the reflective loss principle was not restricted solely to claims made by a party as shareholder but also precluded claims by creditors for loss caused by the abstraction of money from the company. In other words, the Court of Appeal held that the distinction between shareholders and non-shareholder creditors was artificial when considering the reflective loss principle, and the same principle should apply to all creditors of the company. As such, the reflective loss principle applied to Marex's claims (save its claim to recover the costs of enforcement of its judgment), with the consequence that Marex was unable to pursue the majority of its claims.

According to the Court of Appeal, one possible exception to the reflective principle was the exception established in the case of *Giles v Rhind* [2002] EWCA Civ 1428, which applied where the alleged wrongdoing had caused the company to be unable to pursue the wrongdoer. The Court of Appeal found that this exception did not apply in Marex's case.

The Supreme Court

Marex sought and obtained permission to appeal to the Supreme Court.

The Supreme Court unanimously allowed Marex's appeal, and took the opportunity to restate the law on the reflective loss principle. However, while all seven Justices reached the same overall conclusion, the reasoning of the four Justices in the majority (Lord Reed, with whom Lady Black and Lord Lloyd Jones agreed, and Lord Hodge, who delivered a concurring judgment) was markedly different to that of the minority (Lord Sales, with whom Lady Hale and Lord Kitchin agreed).

The decision in *Prudential*

Lord Reed considered the decision of the Court of Appeal in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, which had established the reflective loss principle (that a shareholder could not claim for a diminution in the value of its shareholding). Lord Reed explained that decision as follows:

'where a company suffers actionable loss, and that loss results in a fall in the value of its shares (or in its distributions), the fall in share value (or in distributions) is not a loss which the law recognises as being separate and distinct from the loss sustained by the company. It is for that reason that it does not give rise to an independent claim to damages on the part of the shareholders' (at [28]).

He explained that that case had been concerned only with a diminution in the value of the shares or in distributions, suffered by a shareholder merely because the company had itself suffered actionable damage (at [26]).

Lord Reed set out the rationale for the decision in *Prudential* and the reflective loss principle (see [31]-[36]; see also the concurring judgment of Lord Hodge, in particular at [96]-[108]). He explained that a share was not a proportionate part of a company's assets, and did not confer any legal or equitable interest in the company's assets. Rather, it was simply a right of participation in the company on the terms of, and with the rights set out in, the articles of association. A fall in the value of its shares was not an inevitable consequence of loss suffered by a company, and the size of that fall would not necessarily be equivalent or even

correlated to the company's loss. Where a company suffered loss and as a result acquired a right of action, the company's right to damages would restore it to the position that would have obtained but for the wrongdoing. If doing so also restored the value of the shares, then permitting shareholders to vindicate a personal right to claim in these circumstances would give rise to double recovery. Further, if the company chose not to claim for that loss, then the shareholder (even if in a minority) could exercise such rights of control over the company's decision-making, or pursue such other remedies, as have been accorded to it under the articles of association or the general law.

According to Lord Reed, the decision in *Prudential* therefore respected the 'proper plaintiff' rule derived from *Foss v Harbottle* (1843) 2 Hare 461 and the various principled and policy-driven underpinnings of that rule. Establishing a clear rule that only the company may pursue a right of action in circumstances falling within the ambit of *Prudential* also had 'pragmatic advantages' (at [38]), in not leaving the protection of creditors and other shareholders to be determined by a judge in the complexities of a trial. These included issues around the possible proliferation and multiplicity of claims, difficulties with establishing causation in the context of a fall in share value, and double recovery.

The decision in *Johnson v Gore Wood and subsequent cases*

Lord Reed then went on to consider *Johnson v Gore Wood & Co* [2002] 2 AC 1, a House of Lords case which had considered and applied *Prudential* and which was the leading authority on the reflective loss principle.

Lord Reed held that *Johnson* gave authoritative support to the decision in *Prudential* that a shareholder was normally unable to sue for the recovery of a diminution in the value of its shareholding or in the distributions it received as a shareholder which flowed from loss suffered by the company, for the recovery of which the company had a cause of action, even if it declined or failed to make good that loss (at [67]).

However, Lord Reed held that the judgment of Lord Millett and the other judges in the majority in *Johnson* (save Lord Bingham) departed from the reasoning in *Prudential* and should not be followed. In particular, Lord Millett's description of a share as representing a proportionate part of the company's net assets was incorrect, and the rule in *Prudential* was not premised on any necessary relationship between a company's assets and the value of its shares or distributions (at [49]). Further, Lord Millett's approach to the rule in *Prudential* – as being premised on the principle that double recovery should be avoided – was incorrect and did not satisfactorily explain the rule in *Prudential* (at [50]-[60]), including because (a) it assumed unrealistically that there was 'a universal and necessary relationship

between changes in a company's net assets and changes in its share value', (b) it could not explain why a shareholder could not be permitted to pursue a claim where the company had declined to pursue its claim or had settled at an undervalue, and (c) double recovery could arise where there were concurrent claims by companies and persons who had suffered loss in capacities other than as shareholders, and such claims were not prohibited by the rule in *Prudential*.

Lord Reed added that, to the extent that Lord Millet intended to extend the reflective loss principle to cover *all* personal claims against a wrongdoer where the company also had a cause of action and in respect of amounts which the company would have paid to the claimant if it had had the necessary funds, that was also mistaken.

Lord Reed pointed out that *Johnson* had been followed by many cases in which litigants had sought to establish exceptions to the general reflective loss principle, or to establish that the rule against recovery of reflective loss extended more widely than had been determined in *Johnson*.

For example, in *Giles v Rhind*, the Court of Appeal held that a shareholder could recover for loss flowing from the company's loss where the company had a cause of action but failed to pursue it, in circumstances where the wrongdoer's own conduct had prevented the company from pursuing that cause of action. Lord Reed held that this decision, and *Perry v Day* [2004] EWHC 3372 (Ch) which followed it, were inconsistent with the bright-line rule in *Prudential* (at [68]-[71]), given that the rule did not take into account whether or not the company was financially able to bring proceedings to recover its loss. In addition, in *Gardner v Parker* [2004] EWCA Civ 781 and subsequent cases, the scope of the reflective loss principle had been expanded so that it had come to be treated as if it was applicable 'in all situations where there are concurrent claims and one of the claimants is a company' (at [77]), for example where the claimant is not a shareholder but a third party creditor. Lord Reed argued that '[t]he extension of the principle to such cases has the potential to have a significant impact on the law and on commercial life', and warned of the resulting increase in the 'volume of litigation and the level of uncertainty' (at [77]).

Conclusions

Having reviewed the reflective loss principle in detail, Lord Reed held that it was necessary to distinguish between two cases: (a) where claims were brought by a shareholder in respect of loss which it had suffered in that capacity in the form of a diminution in share value or distributions, where that loss was the consequence of loss sustained by the company and in respect of which the company had a cause of action against the wrongdoer, and (b) where claims were brought,

whether by a shareholder or anyone else, in respect of loss not falling within that description, but where the company had a right of action in respect of substantially the same loss.

In the first category of cases, as a bright line rule, only the company has an actionable claim against the wrongdoer. That is because the shareholder has not suffered a loss which is regarded by the law as being separate and distinct from the company's loss. If the company chooses not to pursue the claim, then the shareholder may seek another available remedy (e.g. a derivative action, or equitable relief from unfairly prejudicial conduct).

However, the second category of claims are not caught by the reflective loss principle, and are therefore available to the shareholder or creditor (subject to the need to avoid double recovery).

Accordingly, the majority found that the rule in *Prudential* had no application to the present case, since the claim had not been brought by a shareholder but rather a creditor of the company. Accordingly, the court held that *Marex* should be permitted to pursue the entirety of its claim.

The minority judgment

Although Lord Sales (giving the judgment of the minority) reached the same conclusion as Lord Reed and the majority (i.e. that *Marex's* appeal should be allowed), his reasoning differed significantly in a number of respects.

In Lord Sales' view, the Court of Appeal in *Prudential* had not laid down (and did not purport to have laid down) a strict rule of law, as Lord Reed considered it had. Instead, the Court of Appeal had sought to explain why the shareholder in such a case had not *as a matter of fact* suffered any loss. Lord Sales considered that the reasoning in *Prudential* could not be supported and that there were 'clearly ... some cases where the shareholder does suffer a loss which is different from the loss suffered by the company' (at [118]). He argued in common with Lord Reed and the majority that 'the loss suffered by the shareholder is not the same as the loss suffered by the company', and that there 'is no necessary, direct correlation between the two' (at [132]).

Accordingly, Lord Sales opined that, in light of the deficiencies in the Court of Appeal's reasoning in *Prudential*, the Supreme Court could not now re-characterise that decision in the way in which the majority had sought to do. Indeed, Lord Sales believed that the majority, in deriving from the decision in *Prudential* a clear rule of law, had adopted a 'crude bright line rule which will inevitably produce injustice' (at [167]). Instead, he considered that the question as to whether a shareholder had suffered an actionable loss was one that ought to be considered on the facts of each individual case, rather than by reference to the majority's

bright-line rule, and that other means such as sensible case management and subrogation were available to the court to address issues such as double recovery.

In essence, therefore, the minority went even further than the majority in limiting the scope of the reflective loss principle. Indeed, in holding that it did not apply in this case, Lord Sales went so far as to doubt whether the reflective loss principle existed at all (at [211]).

Comment

As will be evident from the fact that a panel of seven Justices was convened to hear it, this case is likely to be of major significance for various stakeholders, including companies, shareholders, creditors and insolvency practitioners. More than simply *what* was decided, the particular significance of the decision lies in *how* it was decided – in particular, in the decision of the majority to overturn two decades of established case law and establish a bright-line rule which (according to the majority) reflects the proper (narrow) basis of the decision in *Prudential*, namely that the reflective loss principle captures only claims by shareholders for loss in the form of a diminution in share value or distributions,

where that loss is the consequence of loss sustained by the company and in respect of which the company has a cause of action against the wrongdoer.

The majority's approach, in its adoption of that bright-line rule, will bring helpful clarity to an area of law that has vexed litigants and the courts for years, as third party wrongdoers sought to cast the net of the reflective loss principle ever wider. In particular, the decision restores some doctrinal consistency to this area of law and limits the ability of those wrongdoers to rely on the reflective loss principle to stifle otherwise legitimate claims by shareholders and creditors. It appears likely that the majority's approach will result in a marked increase in the volume of claims brought by creditors (including shareholders) who will no longer be locked out by reason of a widely interpreted reflective loss principle.

However, a note of caution: in having decided the case by a bare majority of four to three, the Supreme Court may have left room for argument in future cases as to which side of the line any given case falls on. This may mean that, for all the helpful clarity resulting from the majority's approach, litigants may well continue to argue about the scope of the reflective loss principle for years to come.

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