Corporate Insolvency and Governance Act 2020

2020 CHAPTER 12

An Act to make provision about companies and other entities in financial difficulty; and to make temporary changes to the law relating to the governance and regulation of companies and other entities.

[25th June 2020]

A series of articles by Members of South Square examining the newly enacted Corporate Insolvency and Governance Act 2020
‘The set is highly regarded internationally, with barristers regularly appearing in courts around the world.’

Chambers UK Bar Awards, winner 2019

Chambers/Insolvency set of the year 2019
The CIGA received Royal Assent on 25 June 2020. It contains the most significant changes to UK domestic insolvency law since 1986. It has been enacted in a time of unprecedented global and domestic turmoil arising out of the COVID-19 pandemic and against a backdrop of a recession that many predict will be the worst in living memory. Its focus is on the ‘rescue culture’ first advocated by the Cork Report, at a time when more businesses require rescuing in the UK than ever before.

The new legislation passed through Parliament at a blistering pace. The Corporate Insolvency and Governance Bill (the “Bill”) was presented on an urgent basis on 20 May 2020, a little over six weeks after proposed legislation was first announced by the Government. It passed through the House of Commons in one day on 3 June 2020: somewhat ominously the Secretary of State, Alok Sharma MP, was taken ill whilst introducing it (but later tested negative for COVID-19). The Bill was considered for longer in the House of Lords (including the Committee and Report stages) between 9 and 23 June 2020. Lord Stevenson summarised the mood of the Lords in the last speech before the Bill’s return to the Commons: “All Bills are a trial of stamina, this one probably more than most. I think we all share a sense of exhaustion, having reached its final moments.” Finally, it returned to the Commons for just one day on 25 June 2020 where several amendments, including an extension of the temporary measures to 30 September 2020, were accepted, before receiving Royal Assent on the same day and coming into force at midnight.

Welcome to this special edition of the South Square Digest, which contains a series of articles which examine, in detail, the newly enacted Corporate Insolvency and Governance Act 2020 (the “CIGA”).
The CIGA contains five important new measures:

1) It introduces a new moratorium designed to give companies a breathing space from their creditors while they explore the possibility of rescuing and restructuring the company’s business.

2) It introduces a new restructuring plan for companies in financial distress which includes new cross class cram down procedures that allow a class of creditors to be bound by the restructuring plan even if they do not agree to the plan.

3) It prohibits termination clauses (so called ipso facto clauses) that would otherwise be engaged on entering relevant insolvency procedures.

4) It temporarily prohibits creditors from filing statutory demands and winding-up petitions except in certain limited circumstances where COVID-19 has not had a financial effect on the company.

5) It temporarily “suspending” the wrongful trading provisions.

Given the importance of the legislation and the speed with which it was enacted, the CIGA will, no doubt, give rise to many novel and complex points which the courts will need to resolve, in some cases in short order, over the coming months and years. Indeed, in anticipation of its enactment (and in the light of those parts of the CIGA which have retrospective effect) there have already been several important cases which have considered the draft Bill before it even passed into law, and in which members of Chambers appeared.

With this in mind, in this special edition of the Digest we have six articles which consider, in depth, the main changes made by the CIGA.

First, in an article originally published in the last edition of the Digest but updated to take into account of the changes made to the Act during its passage through Parliament, Mark Phillips QC, William Willson and Clara Johnson provide an overview of the CIGA.

Glen Davis QC provides a detailed review of the role of the Monitor in the new rescue moratorium. Given the novelty of this role in the UK, this is will undoubtedly be an area that will be the subject of important new case law.

Robin Dicker QC and Adam Al-Attar consider the potential implications arising out of the new restructuring plan for companies in financial distress arising out of the new Part 26A of the Companies Act 2006 introduced by Schedule 9 of the CIGA. The new Part 26A has potentially far reaching implications. The ability to impose a cross-class cram down may require a fundamental rethink to the approach to the constitution of classes and the assessment of fairness. It will likely provide an opportunity for the English courts and the UK restructuring profession to develop restructuring proposals hitherto unseen.

Felicity Toube QC and Georgina Peters consider the ipso facto reforms which mark a somewhat dramatic departure from long-held principles of contractual freedom and ask: “Why now, and does it go too far (or not far enough)?”

Hilary Stonefrost and Daniel Judd review the temporary measures introduced by the CIGA relating to statutory demands, winding-up petitions and winding up orders and reflect on the extent to which, for the time being, the winding-up process provides any effective remedy for the non-payment of debts.

And last but by no means least, Richard Fisher QC and Roseanna Darcy consider the temporary “suspension” of the wrongful trading provisions introduced by the CIGA. It is not an easy time to be the director of a limited liability company. But how far will the “suspension” of the wrongful trading provisions really assist? As the title to their article suggests: “Sometimes knowing what to do is knowing when to stop”.

Many thanks to all for their contributions. As always, views expressed by individual authors and contributors are theirs alone.

We hope you enjoy this special edition of the Digest. And if you find yourself reading someone else’s copy and wish to be added to the circulation list, please send an email to kirstendent@southsquare.com and we will do our best to make sure that you will get the next edition and all future editions.

It goes without saying that if you have any feedback to give us in relation to the Digest – positive or negative – we would be delighted to hear from you.

Marcus Haywood and William Willson
Corporate Insolvency and Governance Act 2020
A breath of fresh air
The Government has previously consulted on three of the five insolvency reforms: (1) the moratorium (2) the new arrangement and reconstruction plan and (3) the restriction on enforcement of ipso facto clauses. This consultation culminated in the publication by the Department for Business, Energy and Industrial Strategy in August 2018 of its response entitled “Response to the Insolvency and Corporate Governance Consultation” (“the BEIS Response”).

These three reforms are permanent. They are intended to introduce “greater flexibility into the insolvency regime”5, and to allow companies breathing space to explore options for rescue whilst supplies are protected, so that they can have “the maximum chance of survival”. This puts the rescue culture established in IA86 (itself drawing on the recommendations from the Cork Report) at the front and centre of our insolvency legislation.

The other two central reforms are temporary emergency measures introduced specifically to assist businesses during the current crisis: (1) the suspension of liability for wrongful trading and (2) the restrictions on statutory demands and winding up petitions. These have been introduced to support directors to continue trading through the emergency without the threat of personal liability and to protect companies from aggressive creditor action.

Each of these five central reforms is considered by way of overview below.

The Moratorium

The centrepiece of the CIGA is the free-standing statutory moratorium (“the Moratorium”).

The policy behind the Moratorium is to allow a company in financial distress a breathing space in which to explore its rescue and restructuring options free from creditor action. The provisions in relation to the Moratorium are set out in a new “Part A1”, which will be inserted before Part 1 (but within the First Group of Parts) of IA86.

The aim of the Moratorium is to facilitate a rescue of the company, which could be via a CVA, a new arrangement and reconstruction plan (as introduced by the CIGA, see below) or simply an injection of new funds. Consistent with the ‘rescue purpose’ of the reforms, the intention is that the Moratorium will result in a better, more efficient rescue plan that benefits all of the company’s stakeholders.

Obtaining a Moratorium

The eligibility for and the process of obtaining the Moratorium are addressed in Chapter 2 of the new Part A1.

There are two routes to obtaining the Moratorium.
First, if the company is an English (as opposed to an “overseas”) company, and it is not subject to an outstanding winding-up petition, the directors can obtain a Moratorium by filing the “relevant documents” with the court. These relevant documents are (1) a notice that the directors wish to obtain a Moratorium, (2) a statement from a qualified person (“the proposed monitor”) that they are (i) a qualified person who (ii) consents to act, (3) a statement that the company is an “eligible company” and, crucially, a statement (4) that the company is, or is likely to become, unable to pay its debts and (5) that, in the proposed monitor’s view, it is likely that the Moratorium for the company would result in the rescue of the company as a going concern. The House of Lords introduced an amendment to the CIGA which prevents the Secretary of State from making regulations to change the definition of the “relevant documents”, and only permits documents to be added to the definition.

Second, if the company is an English company that is subject to a winding up petition, or is an overseas company, the directors may apply to court for a Moratorium. On the application of the directors, the Court may only make an order that the company should be subject to the Moratorium where it is satisfied that the Moratorium would achieve a better result for the company’s creditors as a whole than would be likely if the company were wound up (without first being in subject to a moratorium). This test bears an obvious resemblance to the second statutory purpose of administration in paragraph 3(1)(b), Schedule Bt of IA86.

The Moratorium is available to all “eligible companies”. These are defined in Schedule ZA1. A company is “eligible” unless it is an “excluded” company. The list of “excluded” companies is wide. It includes companies which already have their own bespoke insolvency regime: for example, insurance companies, banks, investment exchanges and securitisation companies. However, it also includes companies that have participated in capital market arrangements incurring debt of at least £10 million involving the grant of security to a trustee, a guarantee or security by one party for performance by another. These will rule out many SME and larger companies, and was the subject of a suggested amendment which was not ultimately adopted during the passage through Parliament. Public private partnerships are also excluded.

The Moratorium is not available to companies that either are subject or have recently been subject to a moratorium or other form of insolvency procedure. Again, this is provided for in Schedule ZA1, which provides that a company is excluded if, on the filing date, there is either a moratorium in force and/or it is subject to an insolvency procedure, alternatively, it is excluded where that has been the case at any point in the 12 months leading up to the filing date. For these purposes, an insolvency proceeding includes an interim moratorium under paragraph 44, Schedule Bt, thereby protecting a creditor who has made an administration application or a qualifying floating charge holder who has filed a notice of intention to appoint an administrator.

Finally, an overseas company will only be eligible for a Moratorium if it is one which could be wound up under Part 5 of IA86, and in this regard the courts will apply similar principles when considering such an application as they would when considering the winding up of an overseas company.

Effect of the Moratorium

This is addressed in Chapter 4 of A1.

The effect of the Moratorium is to provide the company with a “payment holiday” in respect of most of its “pre-moratorium debts” and with protection against legal and enforcement action (unless the Court has granted permission).

The new, core concept is the “pre-moratorium debt”. This is any debt or other liability that has fallen due prior to the commencement of the Moratorium or which becomes due during the Moratorium but under an obligation incurred by the company prior to the commencement of the Moratorium.

However, there are some wide-ranging and notable exceptions to what constitutes a “pre-moratorium debt” which qualifies for a “payment holiday”: these include amounts payable in respect of (i) the monitor’s remuneration and expenses, (2) goods or services supplied during the Moratorium (and which would otherwise be pre-moratorium debts because the relevant contract pre-dated the Moratorium); (3) rent in respect of a period during the Moratorium (where the lease pre-dated the Moratorium); (4) wages or salary arising under contracts of employment; (5) redundancy payments; and (significantly, see below) (6) debts or the liabilities arising under a contract or other instrument involving financial services.

This “pre-moratorium debt” is to be contrasted with a “moratorium debt”, which is any debt or other liability to which the company becomes subject during the Moratorium (other than by reason of an obligation entered into prior to the Moratorium) (e.g. a new debt arising under a new contract entered during the Moratorium) or to which the company may become subject after the end of the Moratorium because of an obligation incurred during the Moratorium.

Significantly, the original draft Bill provided that where a company commences administration or liquidation within 12 weeks of the end of the Moratorium, “moratorium debts” and “pre-moratorium debts” that do not qualify for a

1. Paragraph 3(1)(b), Schedule Bt of IA86.
2. A proposed amendment, which would have deleted this provision, was debated in the House of Lords, but not passed.
3. Schedule 1, ZA1, paragraph 14. This is one of the provisions that can be amended by the Secretary of State. A proposed amendment, which would have made changes to the list of exceptions, was debated in the House of Lords, but not passed.
4. See A6. However, A16(5) specifically provides that the Secretary of the State may by regulations amend the section to make changes to the list of exceptions.
5. This is defined in Schedule ZA2. Such contracts include “financial contracts”, meaning a contract for the provision of financial services consisting of (i) lending (including the factoring and discounting of commercial transactions); (ii) financial leasing; or (iii) provisions in respect of guarantees or commitments.
payment holiday are given super-priority, ranking behind fixed charge creditors but ahead of expenses, floating charge security and preferential creditors. As this represents a major shift away from well-established insolvency priorities, it was anticipated that it would attract attention in the House of Lords. And so it did. There was concern that the imposition of a Moratorium could trigger accelerated debt repayments to financial creditors, which have to be paid during the Moratorium, and which would then have super-priority in any insolvency process occurring within 12 weeks of the end of the Moratorium. As such, the amendments passed in the House of Lords removed from the new section 174A of IA86 reference to “pre-moratorium debts” that do not qualify for a payment holiday from this provision and replaces it with the simpler “priority pre-moratorium debt”. This includes, amongst other things, “any pre-moratorium debt that (i) arises under a contract or other instrument involving financial services, that (ii) fell due before or during the moratorium, and (iii) is not a relevant accelerated debt”.

The Monitor

The new role of the “monitor” is addressed in Chapter 5 of A1. Glen Davies QC considers the Guidance for Monitors in his article “The Role of the Monitor in a Rescue Moratorium” also published in this CIGA Special of the South Square Digest. A striking characteristic of the Moratorium is that the directors will remain in control of the company during the Moratorium, making it a Chapter 11-style debtor—insolvency practitioners are entitled to act as monitors. This might give rise to debate about solicitors or accountants who are not licensed insolvency practitioners being entitled to take an appointment as monitor, this was not passed.
act and confirmation that the relevant eligibility tests have been met ("the Monitor"). The Monitor will supervise the Moratorium and his or her consent will be required for, amongst other things, the payment of “pre-moratorium debts”, the disposal of assets and the granting of security.

The key obligation of the Monitor is to “monitor the company’s affairs for the purpose of forming the view as to whether it remains likely that the moratorium will result in the rescue of the company as a going concern”[20]. The provision of information to the Monitor by the directors is central to the operation of the process. The Monitor is entitled to rely on information provided by the company, unless they have reason to doubt its accuracy. The directors are required to provide to the Monitor the information the Monitor requires as soon as practicable[21]. If the Monitor thinks that, by reason of failure by the directors to comply with a requirement to provide information, they are unable to carry out their functions, the Monitor must bring the moratorium to an end[21]. The Monitor is an officer of the Court, and may apply to the Court for directions about the carrying out of their functions[21].

The likelihood of the rescue of the company as a going concern is the condition of not only entry, but also the “Termination of the moratorium by the monitor”[22], see A38.

The Monitor must bring the moratorium to an end[24] by filing a notice with the court if they think that the Moratorium is no longer likely to result in the rescue of the company as a going concern or where they think that the company is unable to pay any of the following that have fallen due (a) moratorium debts and (b) pre-moratorium debts for which the company does not have a payment holiday during the Moratorium.

**Length of Moratorium**

This is addressed in Chapter 3 of A1. The “initial period” of the Moratorium will be 20 days[25]. This will be extendable without creditor consent for a further maximum period of 20 days by the directors filing certain documents with the Court (at any time after the 15th business day of the initial period).

Where the company obtains creditor consent, the Moratorium may be extended for a maximum period of 12 months: see A11 and A12(3). The consent of creditors will be obtained through the qualifying decision procedure.

The Court[26] may also extend the period of the Moratorium on the application of the company[27]. On hearing the application, the Court must take into account and consider the interests of pre-moratorium creditors, and the likelihood that the extension will result in the rescue of the company as a going concern[28].

The Moratorium will also be extended over proposals for a pending CVA[29], or on convening meetings of creditors to consider a scheme of arrangement or an arrangement and reconstruction plan over approval and sanction[30].

In each of these cases, the directors must confirm, when applying for any extension, the payment of all “moratorium debts” and “pre-moratorium debts” for which the company does not have a payment holiday.

**Challenges**

This is addressed in Chapter 6 of A1.

A creditor, director or member of the company or any other person affected by the Moratorium may apply to the Court on the ground that an act, omission or decision of the Monitor during a Moratorium has unfairly harmed the interests of the applicant.
On such an application the Court may confirm, reverse or modify any act or decision of the Monitor, give directions to the Monitor or make such other directions as it thinks fit. Such application may be made during the Moratorium or after it has ended. Any such challenge is necessarily limited by the Monitor’s role. The Monitor is not managing the company but monitoring the directors’ management of the company.

Of more significance is the power to challenge the management of the company by the directors. A creditor or member can apply to court for an order on the ground that during the Moratorium the company’s affairs, business and property are being or have been managed in a manner which has unfairly harmed the interests of the company’s creditors or members. Such an application can be made during or after the Moratorium, which raises the possibility of post moratorium damages. This puts upon the directors managing the company an additional duty not to harm creditors or members unfairly. In administration this duty falls upon the administrators because they are managing the company. In a Moratorium the directors continue to manage the company, but they are subject to this new duty.

**The Pensions Regulator and Board of Pension Protection Fund**

The House of Lords passed a number of amendments relating to the position of the Pensions Regulator and Board of Pension Protection Fund ("PPF"). As explained by Lord Callanan when introducing the amendments, they are aimed at ensuring the Pensions Regulator and Board of the PPF have a “seat at the table” in any restructuring proposal and that its “voice is heard”.

The amendments require the Pensions Regulator (where the company is or has been an employer in respect of an occupational pension scheme that is not a money purchase scheme) and the Board of the PPF (where the company is an employer in respect of such a pension scheme that is an eligible scheme within section 126 of the Pensions Act 2004) to be provided with notice of: (i) the Moratorium; (ii) of the Moratorium coming to an end; and (iii) the appointment of a new or additional Monitor.

The amendments also give the Pensions Regulator and Board of the PPF the right to, amongst other things, challenge the Monitor’s actions (under A42) or the director’s actions (under A44). Finally, the amendments permit the Secretary of State to make regulations granting the Board of the PPF to exercise rights in respect of an extension to the period of the Moratorium under A11 and to participate in the qualifying decision procedure upon an order being made under A44 regulating the conduct of the directors of the company.

**Comment**

The core precepts of the Moratorium – the focus on the rescue of the company as a going concern and the continuing management powers of the directors – mark a return to the original policy goals of the Cork Report, and the assumption of the flexible debtor-in-possession process that characterises Chapter 11.

Thankfully, there is one very key difference between the BEIS Response and the CIGA: the availability of the Moratorium for insolvent, as well as solvent companies. The Government had originally proposed that the Moratorium would only be available to a company that was prospectively insolvent. This raised obvious concerns about the number of companies that would not be eligible for the Moratorium and the fact that this would be counter-productive and would not sufficiently assist the policy of promoting the rescue culture. It also gave rise to difficulties formulating that policy into a coherent and workable test. The countervailing argument was that the Moratorium could be abused by the extension of a payment holiday to ‘zombie’ companies seeking to put off dealing with the company’s financial problems with yet further losses to creditors. It is understood that the shift from an entry test of prospective insolvency to actual insolvency took place relatively late in the drafting process: however, this was a critical intervention.

To protect against abuse by ‘zombie’ companies, the Moratorium imposes a high threshold i.e. that it is likely that a Moratorium would result in the rescue of a company as a going concern (and the termination of the Moratorium in the event that this is no longer possible). The Monitor will be required to state that in their view it is likely that the Moratorium will result in the rescue of the company as a going concern. This formulation is to be compared to, for example, the “reasonable likelihood” test adopted in the “Consent Protocol” for “Rescue Administrations” publicised by the City of London Law Society and Insolvency Lawyers Association, and drafted by Mark Phillips QC, William Willson and Stephen Robins of South Square. Whether the threshold is, as some fear, too high, and whether insolvency practitioners will be willing to make the relevant declaration, will both be key points of interest once the Moratorium has passed onto the statute book.

Another notable feature of the Moratorium, and one which may be a cause for concern for some creditors, is the relaxation of the conditions for obtaining a Moratorium, and extending it, during the initial period. Thus, the process will still be available to companies which are terminally insolvent such that they are likely to enter administration or liquidation. Whilst the policy intention is to give such companies (of which

31. See A44.
32. A44(2). A44(3) provides that the court may make such order as it thinks fit. A44(4) identifies orders that may “in particular” be made which includes an order regulating the management by the directors of the company’s affairs and the discharge of the Moratorium, but those are not exhaustive. On making an order the Court has to have regard to the interests of those who have dealt with the company in good faith and for value.
33. See Hansard, 23 June 2020 (Vol 804).
34. See A44(2).
35. See A44(3).
36. See A45(2).
37. See A45.
38. See A51.
39. The Explanatory Notes to the Consent Protocol state that “The Joint Administrators have only provided their consent to the exercise of these powers on the basis that they have certified that the administration is reasonably likely to achieve the rescue of the company as a going concern, as is the required under Schedule B1”. This drafting is deliberately based on rule 2.3(5)(c) of the Insolvency (England and Wales) Rules 2016, where a proposed administrator is required to give their opinion that it is reasonably likely that the purpose of administration will be achieved.
there will be many) a chance of being rescued or restructured with the attendant protection of jobs, many will argue that the Moratorium is not the right process for such companies.

A further significant characteristic of the Moratorium is the sheer volume of exceptions to it. For example, the carve-out for any company that is party to a capital market arrangement, which will exclude numerous businesses which have bond financings (see above), and there are numerous exceptions to the definition of what is an “eligible company” (including financial services companies). The exclusion for capital market arrangements in excess of £10 million was the subject of proposed amendments in Parliament on the basis that it was unduly restrictive. These were not, however, adopted. Consequently the Moratorium will not be suitable for all companies in all parts of the market: it is far from being “one size fits all” legislation and appears to be better suited to SMEs. This will no doubt leave certain parts of the market relatively agnostic about the Moratorium and its inherent limitations. Promoted by some as what administration (as originally envisaged) was always meant to be, there will be others who believe that administration is a well-established process which can already achieve the same policy goals.

The New Arrangement and Reconstruction Plan

The Plan

The CIGA introduces the new arrangement and reconstruction plan, as a new Part 26A of the Companies Act 2006, which is modelled on the scheme of arrangement, and pursuant to which a company can propose a restructuring plan to its creditors or members (“the Plan”).

A company can use the Plan without first going into the Moratorium.

Its key feature is that it will allow a company to bind all creditors, whether senior or junior, even if they vote against the plan, through the use of the so-called “cross-class cram down” provision.

Eligibility and Conditions

Under the CIGA, all companies will be eligible to apply for an arrangement and reconstruction plan, including overseas companies with a sufficient connection to the UK.

Section 901A provides that the company must meet two conditions in order to propose a reconstruction plan: (1) the company must have encountered or be likely to have encountered financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern (the company does not need to be insolvent), and (2) a compromise or arrangement must be proposed between the company and its creditors or members and the purpose of such compromise or arrangement must be to eliminate, reduce, prevent or mitigate the effect of any of the financial difficulties the company is facing.

That the Plan is to eliminate financial difficulties the company has or is likely to encounter which may affect its ability to carry on business is the context in which arrangements and reconstructions will arise and will inform the interpretation of the new Part 26A. However, no further guidance is provided on the meaning or scope of the term “financial difficulties”, which is seemingly very broad.

The Steps

The first step in the Plan process is for the company, either acting through its insolvency officeholder or its directors, to apply to the court for permission to convene class meetings to consider the Plan: see Section 901C.

At the first hearing, the court will examine the classes of creditors and members proposed by the company. Given the resemblance to schemes, the Court is likely to apply the same test when determining class issues: stakeholders should vote in the same class where their rights are “not so dissimilar as to make it impossible for them to consult together with a view to their common interest”.

As explained further below, there is a significant difference between schemes and arrangements and reconstructions. In schemes identification of the class is critical. That is because in schemes creditor votes in class meetings are determinative. The Court will not consider commercial questions. They are for the properly constituted class meetings. In an arrangement and reconstruction under Part 26A the identification of the classes is not determinative in the same way. If a difficult group of creditors are put into small classes that do not vote in favour of the Plan, the scheme can still be sanctioned under the cram down provisions.

However, the crucial distinction from schemes at the first hearing arises under Section 901C(4), which provides that the general rule that every creditor or member whose rights are affected must be permitted to participate in the meeting will not apply to a particular class of creditors or members who, on an application, the Court is satisfied do not have a “genuine economic interest” in the company. In such circumstances, this class or classes of creditors or members are not entitled to participate in the meeting or in any stage of the Plan. This gives applicants an early opportunity to neutralise another creditor that is ‘out of the money’. This will inevitably give rise to difficult valuation disputes at the first hearing, in relation to which the Court will need to determine the scope and meaning of the new term “genuine” economic interest (i.e. whether that means real as opposed to fanciful, or something else).
The requisite vote will subsequently take place on the order of the Court at the meeting of creditors or members. Section 901F provides that, if the requisite voting majorities are met, the Plan will move onto sanction. The voting majority will be 75% in value of the creditors in each class. This is different to schemes because the additional requirement for a majority in number has not been adopted. The 75% requirement has been questioned when compared to many restructuring processes that require 66% (and this is one of the provisions that might be changed by the Secretary of State). The Court has a discretion to sanction the Plan (“the court may...... sanction”), but (as referred to below), both the CIGA and the Explanatory Notes are silent as to the test that the Court should apply in the exercise of its discretion.

As with the Moratorium, the House of Lords passed amendments requiring any notice or other document that must be sent to any creditor to also be sent to the Pensions Regulator and the Board of the PPF. This amendment also provides for the Secretary of State to make regulations to permit the Board of the PPF to exercise any rights exercisable by the trustees or managers as a creditor of the company, and such regulations may also permit the Board to exercise those rights to the exclusion of, or in addition to, the exercise of those rights by the trustees or managers.

**Cross-Class Cram Down**

If all classes have approved the Plan, the Court may sanction it where 75% in value of creditors or members present and voting in each class have agreed the compromise or arrangement. However, even if the Plan is not agreed by 75% of a class, or more than one class, Section 901G (“Sanction for compromise or arrangement where one or more classes dissent”) provides that the Court may sanction the Plan provided that two conditions are met: first (“Condition A”) that the Court is satisfied that if the compromise or arrangement were to be sanctioned, none of the members of the dissenting class would be worse off in the “relevant alternative”; and second (“Condition B”) that the Plan has been agreed by a number representing 75% in value of a class of creditors or members who would receive a payment, or have a “genuine economic interest in the company”, in the event of the relevant alternative.

If these two conditions are satisfied the Plan can be approved. Significantly, this means the jurisdiction arises if only one class approves the Plan. Other classes may be ‘crammed down’ whether senior or junior to the approving class provided none of the dissenting classes would be worse off in the relevant alternative.

For these purposes, the “relevant alternative” is whatever the court considers in its discretion would be most likely to occur in relation to the company if the compromise or arrangement were not sanctioned by the Court under Section 901F. Given the context in which arrangements and reconstructions will be put to creditors the relevant alternative will be what the company faces absent (i.e. but for) the Plan in question to deal with its actual or likely financial difficulties affecting its survival as a going concern. That may be a liquidation. It might be an alternative Plan. This is likely to result in numerous valuation disputes about likely outturns.

As a consequence, where one ‘in the money’ class of creditors approves the Plan and the Plan delivers a better outcome than the next best alternative option (e.g. administration, liquidation, or an alternative plan) the Plan will become binding on creditors in all classes if sanctioned by the Court.

**Recognition and International Aspects**

The Plan will be available to any company which has a “sufficient connection” to the United Kingdom. As in relation to schemes of arrangement, this will provide debtors with broad scope to found jurisdiction before the English courts. However, and unlike in Chapter 11, there is no express provision that the (English) Court’s orders have extra-territorial effect, though it may be possible to apply for recognition internationally e.g. under Chapter 15 of the US Bankruptcy Code or according to the principles of private international law.
Robin Dicker QC and Adam Al-Attar consider these points in greater detail in their article ‘Cross-Clas... 3 June 2020.
subject to the relevant insolvency procedure if and to the extent that, because the company becomes subject to the relevant insolvency procedure, (a) the contract of the supply would terminate or “any other thing would take place” or (b) the supplier would be entitled to terminate the contract or the supply or to do “any other thing”. The “any other thing” provision is broad and unclear. It appears likely to be a reference to exercising rights under any other provision in the contract which are triggered by an insolvency event, for example, acceleration clauses, default interest or any other contractual consequence.

Section 12(4) provides that where an event has occurred that would have allowed a supplier to terminate a supply contract before the company entered a relevant insolvency procedure but that right has not been exercised, it is suspended once the company enters the relevant insolvency procedure and the entitlement may not be exercised. If the supplier’s right to terminate arises after the insolvency procedure begins (for example, non-payment for goods supplied after that time) then this right is not prohibited.

Crucially, Section 12(7) stipulates that the supplier may not make payment of outstanding amounts (in respect of supplies made prior to the insolvency trigger) a condition of continuing supply.

However, there are various exclusions to the ban.

First, Section 12(5) provides that where the prohibitions are in effect, the supplier may only terminate the contract if (a) the relevant office holder consents to the termination; (b) the company consents to the termination; or (c) the court is satisfied that the continuation of the contract would cause hardship and it grants permission for the termination of the contract.

Second, Section 13 provides for an exclusion which applies to small entities where the counterparty became subject to an insolvency procedure before 30 September 2020. In order to qualify as a small entity, at least two of the following tests must be met: (a) turnover does not exceed £10.2 million; (b) the balance sheet total is not more than £5.1 million; and (c) there are no more than 50 employees.

Third, there are also exceptions for financial services entities and contracts involving financial services: see Schedule 4ZZA.

As in relation to the Moratorium and the Plan, there is a broad Henry VIII clause which allows the Secretary of State, by statutory instrument, to make amendments to Section 233B and Schedule 4ZZA: see Section 233C.

Comment
This is an important amendment to IA86 and brings UK insolvency law into line with much of the rest of the insolvency world. Companies will be entitled to maintain important supplies. If the company does not wish to continue with the supply, it is able to consent to the enforcement by the creditor of the ipso facto clause.

It is very important to note that the CIGA only covers supplier arrangements in relation to goods and services. This may include commercial and financial contracts. Suppliers will still be able to terminate contracts on other grounds in the agreement – unless the ground in question had already arisen prior to the insolvency.

The CIGA does not define what hardship is. In the absence of further guidance, the Courts will need to develop principles to determine what factors to apply when determining whether the continuation of supply is causing the supplier hardship.

Felicity Toube QC and Georgina Peters consider in more detail the ban on Termination Clauses in their article “Ipso Facto Reform – Why now, and does it go too far (or not far enough)” also published in this CIGA Special.

Temporary Ban on Statutory Demands and Winding Up Petitions
Ban
The CIGA puts into effect the Government’s proposal for a temporary “ban” on the use of statutory demands and winding up petitions in respect of debts that are unpaid as a result of Covid-19. When the Government first announced on 23 April 2020 its intention to introduce the ban, it appeared to be focussed on commercial landlords in respect of unpaid rent. In Re Saint Benedict’s Land Trust Limited, Re Shorts Gardens LLP Harper v Camden Borough Council and another, Shorts Gardens LLP v Camden London Borough Council [2020] EWHC 1001, a case concerning a winding up petition threatened against a supplier of storage services, the applicant sought to rely upon the proposed ban as a ground for obtaining an injunction. Snowden J commented that it appeared to be “overwhelmingly” likely that the proposed legislation would only apply to certain limited sectors, e.g. retail and hospitality, and only in respect of claims by landlords for arrears of rent.

More recently there have been three further injunction decisions in the context of the ban: first, Travelodge Ltd v Prime Aesthetics Ltd [2020] EWHC 1217 (Ch) (Birss J), which preceded the ban, but was based on ministerial statements; second, Re a Company (Injunction to Restrain Presentation of a Petition) [2020] EWHC 406 (Ch) (Morgan J), which was heard on 1 June 2020. In both cases, the Court took into account the possibility or likelihood of a change in the law.

In the third most recent case, Re a company (Application to Restrain Advertisement of a Winding Up Petition) [2020] EWHC 1551, ICC Judge Barber adopted the same course as Morgan.
The key temporary measures, set out in Section 8 and Schedule 10 of the CIGA, are as follows:

- Paragraph 1 provides that a creditor may not present a winding up petition on or after 27 April 2020 on the ground specified in Section 123(1)(a) of IA86 that a company has failed to satisfy a statutory demand, if the statutory demand was served during the “relevant period” i.e. between 1 March 2020 and 30 September 2020

- Paragraph 2 provides that a creditor may not present a petition for the winding up of the company between 27 April 2020 and 30 September 2020 on any of the grounds specified in Section 123(1)(a)–(d) of IA86 unless it has reasonable grounds for believing that (i) Covid–19 has not had a financial effect on the company, or (ii) the company would have been unable to pay its debts even if Covid–19 had not had a financial effect on the company; or

- Any winding up orders made between 27 April 2020 and 30 September 2020 will be void if the order was not one that would have been made had the Court applied the relevant test, namely, whether or not Covid–19 has had a financial effect on the company before the presentation of the petition.

Paragraph 5 provides that, where a winding up petition has been presented by a creditor during the relevant period that claims that a company is unable to pay its debts, the court will consider whether Covid–19 has had a “financial effect” on the company. The Court may only wind-up a company if (a) for a petition presented in respect of a statutory demand or unsatisfied judgment debt, the ground for winding up would have arisen even if Covid–19 had not had a financial effect on the company, or (b) for a petition presented in respect of a company that is insolvent (either on a cash–flow or balance sheet basis) even if Covid–19 had not had a financial effect on the company. In Re a Company (Application to Restrain Advertisement of a Winding Up Petition) ICC Judge Barber confirmed that at this stage, in relation to issue (a) the burden is on the company and not the petitioner.

The CIGA applies a relatively low threshold test to assess whether Covid–19 has had a “financial effect” on a company. Indeed, ICC Judge Barber held that it is “clearly intended” to be a low threshold. It will be met if the company’s financial position worsens in consequence of, or for reasons relating to, Covid–19. This is likely to catch the vast majority of businesses. However, as the Court must then go on to consider whether the company would have been unable to pay its debts even if Covid–19 had not had a financial effect on the company, this is likely to catch those companies that were unviable before the crisis. ICC Judge Barber confirmed that the burden of proving these matters is on the petitioner, and not the company. This second test goes some way to providing a necessary counterweight to balance these far-reaching provisions which restrict a fundamental class right to wind up a company.

A feature of the CIGA which was not anticipated is the change in the date of the commencement of the winding up in respect of petitions presented during the relevant period. Paragraph 8(9) of Schedule 10 provides that the commencement of the winding up will be the date of the order rather than the date of presentation of the petition, as provided under Section 129 of IA86. This means that Section 127 of IA86 is of no effect: dispositions of the company’s property made between the presentation of the petition and the date of the winding up order will not be void.

Rather, paragraphs 10 to 18 of Schedule 10 makes modifications to various ‘look-back’ periods under the IA86, the most notable of which is in respect of transactions at an undervalue and preferences. The period is to start either (a) 2 years before the date of presentation of the petition (in the case of transactions at an undervalue) or six months (in the case of preferences) or (b) 2½ years before the day on which the winding up order was made (in the case of transactions at an undervalue) or 12 months (in the case of preferences) whichever is the later, ending with the day on which the winding up order is made.

Comment

Many practitioners will be keen to see how the courts will continue interpret and apply the relevant tests under these provisions.

The key battleground is likely to be over the second limb of the test, namely, whether the debtor company would have been unable to pay its debts even if the Covid–19 pandemic had not had a financial effect on the company. There will be many different factual scenarios that will test the boundaries of this pre-condition. For example, it is unclear how the Court will treat those companies which faced temporary liquidity problems prior to the onset of the Covid–19 pandemic, and which expected them to be resolved in a reasonably short period of time but were not as a result of the pandemic. Does a company in this scenario fall within the second period of time but were not as a result of the pandemic.

The court was satisfied, notwithstanding its reservations about the quality of the evidence, that this meant the second limb
The introduction of the cross-class cram down is a significant shift and marks a move from class composition to competing economic outcomes was not met. However, there will doubtless be many other scenarios in respect of which it is unclear what the outcome will be. Uncertainty will be felt by creditors and debtors alike.

In the majority of cases, creditors are unlikely to know very much about the detail of a company’s finances or the causes of its insolvency. Creditors will also be at risk of an adverse costs order if they litigate the issue and lose. As such, many creditors may well be deterred from seeking to wind up a company and will instead have to consider other insolvency processes, such as administration. Alternatively, this may encourage creditors and debtors to engage in a more consensual resolution of their disputes.

As to the change in the date of the commencement of the winding up, this is aimed at facilitating the ongoing trading of a company that is subject to a winding up petition by avoiding the automatic freezing of a company’s bank account. However, there will be concern that this removes an important protection to creditors at a time when the company’s assets are under the control of the directors. The operation of Section 127 seeks to ensure that some creditors are not unfairly paid ahead of others and to give effect to the fundamental principle of pari passu distribution. Where a payment to a creditor during this period promotes the interests of creditors as a whole, it can be validated by the court. Further, given the limited circumstances in which a creditor may present a winding up petition, essentially only against a company that was not viable before the pandemic, some will argue that the protection afforded to creditors under Section 127 is still required and would not undermine the promotion of the rescue culture.

Hilary Stonefrost and Daniel Judd write more fully on this subject in their article ‘Winding down winding up: the temporary restrictions’ later in this CIGA Special edition of the Digest.

Temporary Suspension of Liability for Wrongful Trading

Suspension

The CIGA introduces a suspension of personal liability for wrongful trading under sections 214 and 246ZB of IA86.

On 28 March 2020 the Government announced that the wrongful trading regime would be temporarily suspended “to give company directors greater confidence to use their best endeavours to continue to trade during the pandemic emergency without the threat of personal liability should the company ultimately fall into insolvency”.

The suspension will apply retrospectively from 1 March 2020 until 30 September 2020. However, the CIGA does not in fact suspend the wrongful trading regime. Instead, it directs the Court – when determining the contribution a director who has wrongfully traded is to make to a company’s assets – to assume that a director is not responsible for any worsening of the financial position of the company or its creditors that occurs during the relevant period. As such, the CIGA reduces, rather than removes entirely, personal liability for wrongful trading. It is not intended to allow directors with pre-existing wrongful trading issues to avoid liability. Directors will still have to consider during the relevant period whether to place the company into liquidation or administration.

Further, the provisions do not impact other routes to establishing personal liability of directors. Fraudulent trading is unaffected, as is the common law remedy for breach of duty. This means that directors will remain under the duty to act in the best interests of creditors at the point it when it was known, or ought to have been known, that the company was, or was likely to become insolvent (see BTI 2014 LLC v Sequana SA [2019] EWCA Civ 112). Nor do the measures impact the operation of the disqualification provisions under the Company Directors Disqualification Act 1986.
Comment

The necessary corollary of the continued operation of these provisions – and the narrower relief provided under the CIGA than anticipated – is that most directors will treat the proposed relaxation of the rules with caution.

Further, as with many of amendments in the CIGA, there are broad and notable exceptions, which mean that the temporary suspension does not apply to certain excluded companies, including parties to capital markets arrangements. The £10 million threshold that applies to the Moratorium will not apply in this context.

However, in reality, few directors have been able to make decisions about the trading of their companies during the COVID-19 period.

The suspension of liability for wrongful trading is considered in more detail by Richard Fisher QC and Roseanna Darcey in their article “Sometimes knowing what to do is knowing when to stop: wrongful trading and COVID-19” also published in this CIGA Special.

Conclusion

The insolvency reforms in the CIGA represent the most significant reforms in insolvency law since 1986. UK insolvency laws will become more debtor friendly. In the context of the current financial crisis they give the insolvency profession additional tools they can use to save businesses and livelihoods.
The Role of the Monitor in a Rescue Moratorium

GLEN DAVIS QC
Under the new Part A1 of the Insolvency Act 1986 (Part A1) introduced by section 1 of the Corporate Insolvency and Governance Act 2020 (CIGA), an eligible company12 which is or is likely to become insolvent will be able to obtain a moratorium, in most cases simply by filing documents at court13. During the moratorium, the company will enjoy a ‘payment holiday’ for many of its pre-moratorium debts (although not its bank debts and other debts and liabilities under contracts or instruments involving financial services14) and protection against most enforcement action by creditors. The directors of a financially-stressed company retain day-to-day control and responsibility for management while the company explores a possible rescue.

The objective of the new regime is not set out directly in Part A1, but appears from section A38(1)(b). It is rescuing the company as a going concern. The aim is survival of the enterprise itself, rather than survival of all or part of the company’s business (which might be achieved by a transfer). In that regard, the objective is more limited and more ambitious than in an administration, achieved by a transfer). In that regard, the objective is more limited and more ambitious than in an administration, where rescuing the company is the first objective under paragraph 3(1)(a) of Schedule B1, but the one which is most rarely achieved in practice.

Whether a moratorium can be obtained, whether it should continue, whether the objective has been achieved, and whether the moratorium must terminate, will all be determined by the professional opinion of the monitor. The key question, which the monitor must certify positively, at the outset if the company is to obtain a moratorium, or if it wishes to extend it15, and which the monitor must keep under review during the moratorium, is whether, in the monitor’s view, it is likely that the moratorium will result in the rescue of the company as a going concern.

That is not the monitor’s only function under Part A1, but it is the central and determining one, the new role of ‘monitor’, and the monitor’s relationship with the directors, will therefore be pivotal to this ‘debtor-in-possession’ rescue moratorium procedure. Modifications during the Coronavirus crisis

Although these reforms have been on the books for some time awaiting a parliamentary slot, they have been brought forward urgently as part of the Government’s package to address the immediate economic consequences of the COVID-19 pandemic. CIGA also contains a package of temporary measures to relax the Part A1 regime for the immediate future16. These will apply initially until 30 September 2020 (the Relevant Period)17, but there is power to extend that period by up to six months if the Secretary of State considers it reasonable to do so to mitigate an effect of coronavirus18.

Among the adjustments which apply during the Relevant Period, directors can obtain a moratorium by filing documents at court even if the company is subject to an outstanding winding-up petition19. The threshold question which the monitor must consider at the outset is modified so that any worsening of the financial position of the company for reasons relating to coronavirus is to be left out of account20; the same applies if an extension to the moratorium is sought21.

The monitor’s statutory duty of monitoring under section A35 is similarly modified in relation to a moratorium which comes into force during the relevant period22, so that it becomes:

‘the monitor must monitor the company’s affairs for the purpose of forming a view as to whether:

(a) it is likely that the moratorium will result in the rescue of the company as a going concern, or

(b) that, if one were to disregard any worsening of the financial position of the company for reasons relating to coronavirus, it is likely that the moratorium would result in the rescue of the company as a going concern.’

A monitor’s duty to terminate a moratorium under section A38(1)(a) will arise if the monitor thinks both that the moratorium is not likely to result in the rescue of the company as a going concern, and also that, even if one were to disregard any worsening of the financial position of the company for reasons relating to coronavirus, the moratorium would not be likely to result in the rescue of the company as a going concern23.

The expression ‘reasons relating to coronavirus’ is clearly very wide and no doubt deliberately imprecise. The
intention is clearly to insulate companies which are under financial stress for pandemic-related reasons, but these provisions (which we can probably expect to operate for the immediate and foreseeable future) do mean that monitors are required to approach this central judgment call on a somewhat hypothetical basis.

The Statutory Framework

Part 1A articulates a rather sparse framework for the operation of a rescue moratorium. It prescribes who can be a monitor and prescribes what a monitor may or must do at certain key points, but there is no general description of the monitor’s functions (which include, but go wider than, monitoring) or how a monitor is to go about performing them.

The Insolvency Service has published guidance to coincide with CIGA coming into force, intended to assist insolvency practitioners by setting out the principal duties and actions required of the monitor (the Guidance). Although the Guidance will no doubt assist monitors and those advising them as we all get to grips with the new regime, it will have no statutory force and is not designed to be a complete manual.

For the initial Relevant Period after CIGA (or relevant provisions of CIGA) come into force, there are also temporary procedural rules (Temporary Rules) set out in Schedule 4 CIGA which include application of certain provisions of the Insolvency (England and Wales) Rules 2016 (2016 Rules). The government’s expressed intention is that these temporary provisions will in due course be superseded by permanent provision in amended 2016 Rules.

It is also likely that much of what a monitor will do will in practice be extra-statutory. A company in financial distress which becomes subject to a moratorium will no doubt require expert assistance if it is to achieve a corporate rescue. The monitor or the monitor’s firm will be the obvious and natural source of such advice. There is nothing in the framework to preclude a monitor from assisting in this way, although it may give rise to potential issues of conflict which will need to be managed.

Choice of ‘monitor’ as a title

The word ‘monitor’ has clearly been selected with some care to signpost that this is a new and distinct office under the Insolvency Act. The modern sense of the word ‘monitor’ describes one who observes and keeps under review (although in fact a monitor will have some administrative functions). A monitor will not be expected to superintend the conduct of a company in a rescue moratorium, still less will they be involved in management or administration. They will not have any direct control over assets or spending (although their consent will be required for a grant of security and for significant expenditure).

The expression ‘monitor’ is used in an insolvency context elsewhere but cases from other jurisdictions are unlikely to be relevant (or will at least require to be understood from their different context and treated with some caution). For example, a monitor is appointed in proceedings under the Canadian Companies Creditors’ Arrangements Act, but in that case the monitor acts as the Canadian court’s proactive officer, to implement that court’s commercial oversight of a restructuring and to report to the court, for example, on the fairness and reasonableness of a proposed plan of arrangement or compromise. That is very different from the light-touch monitorship contemplated here under Part A1.
A monitor must be a ‘qualified person’, presently defined in section A52(1) as a person qualified to act as an insolvency practitioner. This drafting structure leaves open the possibility (which has already been canvassed) that other suitably-qualified professionals (particularly accountants or turnaround professionals) might in future be brought within the definition and permitted to become monitors. This would potentially widen the pool of prospective office takers, perhaps with different skill sets. Competition could lead to a reduction in costs, particularly for smaller cases. It could be a material consideration whether the monitor would also be qualified to go on and take an appointment as an administrator or liquidator.

However, for now the Government is relying on the experience and expertise of licensed insolvency practitioners as a known quantity with a ready-made regulatory structure under the insolvency regime. During the debates on the Bill, the Government emphasised that, as Lord Callanan put it when introducing the Bill in the House of Lords, insolvency is a highly-regulated profession, and insolvency practitioners are qualified members of a recognised professional body who are required to abide by legislative, professional and ethical standards. The Government relies in particular on monitors following the ethical and regulatory guidelines laid down by their professional body, and on them having regard to the recently-updated Insolvency Code of Ethics (the Ethics Code).

It remains to be seen how far insolvency practitioners will embrace the new regime rather than their more familiar role as administrators, but it is worth recalling that many leading firms have been calling for years for the UK to introduce a debtor-in-possession procedure. R3, the representative body for business recovery professionals, had already put forward plans for a ‘business rescue moratorium’, drawn up with the support of many experienced IPs, before the Government consulted in this area in 2016, and R3 supported the concept of a rescue moratorium when Government announced its response to the Insolvency and Corporate Governance consultation in 2018.

As the relevant provisions in Part 1A and the Temporary Rules currently stand, the only requirement is that the monitor is an insolvency practitioner who consents to act. There is, for example, no equivalent of the requirement in Rule 3.2(1)(f) of the 2016 Rules for a proposed administrator to state whether or not they have had a prior professional relationship with the company, and if so to provide a short summary of the relationship so that it is at least a matter of public record. It also appears that there would be no bar, in principle, to a practitioner who has acted as monitor going on to act as administrator or liquidator if the rescue moratorium comes to an end.

A monitor ‘acts as an insolvency practitioner in relation to the company’ for the purposes of the Insolvency Act. That means that they will need to have a bond as required under the Insolvency Practitioner Regulations 2005 (the IPR), and to keep records as required by Reg 13 IPR. Those records must contain information sufficient to show and explain their administration of the monitorship and any decisions which materially affect the case.

The Threshold test

As already noted above, the threshold test for a moratorium to be obtained or continued is that it is likely that it would (or will) result in rescue of the company as a going concern.

That formulation reflects a positive series of policy choices which will be material to the monitor’s function. During the Committee Stage in the House of Lords, the Government was invited to accept amendments that would have had the effect of reducing the barriers to obtaining moratorium, by altering ‘would’ to ‘could’ (so that a possibility of rescue would suffice) or providing in the alternative for rescue of part or all of the company’s business, rather than survival of the company itself. These were rejected.

The concept of a company being rescued and surviving as a going concern implies that the company itself will be able to pay its debts into the foreseeable future and so to continue trading with at least a reasonable prospect of profit. The company will need to have paid or compromised its debts (either informally or through a CVA or scheme) and to have sufficient working capital to support a realistic business plan. It may need to curb its expenditure, close loss-making parts of its business, restructure its workforce, re-focus investment.

The question for a monitor when a moratorium is being considered, and on an on-going basis if the question is answered positively at that initial stage, is whether it is ‘likely’ that this outcome will be achieved on the basis of the information then available.

On its face, that appears to be a relatively high barrier to entry, but the word ‘likely’ in a statute is capable of encompassing different degrees of likelihood, varying from ‘more likely than not’ to ‘may well’.

17. References to sections beginning ‘A’ are references to the sections in Part 1 to be introduced by section 11 CIGA.
23. Section 388 of the Insolvency Act is modified by Schedule 3, paragraph 21 CIGA.
When administrations were introduced under the Insolvency Act, it was necessary to make an application to court, and the conditions for the court to have power to make an order were set out in section 8(1) of the Insolvency Act. The court was required to be satisfied that the company was or was likely to become unable to pay its debts (section 8(1)(a)), and also to consider that the making of an administration order would be likely to achieve one or more of the purposes of administration (which were listed in section 8(3), and included the survival of the company, and the whole or any part of its business, as a going concern) (section 8(1)(b)).

In those early days, courts asked to construe the word ‘likely’ in those provisions came to different conclusions before the Companies Court arrived at a settled practice. Peter Gibson J held that the word “likely” meant “more probably than not” in Re Consumer and Industrial Press, and he was followed by Harman J in Re Manlon Trading. But in Re Harris Simons Construction, Hoffmann J held that ‘likely’ in section 8(1)(b) only required the court to consider that there was ‘a real prospect’ that one or more of the stated purposes might be achieved, and he was followed by Peter Gibson J in Re SCL Building Services and by Vinelott J in Re Primlaks. In Re Colt Telecom Group Plc (No.2), Jacob J followed Harris Simons Construction and Re Primlaks on section 8(1)(b), but held that the word “likely” in section 8(1)(a) did mean more probable than not. There was, therefore, a difference in the threshold of persuasion required between section 8(1)(a) and section 8(1)(b).

The wording of the threshold conditions was changed with the introduction of Schedule B1 to the Insolvency Act in 2003. Under paragraph 11 of Schedule B1, the court is now required to be satisfied that a company is or is likely to become unable to pay its debts (paragraph 11(a)), and that the administration order is reasonably likely to achieve the purpose of administration (paragraph 11(b)). In Re AA Mutual Insurance Company Ltd, Lewison J said that this replicated the position which had been arrived at under section 8, so that it was necessary to establish that the company is more probable than not to become unable to pay its debts, but that there is a real prospect that the administration order will achieve its purpose.

There is therefore some room to argue that, in the new context of Part A1, the word ‘likely’ does not inevitably bear the meaning ‘more probable than not’. Interpreting the relevant provisions as only requiring the monitor to form the view that there is a ‘real prospect’ that a rescue of the company would be achieved is undoubtedly more consistent with a rescue culture, and would enable more companies to obtain the benefits of the new process. However, against that it may well be said that Part A1 is to be construed in the context of the Insolvency Act as a whole, and if the draughtsman had wish to provide for a lower threshold, they could and would have used an expression qualifying ‘likely’ (such as the ‘reasonably likely’ which appears in paragraph 11(b) of Schedule B1 and in the statement of opinion regarding the purpose of administration being achieved which a prospective administrator is required to make in their statement and consent to act, under rule 3.2(1)(h) of the 2016 Rules).

It is worth noting in this context that the model offered by the Government to illustrate how the moratorium would work is a relatively simple one. They posit an SME which has suffered a bad debt after a major customer entered administration. The company is described as having a healthy order book, but as being cash-flow insolvent. A director proposes to raise money by re-mortgaging her house, but the company requires protection until this can be achieved. In such a case, the question of whether rescue will be achieved will depend on the probability that the mortgage lending will be granted and will be sufficient, so one can see that a prospective monitor would readily be able on limited enquiries to form the required view. Most cases will be much more complicated. If the prospect of rescue turns on successful negotiations with creditors or lenders, and perhaps on whether a CVA or scheme restructuring historic debt will achieve sufficient support, it is difficult to see how a monitor will be able to reach the view that rescue will be achieved (although it is much more likely that they could rapidly evaluate whether there is real prospect that it will be achieved).

It is likely that the proper construction of the tests which a monitor is required to apply will need to be settled by an application to the court for directions. If it is confirmed that ‘likely’ means ‘more probably than not’, it is perhaps unlikely that there will be many cases in which a prospective monitor feels able to be that certain at an early stage of what is, after all, a process intended to give a company time to explore whether a rescue is possible.

**Officer of the Court**

Section A34 provides that the monitor in relation to a moratorium is an officer of the court. This is of course a familiar proposition in the context of insolvency (compare paragraph 5 of Schedule B1, which makes similar provision for administrators), and has a number of practical implications and consequences.

A monitor will be required to act with integrity and to act independently, even-handedly and impartially. He must avoid any conflict and must not act if conflicted. In the final analysis, a monitor will be required to act fairly and to the standard set by and expected by the court of its officer, the essential principle being that the court would not permit its officers to act in a way in...
which it would clearly be wrong for the court itself to act, to be judged by the standards of right-thinking people, representing the current view of society. This standard is an objective one.

Where a monitor is required to furnish statements in documents to be filed in court (or put before a court) in support of a moratorium being commenced or continued, they will act as an expert, and so will be under an analogous duty to that of an expert in court proceedings under Part 35 CPR.

Where a monitor’s consent is required (for creation of security during a moratorium, under section A26(2), or for the company to make payments which exceed the specified maximum, under section A28(1)(a), or for a disposal of property outside the ordinary course of business, under section A29(2)(b)), the fact that the monitor is an officer of the court means that they will be expected to make their decisions speedily, as far as they are able to do so, and to make them responsibly. A monitor will be well-advised always to record a succinct summary of the reasons for their decisions, and should certainly do so if they are withholding a consent which has been sought.

A court has considerable powers of control over a monitor. It can give the monitor directions on an application by the monitor under section A37. It can ‘confirm, reverse or modify’ a monitor’s act or decision on an application under section A42, or decision on an application under section A42, or decision on an application under section A42. It can also probably act under its inherent jurisdiction to control its own officer.

The court has power under section A39(1) to appoint an additional monitor (for example, to address a possible conflict) or to replace a monitor (for example, in a case of incapacity), and the court also has power under section A39(2) to make an order that a person ceases to act as monitor. Section A39(3) provides that an order under sub-section A39(1) or (2) may only be made on an application by the directors or the monitor. It remains to be seen whether a court will regard itself as powerless to act if it concludes that the conduct of a monitor is such that they should be removed, but neither the directors nor the monitor are willing (or able) to make the requisite application.

As the court’s officer, a monitor will be required to be open and candid in all their dealings with the court. In an extreme case, they may even be required to disclose privileged material if that is required to enable the court to resolve outstanding issues.

Pre-monitorship enquiries and arrangements

There is no bar on accepting a monitorship where there has been a prior professional relationship.

It is left to the professional judgment of the practitioner to assess whether they can carry out the role with sufficient objectivity and independence. The Guidance stresses that they will need to have regard to any guidelines laid down by their Recognised Professional Body, and to the Ethics Code.

A prospective monitor will obviously need to engage with the company. They will need to understand the company’s business and financial position sufficiently to be able to form a reasonable view as to the likelihood that the threshold test will be satisfied (ie that a moratorium would be likely to result in a rescue of the company). They will therefore need to have sufficient comfort about the sources and availability of funding for the duration of a moratorium, and to reach agreement on their own fees and expenses.

On all these matters, the prospective monitor will need to rely primarily on information from the company. The procedure is intended to be ‘light-touch’ and ‘low cost’, and the Guidance suggests that pre-appointment work should be proportionate to the size and complexity of the company. Practitioners will need to exercise their professional judgment as to the extent of the inquiries they should make and the accuracy and completeness of information which is provided.

The prospective monitor will need specifically to confirm that the company is eligible to obtain a moratorium (ie that it is not in one of the excluded categories in Schedule ZA1), because that is something they will be required to certify for a moratorium to be obtained. They will also need to obtain a list of creditors with their contact details and details of their claims as recorded in the books of the company, because they will be required to notify those creditors if a moratorium is obtained.

A monitor will need to have a clear picture of the pre-moratorium debts for which the company will not have a payment holiday (which will include those under ‘financial services contracts’), and of the debts which will fall due for payment during the moratorium. They will need to keep them under review in a moratorium, because (unless they are to be left out of account, as discussed below), if the monitor thinks that the company is unable to pay any of these which have fallen due, they will be obliged to bring the moratorium to an end under section A38(1)(d).

A prospective monitor will need to confirm whether the company is or has been an employer in respect of an occupational pension scheme that is not a money purchase scheme, and whether the company is an employer in respect of such a pension scheme that is an eligible scheme within the meaning given by section 126 of the Pensions Act 2004 (the Pensions Act). If so, there will be...
obligations to notify the monitor’s appointment to the Pensions Regulator or the Board of the Pension Protection Fund (PPF), and the PPF will have certain rights in a moratorium, as discussed below.

A monitor will be well advised to put in place a detailed protocol agreed with directors at the outset, so that it is entirely clear what information is to be provided during a moratorium, and with what frequency.

Commencing a moratorium

In order for a company to obtain a moratorium under Part A1, the proposed monitor must confirm in the documents to be filed for an out-of-court appointment (or which must accompany an application to court where that is required):

(i) that they are a qualified person (section A6(1)(b)(i)) and that they consent to act as the monitor in relation to the proposed moratorium;
(ii) that the company is an eligible company (section A6(1)(c));
(iii) that, in the proposed monitor’s view, it is likely that a moratorium for the company would result in the rescue of the company as a going concern (section A6(1)(e)).

During the Relevant Period, the statement under section A6(1)(e) will be modified so that the proposed monitor is required to state that, in the proposed monitor’s view, it is likely that a moratorium for the company would result in the rescue of the company as a going concern, or would do so if it were not for any worsening of the financial position of the company for reasons relating to coronavirus (Schedule 4 paragraph 6(i) (b)). The threshold condition under section A6(1)(e), whether modified or unmodified, is considered in detail below.

It will be the directors, rather than the proposed monitor, who are required to state that, in their view, the company is, or is likely to become, unable to pay its debts. However, the proposed monitor will no doubt need to understand the extent of the company’s insolvency in order to form a view as to the likelihood of achieving the objective of corporate rescue.

Under the temporary rules, these statements must be made within the five–day period before the documents are filed with the court (or if filed on different days, the last of those days): Schedule 4 paragraph 18 CIGA).

The moratorium will come into force at the time when the relevant documents are filed in court (section A7(1)(a)) or when the court makes an order (section A7(1)(b) or (c)). On the moratorium coming into force, the person or persons who made the statements under section A6(1)(b) (ie that they were a qualified person and consented to act) automatically become the monitor in relation to the moratorium, under section A7(2).

At that point, they have the functions and powers, and become subject to the statutory duties, of a monitor as provided under Part A1.

Joint appointments

It is clear from section A6(2) that more than one person can be appointed to act as monitor. It is likely that joint appointments will be common in all but the smallest cases, and that they will be required by larger firms to cover the possibility of incapacity or unavailability. In that case, section A6(2) requires each of the proposed monitors to make the requisite statements, and the statement of consent under section A6(1)(b) to state which functions are to be exercised jointly and which (if any) are to be exercised by any or all of them.

As with other appointments under the Insolvency Act, it is likely that monitors will usually prefer to be able to act independently, to avoid the inconvenience of having to act jointly. The framework does not envisage that the monitor will be directly involved in filing documents in court or participating in court hearings (although of course it may be helpful for them to do so in a complex case). They provide their statements and then await developments.

The appointment of a monitor takes effect when the moratorium comes into force (section A7(2)). That will be when the relevant documents are filed with the court where that is sufficient under Section A3, or when the court makes an order where an application will required under section A4 because there is an outstanding winding up petition (disapplied during the Relevant Period, as explained above), or under A5 (for other overseas companies).

Section A41 provides that an act of the monitor is valid notwithstanding a defect in their appointment or qualification. This is the equivalent of the provisions which appear in section 232 of the Insolvency Act in respect of administrative receivers, liquidators and provisional liquidators, and in paragraph 104 of Schedule B1 in respect of administrators.
“... the monitor may well be involved in assisting the company with the proposal of a CVA or a scheme ...”

Notification and publicity
As soon as reasonably practicable after the moratorium comes into force, section A8(1) requires that the directors must notify the monitor. Failure to do so without reasonable excuse will be a criminal offence.

It will then be the monitor’s responsibility to notify the registrar of companies and every creditor of whose claim they are aware (section A8(2)). If the company is or has been an employer in respect of an occupational pension scheme that is not a money purchase scheme, the monitor must notify the Pensions Regulator, and if the company is an employer in respect of such a pension scheme that is an eligible scheme within the meaning given by section 126 of the Pensions Act, the monitor must also notify the Board of the PPF. The notice must specify when the moratorium came into force and when, subject to any permitted variation, it will come to an end (section A8(3)). Again, failure to comply on the part of the monitor without reasonable excuse would be a criminal offence (section A8(5)). If the company is a regulated company, the monitor must also send the notice to the appropriate regulator (i.e. the FCA or PRA) (section A48(3)).

It will similarly be the monitor’s responsibility (under section A17) to notify if the moratorium is extended or comes to an end or (under section A39) if a monitor is replaced or an additional monitor is appointed.

During a moratorium, section A19 requires that the name of the monitor must be included in a notice prominently displayed at every place of business to which customers or suppliers of goods and services have access, and that it must also appear on the company’s website and on every business document issued by the company.

Extensions of the Moratorium
The moratorium will initially last for a period of 20 business days beginning with the business day after it comes into force (section A9(2)).

That initial period may be extended once under section A10 for a further 20 days by the directors filing documents with the court. This does not require consent of creditors, and it does not formally require consent of the monitor, but the documents must include a further statement from the monitor that in their view it is likely that the moratorium will result in the rescue of the company as a going concern. The monitor will therefore be required to reappraise that question in the light of information then available, and their statement must be made within the three day period before the last of the documents is filed.

The directors will need to be able to make statements that moratorium debts, and pre-moratorium debts for which the company does not have a payment holiday, that have fallen due have been paid or otherwise discharged, and that the company is or is likely to become unable to pay its pre-moratorium debts. The monitor does not have responsibility for those statements.

Alternatively, the moratorium may be extended under section A11, with creditor consent, for a period of up to 1 year from the start of the initial period. This will again require the support of a further statement from the monitor that in their view it is likely that the moratorium will result in the rescue of the company as a going concern (and the same statements from the directors discussed above). The creditors’ consent is to be obtained using a qualifying decision procedure (Section A12(2)), and Part 15 of the 2016 Rules is applied for this purpose. The monitor is not formally involved in the process of seeking an obtaining the creditors’ consent. However, the Guidance acknowledges that the directors may not be familiar with the rules surrounding decision making in insolvency procedures, and indicates that, whilst it is not part of a monitor’s statutory duty to assist directors in obtaining the consent of creditors, they may choose to do so in an advisory capacity.

Thirdly, the moratorium may be extended by court order on an application by the directors under section A13. Once again, the application must be accompanied by a statement from the monitor that in their view it is likely that the moratorium will result in the rescue of the company as a going concern (and the same statements from the directors). On such an application, section A13(5) requires the court to consider the interests of pre-moratorium creditors, and also the likelihood that the extension of the moratorium will result in the rescue of the company as a going concern.

The monitor is not a party to such an application by the company, and while the monitor will have expressed their view that it is likely that the moratorium itself will result in rescue, they are not required to give reasons for that view. While the court will give weight to the fact that a monitor has felt able to make the requisite statement, it will be obliged to assess the question of ‘likelihood’ for itself (and although that is not a threshold condition for the exercise of the court’s discretion, it is unlikely that a court would order an extension unless it is sufficiently satisfied on this point). There will therefore need to be evidence...
to enable the court to consider the matters it is required to consider, and in many cases it will be appropriate for the monitor to assist in this regard as the court’s officer.

For completeness, a moratorium will also be extended under section A14, while a proposal for a company voluntary arrangement is pending (and until it has been disposed of), or under section A15 where an application is made under section 896 or 901C of the Companies Act 2006 for a meeting to consider a scheme, in which case the court has power to extend the moratorium. In these cases, there is no requirement for any statement from the monitor to support the extension. Although nowhere spelt out, it is to be understood that the monitor or other members of a monitor’s firm may well be involved in assisting the company with the proposal for a CVA or a scheme, and that they may go on to have role in the arrangement or scheme in the future.

The monitor’s core duty

A monitor’s core statutory duty is set out in section A35(1):

During a moratorium, the monitor must monitor the company’s affairs for the purpose of forming a view as to whether

as to whether it remains likely that the moratorium will result in the rescue of the company as a going concern.

Section A35(2) goes on to provide that, in forming that view, the monitor is entitled to rely on information provided by the company, unless the monitor has reason to doubt its accuracy.

The expression ‘the company’s affairs’ – the subject of the monitoring – is very broad. It necessarily encompasses performance of the company’s business and cash-flows, but arguably goes wider than that, and extends to an understanding of the company’s material relationships and stakeholders. There is no detail as to the manner in which, how frequently, or to what level of detail, the monitor is to monitor the company’s affairs. All that is left is to the professional judgment of the monitor. The duty is a continuing one, but in practice a monitor will satisfy it if they put proportionate reporting arrangements in place, together with some system which will immediately alert the monitor to any material adverse changes.

Of course, where the monitor or their firm are themselves involved in advising on a company’s restructuring with a view to rescue, they could well have an alternative source of information from their own experience. In this regard, an inherent tension may arise if the question of whether a rescue is likely to be achieved turns on the monitor’s evaluation of the likelihood of their own or a partner’s success in negotiations.

One particularly important aspect which a monitor will need to keep under close review is whether (or to be precise, whether the monitor thinks) the company is unable to pay any of the moratorium debts, or pre-moratorium debts for which the company does not have a payment holiday. (Under the Temporary Rules, paragraph 37 of Schedule 4 provides that the monitor is to disregard for this purpose any debts the monitor has reasonable grounds for thinking are likely to be paid within 5 days of the decision and any debts the creditor has agreed to defer beyond that date). This requires that the monitor identifies: that a qualifying debt has fallen due and is not deferred, that the company has not paid when the debt fell due; and that the company does not have sufficient cash to pay it and is unlikely to have sufficient cash (and pay) within five days. The reference to what the monitor ‘thinks’ implies that the monitor may (assuming reasonable grounds) form a different view from the directors, for example, as to the likelihood of a sum being received within five days which will enable a debt to be paid.

If, and as soon as, a monitor concludes that it no longer remains likely that the moratorium will result in the rescue of the company as a going concern, or that the company is unable to pay a relevant debt and is unlikely to pay it within the next five days, the monitor has no choice. They must bring the moratorium to an end by filing a notice in court as soon as practicable after the duty to do so arises (section A38(1) (a) or (d), Temporary Rules: Schedule 4 paragraph 36(1) CIGA).

Relationship with directors

In most cases, it is likely that the relationship between the monitor and the directors will be a co-operative one, at least at the outset. After all, the directors want the benefit of the moratorium while they explore a possible rescue, and are reliant on the monitor continuing to support that objective and remaining of the view that it is likely to be achieved.

A monitor has power under section A36(1) to require the directors of the company to provide ‘any information required by the monitor for the purpose of carrying the monitor’s functions’. Section A36(2) provides that the directors must comply with a requirement to provide information as soon as practicable.

If the directors fail to provide information which the monitor requires, the monitor has no coercive power to compel them. The question will be whether the monitor thinks that the failure means that the monitor is unable properly to carry out their functions. If the information has been identified by the monitor as ‘required’, it is clearly likely to follow that failure to provide it does affect the monitor’s ability to carry out their functions.

However, the directors’ duty under A36 is to provide information ‘as soon as reasonably practicable’. That is not the most precise formulation. It is reasonable to expect that a monitor...
would afford the directors some margin in this regard, and would wish to act proportionately. A short delay or an initial and inadvertent provision of incomplete information should not generally trigger termination, and a monitor would probably be well advised to give the directors a warning and an opportunity to remedy the default before deciding that they are now unable to carry out their functions as monitor.

A monitor who reaches that conclusion has no choice in the matter; this is another case in which they must bring the moratorium to an end by filing a notice in court as soon as practicable after the duty to do so arises (section A38(1)(c); Temporary Rules: Schedule 4 paragraph 76 CIGA). That is likely to be a considerable incentive to ensure that timely information is provided in most cases.

Separately, the fact that the directors remain in control of the company means that they are in a position to initiate insolvency proceedings in respect of the company. Section A24 imposes a duty on the directors to notify the monitor before they present a winding-up petition, make an administration application or appoint an administrator under paragraph 22(2) of Schedule B1, or recommend that the company passes a resolution for voluntary winding up under section 84(1)(b) of the Insolvency Act.

**Relationship with creditors**

The legislative framework provides for the monitor to have only very restricted contact with creditors. The monitor is required to notify those creditors of whom the monitor is aware when a moratorium has been obtained (section A8) or if it is extended or comes to an end (section A17), and if the monitor is replaced or an additional monitor is appointed (section A39). Otherwise, there is no requirement to inform or engage with creditors. The creditors’ approval or sanction is not required for a monitor’s actions or decisions. In this regard, the rescue moratorium differs from other processes under the Insolvency Act.

However, that may not be the end of the story. The attitude of creditors – particularly a company’s bank and any significant creditors such as trade suppliers – may well be relevant to the monitor’s consideration of the key question of whether it continues to be likely that the moratorium will achieve a rescue of the company. A creditor who considers themselves to have been significantly harmed may challenge the monitor’s act or omission by an application to court under section A42. The Guidance unsurprising anticipates that monitors may find it helpful on occasions to provide additional information to some creditors.

**Consent to payments**

Section A28 restricts the amount the company can pay to a person in respect of pre-moratorium debt for which it has a payment holiday (i.e. those which are not in a category excluded under section A18(3)) without the monitor’s consent (unless the payment is in pursuance of a court order or is required by A31(3) (proceeds of charged property) or A32(3) (proceeds of goods which were subject to a hire-purchase agreement).

This will apply to unsecured debts owed to trade and service suppliers. The effect of section A18(3) is that there is no payment holiday for:

(i) the monitor’s own remuneration or expenses for the period after the moratorium begins;

(ii) amounts payable in respect of goods and services supplied during a moratorium;

(iii) rent payable in respect of a period during a moratorium;

The Guidance makes clear that the definition of ‘pre-moratorium debt’ in Part A1 is intended to reflect the distinction between provable debts and expenses in administration made in Re Nortel GmbH (in administration) [2013] UKSC 52, so that liabilities such as contribution notices and financial support directions under the Pensions Act 2004 should be considered pre-moratorium debts and therefore not payable during the moratorium; see Guidance at p18.

40. The Guidance makes clear that the definition of ‘pre-moratorium debt’ in Part A1 is intended to reflect the distinction between provable debts and expenses in administration made in Re Nortel GmbH (in administration) [2013] UKSC 52, so that liabilities such as contribution notices and financial support directions under the Pensions Act 2004 should be considered pre-moratorium debts and therefore not payable during the moratorium; see Guidance at p18.
(iii) wages and salary arising under a contract of employment, defined under section A18(7) to include holiday pay, payment in lieu of holiday, sick pay and pension contributions;

(v) redundancy payments;

(vi) debts or other liabilities arising under a contract or other instrument involving financial services (an expression defined under section A18(7) and Schedule 2A2 to include a wide range of contracts including contracts for lending or providing guarantees, securities contracts, commodities contracts, and swaps, so prospectively wide enough to catch bank and inter-group lending).

The limit for such payments is the greater of £5,000 or 1% of the aggregate value of the debts and liabilities owed by the company to its unsecured creditors when the moratorium began, to the extent that the amount of such debts and liabilities can be ascertained at that time. It will therefore be necessary for the monitor (and the company) to identify that aggregate amount at the start of the moratorium, in order to calculate the 1% figure.

It is worth noting that the expression ‘debt or liability’ here (and in Part A1 generally) carries the usual wide meaning that it has under the Insolvency Act: i.e. that it is immaterial whether it is present or future, whether it is certain or contingent, or whether its amount is fixed or liquidated, or is capable of being ascertained by fixed rules or as a matter of opinion (here provided by section A52(2)). It is therefore at least theoretically possible that some of the sums which fall to be included in the aggregate amount will be unascertained but capable of being ascertained, and it will be a question of fact and for inquiry by a monitor whether there is sufficient information available to enable them to be ascertained.

Section A28(3) provides that the monitor is only permitted to give consent to such a payment if the monitor thinks that the payment will support the rescue of the company as a going concern. An example of a situation when that might be the case would be where a supplier is insisting on a ransom payment as the price of continuing supply. As elsewhere under Part 1A, the monitor is entitled to rely on information provided by the company unless the monitor has reason to doubt its accuracy (section A28(4)).

A monitor’s firm’s pre-moratorium fees and expenses may pose a particular challenge in this area. They are carved out by section A18(7) from the exclusions from the payment holiday: so they are subject to the payment holiday. They may well exceed £5,000 or 1% of the aggregate unsecured debts, so payment would require the monitor’s consent. The monitor would be in a position of conflict in consenting to a payment in which they have a direct interest. It would therefore be sensible to ensure that arrangements are in place to ensure that this issue does not arise.

Where a monitor does consent to a payment being made, or decides to withhold consent, they should document the information on which they have relied and their reasons for doing so.

**Consent to property disposals**

The monitor’s consent is required for a company to dispose of property which is not subject to a security interest, unless the disposal is in the ordinary course of business or the disposal is in pursuance of a court order (section A29(2)).

Where a monitor’s consent is required, the monitor may only consent if the monitor thinks that the disposal will support the rescue of the company as a going concern (section A29(3)). That is a subjective test, but the formulation suggests that the monitor must be of the opinion that it is more probable than not that the grant of security will support that objective; it will be insufficient if the monitor only thinks that the grant might achieve that end. There will need to be reasonable grounds for the monitor reaching that opinion, but in deciding whether to consent, the monitor is entitled to rely on information provided by the company unless the monitor has reason to doubt its accuracy (section A29(4)).

If the property is subject to a security interest, the monitor’s consent is not required. The company may dispose of the property if that is permitted under the terms of the security or with the permission of the court under section A31.

Similarly, the monitor’s consent is not required if the company wishes to dispose of property in its possession under a hire-purchase agreement. The company may dispose of the property if that is permitted under the terms of the agreement or with the permission of the court under section A32.

Of course, the monitor may well be interested in the possible effects of such property disposals on the financial position of the company and the implications for the prospective rescue.

**Consent to grant of security**

A company which is subject to a moratorium is only permitted to grant security over its property if the monitor consents (section A26(1)).

The monitor only has power to consent if the monitor thinks that the grant of security will support the rescue of the company as a going concern (section A26(2)). Again, that is a subjective test, and the monitor will need to have reasonable grounds for their opinion.

In deciding whether to give consent, the monitor is again entitled to rely on information provided by the company unless the monitor has reason to doubt its accuracy (section A26(3)).

Section A26(6) provides that the monitor is not permitted to give consent if the granting of security would be an offence under section A27, which prohibits the company entering into a market contract or financial collateral arrangement, giving a transfer order, granting a market-charge or system-charge or providing collateral security.

Security granted by the company without the consent of the monitor will be unenforceable (section A33(1)).

**Challenges to a monitor’s conduct**

A creditor, director or member of the company, and any other person affected by the moratorium, has standing under section A42(1) to apply to the court to challenge a monitor’s ‘act, omission or decision’. It appears that this extends to a failure to take a decision it is alleged the monitor should have taken.

If a moratorium is in force in relation to a company which is (or has during the moratorium been) an employer in respect of an eligible scheme as defined in section 126 of the Pensions Act and...
the trustees or managers of the scheme are a creditor of the company, section A44A provides that a challenge to a monitor’s conduct which could be brought by those trustees or managers as a creditor under section A42(1) may be made by the PPF. (The PPF will also have a similar power to challenge the conduct or prospective conduct of directors during a moratorium under section A44).

The particular example which appears in the section is a failure by the monitor to bring the moratorium to an end under section A38(1). No doubt there will also be challenges where a monitor’s consent is required and is not forthcoming.

The sole ground for an application under section A42 is that the act, omission or decision has unfairly harmed the interests of the applicant. This contrasts with the position in an administration under paragraph 74 of Schedule B1, where it is possible to complain that a present act or proposed act threatens unfairly to harm the interests of the applicant. An application will therefore need to be founded on an allegation of actual and non-trivial harm which has been suffered.

On an application, the court has power under section A42 to:

(a) confirm, reverse or modify any act or decision of the monitor;
(b) give the monitor directions; or
(c) make such other order as it thinks fit (although it cannot order the monitor to pay compensation).

In making an order, the court is required by section A42(7) to have regard to the need to safeguard the interests of those who have dealt with the company in good faith and for value.

The concept of ‘unfair harm’ is a familiar one. It is the preferred modern formulation (as in paragraph 74 of Schedule B1) whereas section 27 of the Insolvency Act, the statutory predecessor of paragraph 74, had referred to ‘unfair prejudice’.

It is not mere ‘harm’ but only harm which is ‘unfair’ which invokes the court’s jurisdiction. It has long been accepted in an insolvency context that some harm may be necessary, especially as a price worth paying for the prospect of a corporate rescue or at least a better realisation.

The expression ‘unfair harm’ can connote some unequal or differential treatment to the applicant’s disadvantage, which cannot be justified by reference to the interests of the creditors as a whole or to achieving the statutory objective: that was how Norris J understood it in Re Coniston Hotel (Kent) LLP. In Hockin v Marsden, Nicholas Le Poidevin QC said that the requirement of unfairness certainly prevents a creditor complaining of a disadvantage to his own interests when the disadvantage is justifiable by reference to the interests of the creditors as a whole, but it did not necessarily require unjustifiable discrimination; a lack of commercial justification for a decision causing harm to the creditors as a whole may be unfair in the sense that the harm is not one which they should be expected to suffer. In Re Meem SL Limited, David Halpern QC agreed and said that, as a matter of language, the term “unfair” is not limited to cases of unequal treatment but is capable of including conduct which is unfair to everybody within the class.

More recently, the concept of ‘unfair harm’ in the analogous context of paragraph 74 of Schedule B1 was considered in some detail by the Court of Appeal in Lehman Brothers (Australia) (in Liquidation) v MacNamara and although paragraph 74 is couched in wider terms than section A42, the discussion of principles by David Richards LJ at [81]-[84] is directly relevant. Applying those principles to a monitor exercising statutory functions and discretions under Part A1, and paraphrasing where necessary:

i) the office of monitor is a statutory creation, and a monitor is empowered to take only those steps for which there is express or implied statutory authority,
ii) if a monitor acts without authority, they would be acting unlawfully and an aggrieved creditor would not need to rely on section A42, and equally if an administrator exercised a power in bad faith or for an improper purpose, it would be an unlawful exercise of the power;

iii) where a monitor is acting in accordance with his obligations under Part A1, there can be no question that he is causing unfair harm;

iv) however, where the monitor is exercising a discretion, but does so in a manner which unfairly harms a creditor, the court should grant relief in an appropriate case;

v) the court’s jurisdiction under section A42 is not restricted to those cases where a monitor’s act cannot be justified by reference to the interests of the creditors as a whole or to achieving the objective of a rescue moratorium, or is discriminatory in effect;

vi) section A42 adopts an objective test of unfairness and conduct engages section A42 if it meets that objective test;

vii) in judging whether any conduct can be said to have caused unfair harm, it is a factor of great importance that the monitor is carrying out statutory functions and is or should be doing so in the interests of creditors as a whole (or in the interests of rescuing the company), but that may still involve the infliction of unfair harm on a particular person.

It is also material to consider that, while a moratorium is in place, a monitor is required to exercise independent commercial judgement. The courts are traditionally and notoriously reluctant to interfere with such commercial judgments of office-holders. In Re CE King Ltd (2000) 2 BCLC 297 Neuberger J said at 302-3: ‘First, prima facie, what the administrators should do about a particular contract is a commercial decision. Secondly, at least in principle and in general, it is not for the court to interfere with such commercial decisions: those are to be left to the administrator.’

It is generally only if what an office–holder is proposing to do (or has done) is ‘so utterly unreasonable and absurd that no reasonable man would have done it’ (per the Court of Appeal in Re Edenvotee) or an office–holder is ‘proposing to take a course which is based on a wrong appreciation of the law and/or is conspicuously unfair to a particular creditor or creditors or contractor of the company’ (per Neuberger J in CE King) that the court is prepared to interfere.

It is probable that there will be early challenges to test the proper interpretation of these provisions in the context of a rescue moratorium, but where a suitably–experienced insolvency practitioner has on reasoned and apparently reasonable grounds taken a view of what is (or what is not) likely to support the rescue of the company as a going concern, or as to the fundamental and continuing question of whether the moratorium is likely to achieve that objective, they will be afforded a wide margin of appreciation and it is likely to be very difficult to persuade a court to substitute its own judgment. That is not to say, impossible, but the cases in which a court is prepared to do so will be rare.

Conversely, where a decision is one which a monitor is bound to take if certain facts are proved, and the court forms a different view of those facts on the available evidence (which may go beyond what was available to the monitor), there can be little doubt that a court would be prepared to substitute its own decision for that of the monitor.

End of a Moratorium

A moratorium lasts for the initial 20–day period or that period as extended, and comes to an end at the end of that period (section A9(1)).

A moratorium automatically comes to an earlier end (under section A16(1)(a)) at the time when a court sanctions a compromise or arrangement under section 899 or section 901F of the Companies Act 2006.

A moratorium also automatically comes to an end (under section A16(1)(a)) at the time the company enters a relevant insolvency procedure. This will be when a voluntary arrangement takes effect, or that period as extended, and comes to an end at the end of that period (section A9(1)).

When a moratorium ends, the directors are required to notify the monitor under section A17, and the monitor must in turn notify the Registrar of Companies and every creditor of the company of whose claim the monitor is aware.

Termination of a Moratorium

There are also four circumstances specified in section A38, some of which have been referred to above, where the monitor must bring a moratorium to an end by filing a notice with the court. In these cases, the moratorium comes to an end when the notice is filed (section A38(3)).

The four situations listed in section A38(1) each turn on a subjective assessment by the monitor. Once the relevant opinion is formed, the monitor has no choice or discretion. The duty will arise if (and immediately when) the monitor thinks:

(a) that the moratorium is no longer likely to result in the rescue of the company as a going concern;
(b) that the objective of rescuing the company as a going concern has been achieved;
In general, any dispute regarding a monitor’s remuneration or expenses will be a civil matter to be resolved between the monitor and the company.
from the court, or if there is a challenge to a monitor’s conduct. In such cases, a monitor will be in a weaker position than, for example, an administrator, precisely because they do not have control over the company’s cash.

The effect of the new paragraph 64A of Schedule B1 is that if the end of a moratorium is followed by an administration with 12 weeks, moratorium debts and pre-moratorium debts for which the company did not have a payment holiday are to be paid with super-priority over floating charge security and the costs and expenses of the administration payable under paragraph 99 of Schedule B1. Similarly, if winding-up proceedings are begun (a petition is presented or a resolution for voluntary winding-up is passed) within 12 weeks of the end of a moratorium, moratorium debts and pre-moratorium debts for which the company did not have a payment holiday will have super-priority under new section 174A of the Insolvency Act.

Where section 174A or paragraph 64A of Schedule B1 apply, the Temporary Rules provide that the monitor’s remuneration and expenses will rank for payment behind:

(a) amounts payable in respect of goods or services supplied during the moratorium under a contract where, but for section 233(B) (3) or (4) of the Insolvency Act, the supplier would not have had to make that supply;

(b) wages or salary (including holiday pay, sick pay and pension contributions) arising under a contract of employment;

(c) other debts or other liabilities apart from the monitor’s remuneration or expenses.

In general, any dispute regarding a monitor’s remuneration or expenses will be a civil matter to be resolved between the monitor and the company.

A subsequent administrator or liquidator will be able to challenge the remuneration charged by a monitor on the ground that it was excessive. The application will have to be brought within a 2-year period beginning the day after the moratorium.
ends. The court will have power to order the
monitor to repay some or all of the remuneration
(or make such other order as it thinks fit). Unless
the court orders otherwise, the costs of the
application will be paid as an expense of the
administration or liquidation. An administrator
or liquidator will be able to assign the right to
bring this claim, which is regarded as a ‘cause of
action’.

Reporting Offences
Chapter 7 of Part 1 creates a number of offences
which may be committed by a director or shadow
director in connection with a moratorium.
These include, for example, making a false
representation for the purpose of obtaining a
moratorium or an extension of a moratorium
(section A46(1)), or concealing a debt due to or
from the company or property worth £500 or more
(section A45(2)(a)).

If it appears to a monitor (i.e. the monitor forms
the view) that a past or present officer of the
company has committed an offence in connection
with the moratorium, section A47 requires
them to report it ‘forthwith’ to the appropriate
authority (in the case of a company registered in
England and Wales, the Secretary of State). The
monitor must give the appropriate authority the
information and access to documents that the
authority requires.

A monitor may also be required to assist the
Secretary of State if there is an investigation into
the affairs of the company.

Concluding thoughts
The new rescue moratorium regime represents a
reform of the UK’s insolvency procedures which is
long overdue, but the bill’s rapid passage through
Parliament as part of the economic response to
the Coronavirus pandemic means there has not
been time for the usual degree of scrutiny. As with
any new insolvency regime, there is likely to be
a period of bedding down before the meaning of
key provisions becomes settled, and it appears
inevitable that a number of provisions will be
tested in the courts in the coming months.

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52. The present provision is in Schedule
4 paragraph 40 CIGA, the power to make
rules is this regard is in
section A43.
53. Section 246ZD of
the Insolvency Act is
amended to that effect
by Schedule 3 paragraph
16 CIGA.
Cross-Class Cram Downs

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Introduction

This article considers the potential implications for UK restructurings arising out of the new Part 26A of the Companies Act 2006 (“Part 26A”) which was introduced by Schedule 9 of the Corporate Insolvency and Governance Act 2020 (“CIGA”) and received Royal Assent on 25 June 2020.

The purpose of this article is to alert lawyers and other practitioners to the potentially far reaching implications of Part 26A. It is not, as was first envisaged by the Government, a mere efficiency saving that rolls into one process the attendant benefits of a scheme of arrangement coupled with a pre-pack administration. Its terms are not so constrained and the ability to impose a cross-class cram down may require a fundamental rethink to the approach to the constitution of classes and the assessment of fairness. These and other issues are considered below alongside the following other matters:

1. the impetus to reform;
2. the Government’s original proposals;
3. the existing ability to cram down a single class;
4. the new thresholds of financial difficulty and purpose;
5. the new voting thresholds;
6. the constitution of classes and the potential for ‘gerrymandering’;
7. the need for a new standard of fairness; and
8. the ability to ‘cram up’ as well as ‘cram down’.

Impetus to reform

Part 26A originates from the Government’s proposals in May 2016. The spur to those proposals was the World Bank’s “Doing Business” ranking. In 2016, the UK was ranked 6th overall and 13th on the World Bank’s “Resolving Insolvency” ranking. The US was ranked 7th overall but 5th for “Resolving Insolvency”. The Government was, therefore, incentivised to emulate aspects of Chapter 11 of the US Bankruptcy Code, as it was the lower “Resolving Insolvency” ranking that impacted most on the UK’s overall ranking and the Government’s ambition to take 5th place from the Hong Kong Special Administrative Region, which ranking had been inaccurately reported as indicating that China, as a whole, was a better place to do business than the UK. The focus of the World Bank’s report at all1. As explored below, the reason for its inclusion appears to have been a desire to emulate part of Chapter 11 in a way which the Government perceived would not change UK law in a radical or substantive way. Part 26A does not however correspond to the Government’s initial proposal nor to the terms of its response to the initial consultation. It appears that it will be for the courts to decide the principles that should guide the exercise of the new power to cram down a single dissenting class. There is little guidance in the text and the decision not to implement the guidance proposed in the Government’s response to its initial consultation is a puzzle that is likely to reduce the assistance the court can derive from the pre-legislative material.

Original proposals

The original proposals were summarised by the Government as follows (p.22):

- Companies will be able to bind all creditors to a restructuring plan.
- Introduce ‘cram down’ provisions allowing for a restructuring plan to be imposed on a junior class of creditors even if they vote against the plan, as long as they will be no worse off than in liquidation.
- The classes of creditors would be proposed by the distressed company on a case by case basis.
- For a class to vote in favour, 75% of creditors by value, and more than 50% by number must agree to the plan.

In support of these reforms, the Government cited World Bank Principle C14.3 (p.23, §9.7):

“For voting purposes, classes of creditors may be provided with voting rights weighted according to the amount of a creditor’s claim. Claims and voting rights of insiders should be subject to special scrutiny and treated in a manner that will ensure fairness. Plan approval should be based on clear criteria aimed at achieving fairness among similar creditors, recognition of relative priorities, and majority acceptance, while offering opposing creditors or classes a dividend equal to or greater than they would likely receive in a liquidation proceeding. Where court confirmation is required, the court should normally defer to the decision of the creditors based on a majority vote. Failure to approve a plan within the stated time period, or any extended periods, is typically grounds for placing the debtor into a liquidation proceeding.”

World Bank Principle C14.3 does not require the inclusion of cross-class cram downs. It is a principle equally consistent with a cram down under Chapter 11 and the current law on schemes of arrangement and CVAs. Nonetheless, the Government’s original proposal continued (p.23, §9.8–9.9).

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1. We are extremely grateful for the comments on a draft of this article received from James Peck, of Morrison & Foerster and formerly a United States Bankruptcy Judge for the Southern District of New York, and from Michael Crystal QC. The opinions, errors and omissions are our own.

2. For those who are interested, Singapore claimed the number one spot for “Doing Business” in 2016. It was however ranked 27th for “Resolving Insolvency”.

creditors, not as an indication of inherent value: see In re Tea Corp Limited [1904] 1 Ch 12 (Buckley LJ), affirmed and applied in In re My Travel Limited [2005] 2 BCLC 123 (Mann J) and In re Bluebrook Limited [2010] 1 BCLC 338 (Mann J).

In Bluebrook (the IMO Carwash case) a scheme of arrangement was proposed by the senior lenders; it being necessary as not all could agree on the way forward, absent which there would simply have been a security enforcement. The scheme authorised the security enforcement, overriding the moribund contractual mechanism in that case. The mezzanine debt holders objected. However, on the basis of the above propositions, the mezzanine creditors had no basis to object on class or fairness grounds. The mezzanine creditors’ evidence, which was based on a ‘Monte Carlo’ valuation as to where value broke, was rejected, as was the asserted comparator of another potential restructuring.

An unusual feature of Bluebrook was that the court entertained the mezzanine creditor’s objections at all. Their essential objection was as to value that would be realised by the administrator appointed following the sanction of the scheme. Rather than requiring the mezzanine creditors to seek to enjoin the proposed sale, for which they would have been required to offer a cross-undertaking in damages, the court was prepared to entertain their objection within the forum of a scheme hearing notwithstanding that the mezzanine creditors were not scheme creditors. (This observation is important because, as we shall see, one feature of Part 26A is that it too provides objectors with such a forum.)

There are important limitations in the ability to cram down an entire class by the means summarised above however:

(1) It is dependent upon the jurisdiction to open a pre-pack administration, given the likely reluctance of directors to effect the necessary disposal. If the company’s COMI is not in the UK and cannot effectively be shifted to the UK, then the approach used in Bluebrook is not available.

(2) There must also be a sufficiently broad intercreditor agreement in place that subordinates the rights of the junior creditors to those of the senior creditors in an enforcement scenario and permits a release of the security. It will not otherwise be possible for the pre-pack administration sale to sell free of the existing security following the scheme between the company and the senior creditors.

Whilst many responses to the initial consultation were unenthusiastic (in large part because of the arguable over-reaction of the Government to the World Bank’s “Doing Business” rankings), the ability to cram down a single class prior to the enactment of Part 26A was subject to important practical limitations. These limitations
may become increasingly significant in the future because of the accelerated development of a substantive EU insolvency law following Brexit which may make it less likely that EU companies will seek to COMI-shift to the UK for purposes of making use of UK restructuring tools.

**Part 26A: a review of the new law**

**Financial difficulty threshold**

Part 26A, Section 901A(2) defines “Condition A” to the application of Schedule 10 as follows:

“Condition A is that the company has encountered, or is likely to encounter, financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern.”

The financial difficulty threshold for the new regime has, therefore, been extended to include a futurity aspect that is intended to be more forward looking than that permitted under Schedule B1 (“...likely to become...”) in the case of administration. The likely reason for this low threshold is to permit a financial restructuring in anticipation of financial difficulties.

One immediate issue is what conceptual and practical bounds limit this potentially almost unrestricted test of financial difficulty. The need for such bounds was one specifically noted by the Chancery Judges’ response to the Government’s initial proposals (albeit in connection with the related new moratorium) (§4-5):

“As to the conditions for entry, the proposed moratorium is a unilateral act of a company which “is experiencing or anticipates imminent financial difficulty”. To use it otherwise e.g. to frustrate court proceedings or to secure commercial advantage in the renegotiation of a contract, would be an abuse of process. It is therefore essential that the circumstances in which the relief can be invoked are clearly defined, that the conditions for entry are such that it can be clearly demonstrated that they are satisfied, and that creditors can have confidence in the person or persons making the judgment.

We do not consider that the anticipation of imminent financial difficulty provides a sufficiently stringent test. A test that the company “is or is likely to become insolvent” employs a defined, effective and well-known statutory test of insolvency and the need publicly to acknowledge this state of affairs will deter abuse.”

The Government did not refine its proposals in this respect. In its response to the consultation, it said (p.66, §§5.130–5.132):

“No financial conditions will be set in order to qualify for a restructuring plan. This means both solvent and insolvent companies will be able to propose restructuring plans to their creditors.

The Government believes allowing solvent companies to address emerging financial difficulties will reduce stigma and encourage earlier action on the part of directors, thereby avoiding value-destructive action and leading to better outcomes on the whole for creditors and other stakeholders in a company. The protections built into the proposals will safeguard creditors from unfair detriment where their contractual rights are interfered with by the effect of a restructuring plan.

As there will be no financial entry criteria, a company in an insolvency procedure, acting through the insolvency office-holder, may propose a restructuring plan to creditors. This is in line with existing provisions in the framework such as the ability of a liquidator to propose a CVA. While the Government does not think this would happen often, maximum flexibility is desirable to ensure viable businesses do not fail unnecessarily.” (Emphasis added.)

The absence of financial entry criteria was an intention repeated in the December 2019 briefing paper for the House of Commons (p.28).

The language of Condition A means that it will prove difficult to set any conceptual bounds on what amounts to qualifying “financial difficulties”. For instance, an attempt to differentiate “legal difficulties” (e.g. a foreign import restriction on a UK exporter) will likely fail because the legal restriction is merely the proximate cause of “financial difficulties”. The causal connection between events affecting the company and its financial position, therefore, makes it very difficult to say what disqualifies a company from satisfying Condition A.

**The purpose threshold**

Part 26A, Section 901A(3)(b) defines “Condition B” to the application of Schedule 10 as requiring that:

“the purpose of the compromise or arrangement is to eliminate, reduce or prevent, or mitigate the effect of, any of the financial difficulties mentioned in subsection (2).”

Thus, although Condition A permits a company to propose a restructuring in a very wide range of financial circumstances, Condition B requires that any such restructuring is for a particular purpose, namely to address such financial difficulties.

This condition is plainly intended to limit the permitted nature and effect of a restructuring under Part 26A. It has to address financial difficulties, rather than have any other purpose. Given, however, the broad nature of such financial difficulties and their causes, it is not clear what constraints Condition B will in practice provide, nor how the courts will control the scope of restructuring proposals to ensure that they are not used, in whole or in part, for some extraneous or collateral purpose.

In this regard, however, a lesson might usefully be drawn from the US jurisprudence under Chapter 11 of the US Bankruptcy Code. There is no insolvency requirement for the commencement of a Chapter 11 case. However, a case can be dismissed early if it has been filed in bad faith or without reasonable hope of success: see e.g. SGL Carbon Corporation 200 F. 3d 154 (3rd Cir., 1999), which dismissed the proceedings for a lack of “reorganizational purpose”. This approach is not dissimilar to the English case law concerning an interim moratorium for an individual voluntary arrangement. The Court requires a proposal to be “serious and viable” if a moratorium is to be sustained: see Hook v Jewson [1997] 1 BCLC 664 (Rimer J).

In the absence of qualifying financial criteria with any teeth and the inclusion of a broad requirement as to purpose, the protection against abuse is, therefore, likely to have to be developed by similar means.

**Voting requirements**

The attitude to voting requirements has varied throughout the course of the legislative process. The Government’s initial proposal was to retain the same numerosity and value thresholds as apply to scheme of arrangement
An application under subsection (4) is to be made by the person who made the application under subsection (1) in respect of the compromise or arrangement.”

The basic process is not therefore that different to the existing scheme of arrangement regime. The intention appears to be to piggy-back on the existing learning as to class compositions; a matter emphasised in the explanatory notes to the iterations of the bill as it passed through Parliament. In this regard, one might reasonably expect the two-stage rights-based class analysis to carry over.

The only apparent difference is the option for the proponent to make an additional application to exclude ‘out of the money’ creditors within a putative class, defined as creditors without a "genuine economic interest". It is not however clear as to how sub-paragraphs (3) and (4) are to operate against the background of the existing law.

The power of the company, recognised in Sea Assets v Garuda, to control to whom a compromise or arrangement is put does not appear to be overridden by the new provision. Sub-paragraph (3) merely requires that all putative members of a class be permitted to participate at meetings. It does not, as such, preclude a company from carving out members of that putative class for commercial reasons (for instance, because they are willing to enter into bilateral arrangements, as was the case with the government creditors in Sea Assets v Garuda).

The intention of sub-paragraph (4) appears to be that creditors whose rights are affected by the compromise or arrangement do not have to be permitted to participate in a meeting if, on an application, the court is satisfied that none of the members of that class has a genuine economic interest in the company. This represents a change in the law and avoids the need for security enforcement structures, such as in Bluebrook, being used to dispose of the company’s assets to a new SPV for the benefit of the senior creditors, whilst leaving the (uncompromised) junior creditors with a claim against a now empty shell.

As to what is meant by "genuine economic interest", the phrasing is unusual because “genuine” connotes sincerity, and, however sincere, a belief in value is irrelevant to an objective test of value. The phrase is likely to be construed as akin to a “tangible” or a "real" (as opposed to a "fanciful") economic interest in the company. Further, given the apparent adherence to the existing law on class composition, it is reasonable to suppose that the Court will construe that economic interest as one that has to flow from the rights of the creditors against the scheme company. For instance, the value in rights against a guarantor or a third party such as an insurer or a market counterparty under a CDS would not, on this
approach, constitute a “genuine economic interest in the company”.

**Gerrymandering and the artificial creation of classes**

On its face therefore, Part 26A does not appear very different from the approach to classes under Part 26. The modern approach to the constitution of classes under Part 26 is against the proliferation of classes, in particular, in circumstances in which the division of a putative single class would create an unjustified veto or hold-out position. This approach is both commercially required, if the scheme of arrangement is to continue as a viable restructuring tool, and consistent with the purpose of Part 26 as a means of binding dissent within a class. If creditors or members can properly consult together within a single class, differences in their rights against the company which might fracture that class should not do so, so that the aim of consultation together on a proposal in their common interest can be achieved. It is this impulse that drives the modern line of cases following *Re Hawk Insurance Company Limited* [2001] 2 BCLC 480.

Part 26A however is very different, notwithstanding the use of some of the same concepts as Part 26, namely of a “compromise” or “arrangement” and a rights-based class test, because Section 901G, considered in detail below, permits a cram down of a dissenting class provided that another class with a “genuine economic interest” in the relevant comparator votes for the proposal and the dissenting class is not any worse off than in the relevant comparator. Part 26A is therefore concerned with inter-class dissent, as opposed to intra-class dissent. The seismic implications of this change for the test of fairness are considered in the next section of this article. The change is, however, also likely to have profound implications for the constitution of classes because the affirmative vote of an economically enfranchised class is the gateway to the cross-class cram down. The “someone likes it” rule, as Section 901G(5) might be termed, controls access to the cram down power. There will be an incentive on the part of the proponent, be it the company or another creditor, to constitute the classes to ensure that there is someone who does like the proposal in order to cram down someone who does not.

The problem posed by the new legislation is what limits, if any, should the court set on the constitution of classes. As noted above, insofar as Part 26A addresses classes, Section 901C borrows from the language of Part 26 in part and would appear to direct the court to a rights-based class test: see, in particular, the language of Section 901C(3) (“Every creditor or member of the company whose rights are affected by the compromise or arrangement must be permitted to participate in a meeting ordered to be summoned under subsection (1).”) Part 26A provides no assistance on the question of whether or how the court should further control the constitution of classes.

What limits, if any, the court should set is an area in which the court might usefully examine the Chapter 11 caselaw, which has dealt with the “artificial” creation of an impaired class (sometimes termed “gerrymandering”) for decades.

Chapter 11 requires the classification of claims against a debtor for two reasons. First, each class of creditors will be treated in the debtor’s plan of reorganization based upon the similarity of its members’ priority status and other legal rights against the debtor’s assets: see §1122. Proper classification is essential to ensure that creditors with claims of similar priority against the debtor’s assets are treated similarly. Secondly, the classes must separately vote whether to approve a debtor’s plan of reorganization: see §1129(a)(8). A plan may not be confirmed unless either (1) it is approved by two-thirds in amount and more than one-half in number of each “impaired” class: see §1126(c), 1129(a)(8), or (2) at least one impaired class approves the plan (see §1129(a)(10)), and the debtor fulfills the cramdown requirements of §1129(b) to enable confirmation notwithstanding the plan’s rejection by one or more impaired classes.

The ability to select the classes arises under §1122. §1122 permits a plan to place “a claim or an interest” in a particular class only if such claim or interest is “substantially similar” to the other claims or interests of such class. It is a test based on claims or interests; concepts which include rights against the debtor, but which it appears are not limited to (nor dictated by) such entitlements.

Gerrymandering can involve, among other things: (i) the joint classification of supporting creditors’ claims with the claims of creditors who are not, with the expectation that supporting claims will sufficiently outnumber dissenting claims to ensure acceptance of the plan by the class as a whole (something which can be done under an existing Part 26 scheme), or (ii) separately classifying the claims of dissenting creditors from the claims of supporting creditors to ensure that the dissenting creditors cannot block the exercise of the power to cram down the dissenting class (something which cannot be done under an existing Part 26 scheme). In response to, or in anticipation of such action by the debtor, creditors may seek to purchase the claims of other creditors to block a majority vote within a class or to hollow out an impaired class whose vote might otherwise be used to engage the cram down power.

In response to such tactics, the US courts have developed two principal controls. The first is to articulate a limit on the power to classify claims under §1122. The second is to “designate”, i.e. to disqualify, votes whose acceptance or rejection of

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5. “Impairment” is, in broad summary, defined under §1124 as an alteration of the legal, equitable, and contractual rights to which the holder of the claim or interest is entitled.
The creditor may elect recourse status and obtain the right to vote in the unsecured class, or it may elect to forego recourse to gain an allowed secured claim for the entire amount of the debt.

As to the first of these controls, the US courts have identified inherent limitations in the power to select classes under §1122. In In re Greystone III Joint Venture 995 F.2d 1274 (5th Cir. 1992), the US Court of Appeals for the Fifth Circuit overturned the decision of the lower court to the effect that the “legally different” unsecured claims of trade creditors were to be classified differently from the deemed unsecured claim of a non-recourse secured creditor. The premise of the reasoning of the lower court was that §1122 does not “unambiguously prevent classification of like claims in separate classes”. The Fifth Circuit held that this construction was wrong because, first, §1122(b) had to specifically except “convenience claims”, i.e. claims of a de minimis value set by the court which would otherwise form part of a given class. It was inherent within §1122 that there was some notion of a properly constituted class. Secondly, having regard to the “substantially similar claims” test, it said:

“A fair reading of both subsections suggests that ordinarily ‘substantially similar claims, those which share common priority and rights against the debtor’s estate, should be placed in the same class’”

In the light of this inherent limitation within §1122, the court emphasised in place of the “otherwise muddled caselaw on §1122 claims classification”, the Fifth Circuit emphasised “the one clear rule” “thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan”. In support of this rule, the Fifth Circuit approved the observation of the Sixth Circuit in In re U.S. Truck Co., 800 F.2d 581, 586 (6th Cir. 1986):

“[I]t there must be some limit on a debtor’s power to classify creditors in such a manner...Unless there is some requirement of keeping similar claims together, nothing would stand in the way of a debtor seeking out a few impaired creditors (or even one such creditor) who will vote for the plan and placing them in their own class.”

In conclusion it said:

“We conclude that if §1122(a) permits classification of “substantially similar” claims in different classes, such classification may only be undertaken for reasons independent of the debtor’s motivation to secure the vote of an impaired, assenting class of claims.” (Emphasis added.)

The Fifth Circuit, accordingly, focused its assessment on the ‘independent’ reasons given for the separate classification. On the facts, it concluded that the different juridical bases for the two sets of unsecured claims was irrelevant. Trade creditors had an unsecured claim of the same quality in the circumstances as the deemed unsecured claim of the non-recourse secured creditor who had elected an unsecured claim in respect of the deficiency in its security. There was no independent reason (distinct from the desire to skew the classes in favour of a cram down) that justified the difference.

Under Part 26 the court already scrutinises claims of creditors to determine whether their rights are sufficiently similar to permit them to vote together with a view to their common interests. One difference is that, under Part 26A, a court may now need to examine more closely a proposal which asserts that the rights of two different groups of creditors are sufficiently different to require them to be placed in separate classes.

A scrutiny of a company’s commercial reasons for proposing a particular class is also already undertaken by the court under Part 26 in the context of a company’s decision to exclude creditors or members from the putative class, as was the case in Sea Assets Ltd v PT Garuda Indonesia [2001] EWCA Civ 1696 and In SAB Miller plc [2017] Ch 173. An enquiry into a company’s reasons for a particular classification is not, as such, impracticable nor a matter on which the court cannot adjudicate.

A principal difficulty for the development of a control akin to that described above is the rights-based test under Part 26A. Legal, equitable and other rights are the stock in trade for a court of law, and differences in rights and how the same will perform in the relevant comparator, is likely to prove to be a fertile source of justification for the separate classification of particular creditors.
in order to target others with the cram down power under Section 901G. The obvious riposte to an asserted distinction based on a difference in rights in the relevant comparator is that the company’s assessment of what those rights are and how those rights will perform is wrong. If the court is satisfied that there is no relevant difference because the company’s assessment is wrong, the conclusion is that the asserted separate classes are in fact a single class. This approach explains Greystone above. It also explains the factually similar later case of Travelers Insurance v. Bryson Properties, XVIII 961 F.2d 496 (4th Cir. 1992) in which the Fourth Circuit said:

“Where all unsecured claims receive the same treatment in terms of the Plan distribution, separate classification on the basis of natural and unnatural recourse claims is, at a minimum, highly suspect. In this case, Bryson has failed to offer any reason for separate classification of the unsecured claims which will withstand scrutiny.”

In the context of a rights-based class test, it may well be possible to stop the enquiry after an assessment of the rights in the comparator and under the proposal without having to enquire further into “any reason for separate classification”. This may well prove to be a better control of “gerrymandering” than a separate doctrine that is hard to withstand scrutiny.

It is likely for this reason that no law has yet been developed under Part 26 further to Hildyard J’s obiter dictum in Re Apcoa Parking Holdings GmbH [2015] 2 BCLC 659. In response to Mr Snowden QC’s submission that “the court should be very astute to detect attempts to manipulate the class composition to achieve a particular result” (for which Sea Assets was cited as authority), Hildyard J said, at [171]:

“[It] seems to me that the Sea Assets case was really concerned with the selection of who are to be scheme creditors. But I can well understand and accept more generally that the court will be astute to avoid gerrymandering or its like.”

On the facts of Apcoa, Hildyard J rejected the challenge to the composition of classes on orthodox principles, and no subsequent case has sought to develop the above observation. Part 26A may in due course provide the occasion for such development, however, given the rights-based approach to classes that Part 26A shares with Part 26, we think the court will likely seek to resolve disputes as to the correct constitution of classes without developing an additional doctrine. If, however, the traditional rights-based approach to class composition is not adequate, there does appear to be support for the incremental development of additional controls.

In this regard, one potentially difficult problem arises if the different classes are sought to be justified by differential treatment under the restructuring. Class manipulation can also take the form of manufacturing an impaired class even though impairment is unnecessary. For example, a plan could pay creditor claims nearly, but not entirely, in full or modify their rights in some minor but not immaterial respect such that they are still willing to vote to accept the restructuring (such as a minor but not immaterial change in interest rates or rest periods for interest calculation). To the extent that the restructuring proposal treats creditors differently, they will need to form a different class on the rights-based approach. There may be further scope for companies to use this fact to artificially manufacture supporting and dissenting classes. This may be one area in which additional controls are required.

As to the second of the controls developed by the US courts, in Young v. Higbee Co, 324 U.S. 204 (1945), the Supreme Court considered the predecessor of §1126(e). It declared, at pp.210–11, that if certain persons “had declined to accept [the] plan in bad faith, the court…could have denied them the right to vote on the plan at all.” It went on to explain that the provision was intended to apply to those “whose selfish purpose was to obstruct a fair and feasible reorganization in the hope that someone would pay them more than the rateable equivalent of their proportionate part of the bankrupt assets.”

In Re Figter Limited 118 F.3d 635 (9th Cir. 1997), the US Court of Appeals for the Ninth Circuit took the decision in Young v Higbee as a starting point, recognising that the sweeping dictum was too broad. It said, at p.639: “If a selfish motive were sufficient to condemn reorganization policies of interested parties, very few, if any, would pass muster.” It continued:

“Our other hand, pure malice, “strikes” and blackmail, and the purpose to destroy an enterprise in order to advance the interests of a competing business, all plainly constituting bad faith, are motives which may be accurately described as ulterior.”

In that case, the respondent (Teachers, the sole secured creditor) had purchased the majority of the claims in the impaired unsecured class at 100c/$ to block the debtor (Figter, the owner of a single residential complex in Los Angeles) from using the approval of the plan by the unsecured class to engage the cram down power. On the facts the appeal court said that there was no basis to interfere with the judge’s finding that the respondent’s actions in its self-interest to protect its existing claims amounted to bad faith.

The focus on a motive that is “ulterior” and the recognition of its rarity and difficulty of definition is, on one view, similar to the reasoning of Vos C In re Dee Valley Group plc [2017] 3 WLR 767, which decision held that a meeting convened under Part 26 was a court meeting under the control of the court and that, as such, the court had power to discount votes split for numerosity purposes to defeat an otherwise proper scheme of arrangement. In that case, the employees who opposed a takeover had acquired and split a small shareholding to defeat the takeover scheme because they did not consider it in their interests as employees. Vos C said, at [43] and [47]:

“[The Court] is then deciding, amongst other things, first whether the statutory pre-requisites have been fulfilled, and secondly whether the class attending the meeting the court called was fairly represented by those attending the meeting, whether the statutory majority were acting bona fide and not coercing the minority in order to promote interests adverse to those of the class they purport to represent. It is quite clear from that exercise that the court is indeed concerned with those matters in sanctioning a scheme. The clue as to what members are supposed to be doing in voting at the court’s class meeting is also, I think, to be found in that second well-established formulation. The members are supposed to be fairly representing their class, and acting bona fide, and not...
Restructuring proceedings in England have not tended to encourage trials to determine contested issues. This may need to change

coercing a minority in order to promote interests adverse to the class they purport to represent.

... I have therefore concluded that members voting at a class meeting directed by the court must exercise their power to vote “for the purpose of benefiting the class as a whole, and not merely individual members only”: see Viscount Haldane’s formulation in the British America Nickel case. I am not sure that the gloss suggesting that members at such a meeting must not vote for extraneous reasons is helpful. The key is that the members of the class must vote in the interests of the class as whole and not in their own specific interests if they are different from the interests of the class. I turn under the next heading to consider when a vote might be held to contravene this requirement.”

On the facts, Vos C held that the “only” explanation for the employee shareholders’ vote was their interest as employees, not as shareholders. He said, at [58]:

“[T]he only possible explanation for the conduct of the Individual Shareholders was to further a share manipulation strategy to defeat the Scheme by use of the majority in number jurisdictional requirement. The actions of the Individual Shareholders in accepting the gift of a single share in the circumstances I have described demonstrated that they could have given no consideration to the interests of the class of members which they had joined. They can only have joined that class with the pre-conceived notion of voting down the Scheme.”

The result in Dee Valley makes for an interesting comparison with Figter. The defensive acquisition of shares and vote splitting was, on the evidence, sufficient to support an inference of a purpose adverse to the class interest in Dee Valley. It was not so in Figter, despite the respondent having paid 100c$/S for the claims acquired, thus negating any possible commercial explanation for the purchase other than to defensively block the exercise of the cram down power. The difference in result is in large part likely the result of the view, explicit in the reasoning in Figter, that in an inter-class context there should be greater tolerance of self-interested action. In comparison, Dee Valley and the line of cases relied on, dating back to British America Nickel Corpn Ltd v MJ O’Brien Ltd [1927] AC 360, are all cases of intra-class conflict in which the defined class interest should be given priority. The Chapter 11 cases therefore serve to highlight that the English court should not uncritically borrow from the case law under Part 26 to develop appropriate controls for Part 26A. The case law under Part 26A might therefore rationally develop to permit the sort of defensive acquisition of claims allowed in Figter.

One difficulty in this area, however, is that traditionally proceedings for a restructuring in England have not tended to encourage the possibility of trials to determine contested issues of fact, as that would delay the outcome of the restructuring. If, however, controls are to be placed on the ability of creditors to buy up claims to frustrate a restructuring or which require a more detailed assessment of the reasons for structuring the classes in the manner proposed, this may need to change.

Cram down upon approval by the Court

Section 901F(1) quoted above is subject to section 901G, pursuant to section 901F(2)(a). Section 901G contains the means to cram down a dissenting class. It relevantly provides:

“(1) This section applies if the compromise or arrangement is not agreed by a number representing at least 75% in value of a class of creditors or (as the case may be) of members of the company (“the dissenting class”), present and voting either in person or by proxy at the meeting summoned under section 901C.

(2) If conditions A and B are met, the fact that the dissenting class has not agreed the compromise or arrangement does not prevent the court from sanctioning it under section 901F.

(3) Condition A is that the court is satisfied that, if the compromise or arrangement were to be sanctioned under section 901F, none of the members of the dissenting class would be any worse off than they would be in the event of the relevant alternative (see subsection (4)).

(4) For the purposes of this section “the relevant alternative” is whatever the court considers would be most likely to occur in relation to the company if the compromise or arrangement were not sanctioned under section 901F.

(5) Condition B is that the compromise or arrangement has been agreed by a number representing 75% in value of a class of creditors or (as the case may be) of members, present and voting either in person or by proxy at the meeting summoned under section 901C, who would receive a payment, or have a genuine economic interest in the company, in the event of the relevant alternative.” (Emphasis added.)

An entire dissenting class can therefore be bound by the compromise or arrangement provided that (A) no member of that dissenting class would be worse off than they would be in the likely relevant comparator; and (B) at least one ‘in the money’ class votes for the scheme.
The drafting of sections 901F and 901G means that the satisfaction of the above conditions does not mandate the exercise of the discretion of the Court. The conditions in section 901G regulate the power of the Court to approve the compromise or arrangement but do not compel the exercise of that power. Accordingly, a critical question unresolved by the legislation is what standard the Court should develop to regulate the exercise of its discretion. For instance, if Condition A is satisfied, should there be a presumption that the Court should sanction the compromise or arrangement, as it has, on that premise, been established that the dissenting class is no worse off than in the comparator? Notwithstanding the satisfaction of Condition A, can the dissenting class nonetheless successfully oppose sanction, for example because the terms of the proposal allow value to be ceded to a lower ranking class such as shareholders? These and other questions will require the Court to formulate the standard which it is to apply to govern the exercise of its discretion.

Is there room for the honest, reasonable and intelligent creditor test?

The test of fairness fashioned by the Victorian judges and received into the modern era under Part 26 is a test of rationality. It postulates a hypothetical honest, intelligent and reasonable member of the class to be bound by the scheme and asks whether such a member could approve the scheme. In the event of a representative majority vote, the Court will presume rationality and thus fairness; hence, the expression that the Court should be “slow” to differ from the view of the scheme expressed by a representative majority vote. The presumption does not mean the Court is a rubber-stamp and will not apply its own mind to the question of fairness. It means that the Court will recognise that creditors are usually the best judge of their own interests and give weight to their views in assessing the view of the hypothetical honest, intelligent and reasonable member of that class.

So assessed, it is readily apparent that the test of fairness developed in the existing scheme case law is manifestly inadequate as a test of whether it is fair to cram down a distinct, dissenting class. Whatever test should be fashioned it must be capable of sensible operation even if all members of the dissenting class should vote against the scheme. A test based on the view of a hypothetical honest, intelligent and reasonable member of the class in question makes no sense when all members of that class may have dissented. Part 26A is a new set of provisions intended to achieve outcomes that could not be achieved under Part 26, and the Court is likely to recognise that, much as it recognised that it was not appropriate in all cases to burden the 1986 legislation with the intellectual freight of previous regimes.

No substantial guidance is to be found in other related lines of English case law because, although the amorphous standard of “just and equitable” has been in the Companies Acts since before 1862, it has always been applied on the facts and has resisted definition. In Re Wear Engine Works Co (1875) LR 10 Ch App 188, James LJ said, at 191: “[T]he equity must be founded on facts alleged in the petition.” In the context of a winding up this has been taken to mean that whether it is “just and equitable” that a company should be wound up is “an inference of law from the facts of the situation”. French,
The power to reject a plan if it is not fair and equitable and the governance of corporate insolvency. Section 93(8) defines “fair” as follows:

“The court will still have an absolute discretion whether to sanction the [restructuring plan] and may refuse to sanction it if it is just and equitable to do so.”

Notwithstanding the lack of definite content to the expression “just and equitable” (and its “shorter modern equivalent” “fair”), it is this form of words that the Government alleged upon in its ‘fact sheet’ on 5 June 2020 and in the explanatory notes to the bill introduced to Parliament:

“The court has an absolute discretion whether to sanction the [restructuring plan] and may refuse to sanction it if it is just and equitable to do so.”

“The court will still have an absolute discretion whether or not to sanction a restructuring plan, and may refuse sanction on the grounds that it would not be just and equitable to do so, even if the conditions in section 901G have been met.”

And, at p.26, §9.32:

“A restructuring plan will be considered fair and equitable if the following conditions are met:

• all creditors will be no worse off than in liquidation;
• secured creditors will be granted absolute priority on repayment of debts; and
• junior creditors should not receive more on repayment than creditors more senior than them.”

This proposal had the merit of clarity but little else. If enacted it would have required the imposition of plan based on a liquidation value, even if the probable comparator was not a liquidation but, for instance, a relatively better outcome in an administration.

The Government’s initial paper was however not committed to the view expressed in the above-quoted passages because, in later passages (p.27, §9.35) the suggestion appears to have been that the liquidation value should merely function as a necessary but not sufficient condition to a “fair and equitable” plan:

“Valuations in a restructuring can be particularly contentious and numerous valuations are used in different situations (for example going concerns, fair market, break up and liquidation). For this proposal, the Government is considering legislating for the use of a minimum liquidation valuation, so when determining the value of interests in a restructuring plan, impaired classes should receive at least what they would have received in a liquidation situation. This provides flexibility for the use of other methods of valuation where appropriate, whilst providing a minimum liquidation valuation as part of the court’s ‘fair and equitable’ determination of the plan.” (Bold text in italics in the original text.)

In developing its thinking, the Government appears to have heeded the concerns about a sole liquidation comparator. See, in particular, its response to the consultation (pp.73–74, §5.169–5.176) and in the House of Commons Library briefing in December 2019. In those documents,
the Government defined the comparator in terms of “the next best alternative”, referencing administration as an outcome that was an alternative to a winding up. In its response to the consultation, it wrote:

“The Government agrees administration would often be a likely outcome were a plan to be rejected, and notes the minimum liquidation valuation basis would allow a valuation based on administration (as the valuation is a minimum, not a ceiling). However, this nuance may be lost and a lower liquidation valuation might be used instead. The Government has concluded that the next best alternative for creditors if the restructuring plan was not to be agreed is the best alternative valuation basis.

The next best alternative for creditors is a flexible protection, as it will fit the circumstances of the particular case in question. Administration will often be the next best alternative for creditors, but in some cases administration might not be a realistic option. Meaning liquidation is the only alternative that can be used. In the event of challenge, the court will decide, based on the evidence put before it, what the next best alternative is.” (Emphasis added.)

What amounts to “the next-best-alternative scenario in the absence of a plan” is, therefore, a concept that rightly admits of a going-concern valuation as a possibility to be established on the evidence. It is however likely to prove to be a lightning rod for litigation under Part 26A.

The protracted litigation of valuation disputes within a restructuring process may not be a welcome development. Its advantage is certainty at the very end of the process, if the plan should be approved; however, it is likely to protract the process itself with attendant increases in expense and decreases in the certainty of a successful outcome. A concern about the new regime is the encouragement of more sophisticated valuation disputes. The Chancery Judges’ response to the Government’s initial proposal said frankly (at §23): “We express apprehension whether the courts have either the resources or the procedures to resolve these issues.”

Chapter 11 was, in contrast, drafted with a different mindset. It is a set of rules purposefully designed to influence the negotiating position of the interested parties and, as such, is prepared to litigate the issues of central importance to those interests. As explained in 1979 by Kenneth Klee, one of the principal draftsmen of Chapter 11:

“In some cases, agreement with each class will not be reached and the plan may only be confirmed over the dissent of a class of claims or ownership interests – the ‘cram-down’ power. In those cases special rules apply to protect dissenting classes of secured claims, unsecured claims, and ownership interests. While these rules will be important in the context of confirmation of a plan when a class dissents, one of the hypotheses of the Code is that the rules will also affect the negotiating posture of the debtor and creditors with respect to formulation of a plan. Hence, an ancillary effect of the cram-down rules will be to produce a plan which all classes will accept voluntarily.” (Emphasis added.)

Chapter 11 and its willingness to embrace valuation disputes was, and remains, a positive attribute from the perspective of a set of rules intended to incentivise the interested parties to negotiate a solution for themselves. This point has been impressed upon us in our discussions with those with direct experience of Chapter 11. It may therefore be the wrong perspective in the long run for the court to be reluctant to engage with and develop appropriate principles and practices to resolve disputes as to value and the appropriate comparator.

Notwithstanding the prospect of development in the future, it is likely in recognition of the potential teething problems with the new regime that the Government has enacted Part 26A as a separate, parallel regime to Part 26, rather than as a replacement.

The need for caution in this regard is reinforced by the prospect of the classification of the new regime as an insolvency proceeding with implications for its EU-wide recognition outside the Recast Insolvency Regulation. Part 26A restructuring plans are likely to obtain extra-territorial effect through a combination of recognition under UNCITRAL Model Law implementations and the fact that choice of law rules globally tend to accept the validity of a contractual discharge or variation where the law of the restructuring aligns with the law of the debt that is restructured. A potential future additional recognition tool is the combination of a Part 26A restructuring plan and a pre-pack Chapter 11 plan, the former providing the framework for the latter.

What is the next best alternative comparator?

The next-best alternative comparator is not too far removed from the existing law. The relevant comparator for the purpose of a scheme of arrangement is the likely (counter)factual scenario if the scheme should not be approved. That is a question of fact to be determined in all the circumstances. The company might well assert a particular scenario on the evidence it puts before the court. It is up to creditors to dispute that asserted scenario if they should so wish and to evidence an alternative. In either scenario, the relevant questions of valuation will fall to be determined on evidence consistent with the premises or assumptions of the rival scenarios.
Within this framework, there is no conceptual limit as to what evidence may be admitted save that it must be probative of the issue in dispute and, if expert opinion evidence, justified in the light of the cost of that particular form of evidence.

The present approach to the comparator and to the related issue of valuation has attracted the criticism that English law lags the jurisprudence under Chapter 11 as to its recognition of how value can and should be assessed. These criticisms appear to fall into two categories: (i) English courts are not familiar with particular valuation techniques; and (ii) English law is close-minded in failing to recognise that enterprise value should be assessed on the going concern premise of the success of the plan in question or, at least, of a plan that would be passed but for the plan at issue.

The first of these criticisms is not well founded. Bluebrook is one example in the reported cases of the court receiving and assessing multiple forms of valuation evidence, whether based on actual sales processes, a comparable EBITDA analysis or a DCF. If one were to search LexisNexis or Westlaw in these respects, there are dozens of such cases. English judges are entirely familiar with resolving valuation disputes and assessing the appropriateness of particular discount factors and other components of valuation evidence. This is all part and parcel of a fact and evidence-based approach to valuation.

Of greater moment is whether the relevant comparator can be the success of the scheme or of another proposal that might be agreed but for the scheme in question. This is a matter of intense interest, in particular to junior ranking creditors whose interests lie in a maximal enterprise valuation.

This debate is not wholly new and has been canvassed to some extent in My Travel and Bluebrook. The principal difficulties with an enterprise value based on another proposal are, first, a sufficient level of support for the proposal at hand or, at least, a sufficient level of support against any counterproposal; and, secondly and relatedly, the need for that alternative proposal to articulate and explain its own comparator. These objections have force.

The wording of Part 26A, section 901G appears to preclude a comparator based on the success of the very compromise or arrangement under consideration:

“(4) For the purposes of this section “the relevant alternative” is whatever the court considers would be most likely to occur in relation to the company if the compromise or arrangement were not sanctioned under section 901E.” (Emphasis added.)

This limitation in Part 26A appears to acknowledge, in particular, the Chancery Judges’ response to the Government’s initial proposal, which response indicated that the judges would be inclined against speculative, going-concern values based on the success of the plan itself. The Chancery Judges said (at §63):

“The approach we suggest based upon the counter-factual if the Plan is not approved would, we believe, also mark a principled difference to the approach under Chapter 11 in the US, where the courts frequently entertain contentious and often speculative evidence as to the value that the company will have if the Chapter 11 plan succeeds. This approach has been rightly criticised as enabling creditors and even shareholders who are “out of the money” to claim what (at least on the basis of the prevailing English cases) is an unwarranted benefit in the restructuring negotiations.”

(Underlining in the original text.)

In the light of the Part 26A restriction upon a comparator based on the success of the scheme at hand and the apparent reasons for that limitation described above, any argument that the relevant comparator is some other compromise or arrangement would have to overcome these apparent hurdles. That prospect is not however ruled out by Part 26A, in particular given the reference in subsection (4) to what would be likely to occur if “the compromise or arrangement” were not sanctioned. Whether and in what circumstances such a comparator can be advanced is likely to be one of the most interesting issues under the new regime. We consider this further below in connection with the potential to ‘cram up’ a class of senior creditors.
Fair and equitable
Returning to the question of what standard of fairness the court might develop, given the silence of Part 26 on the question and the Government’s apparent decision not to give further guidance in the form of a UK statement of a ‘flexible’ absolute priority rule, the English court might again find assistance from an analysis of the Chapter 11 caselaw, as well as its own caselaw developed in the context of CVAs.

Chapter 11 and its specific safeguards
As above, before descending into the Chapter 11 cases, it is useful to examine the statutory framework. §1129(b)(1) provides that

“If all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.”

§1129(a)(8) requires that:

“With respect to each class of claims or interests—

(A) such class has accepted the plan; or

(B) such class is not impaired under the plan”.

The standard imposed by §1129(b)(1) is, therefore, a safeguard for those who have rejected the plan or who are deemed bound by it.

§1129(b)(2)(A) provides that for a plan to be “fair and equitable” for secured creditors it must include provision for, inter alia, the secured creditors to retain their liens, for those liens to attach to the proceeds to any sale to the value of those secured claims, or for the realisation of “the indubitable equivalent of such claims”.

§1129(b)(2)(B) provides that a plan is “fair and equitable” with respect to a dissenting impaired class of unsecured creditors if the creditors in the class receive or retain property of a value equal to the allowed amount of their claims or, failing that, no creditor of lesser priority, or shareholder, receives any distribution under the plan. In terms §1129(b)(2)(B)(ii) requires that “the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.”

At first blush therefore, Chapter 11 provides little guidance as to how English judges might develop a workable standard of fairness to apply to compromises of arrangements under Part 26A, given that Part 26A lacks the detailed guidance provided by the text of Chapter 11.

The absolute priority rule, a codification of the common law
However, as held by the US Court of Appeals for the Second Circuit in Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC) 478 F.3d 452 (2d Cir. 2007), which decision is considered further below, §1129(b)(2)(B)(ii) codifies the judge-made “absolute priority rule” which provided that any plan of reorganization in which “stockholders [a]re preferred before the creditor, [is] invalid.” see In re Armstrong World Indus., Inc., 320 B.R. 523, 533 (D. Del.), aff’d 432 F.3d 507 (3d Cir. 2005), quoting Northern Pacific Railway Co v. Boyd, 228 U.S. 482 (1913).

Northern Pacific Railway Co v Boyd was the third in a line of cases in the United States Supreme Court concerning transactions to recapitalise railroad companies. The previous cases, Railroad Co v Howard 74 US 393 (1868) and Louisville Trust Co v Louisville, New Albany & Chicago Railway Co 174 US 674, (1899) had concerned receivships in which the former owners had acted with the senior secured creditor to sell the assets to a new company, which they controlled, on terms that eliminated the unsecured debt. Railroad Co v Howard held that the sale was fraudulent as against general creditors not secured by the mortgage because if there had been an ordinary foreclosure independent of the arrangement between the mortgagees and the stockholders, the whole proceeds of sale would have belonged to the mortgagees and would not, in that scenario, have been shared in by the shareholders of the old company. The opinion of the Supreme Court was delivered by Justice Clifford, who said (at pp.409-411):

“...Equity regards the property of a corporation as held in trust for the payment of the debts of the corporation, and recognizes the right of creditors to pursue it into whosesoever possession it may be transferred, unless it has passed into the hands of a bona fide purchaser, and the rule is well settled that stockholders are not entitled to any share of the capital stock or to any dividend of the profits until all the debts of the corporation are paid...”

Creditors are preferred to stockholders on account of the peculiar trust in their favor and because the latter, as constituent members of the corporate body, are regarded as sustaining, in that aspect, the same relation to the former as that sustained by the corporation” (Emphasis added.)

In the factually similar case of Louisville Trust case, the Supreme Court amplified its expression of the absolute priority rule. In its opinion delivered by Justice Brewer, the Supreme Court said, at pp.683-684:

“Assuming that foreclosure proceedings may be carried on to some extent, at least, in
the interests and for the benefit of both mortgagee and mortgagor (that is, bondholder and stockholder), we
observe that no such proceedings can be rightfully carried to consummation which recognize and preserve any interest in the stockholders without also recognizing and preserving the interests not merely of the mortgagee, but of every creditor of the corporation. In other words, if the bondholder wishes to foreclose and exclude inferior lienholders or general unsecured creditors and stockholders, he may do so; but a foreclosure which attempts to preserve any interest or right of mortgagor in the property after the sale must necessarily secure and preserve the prior rights of general creditors thereof. This is based upon the familiar rule that the stockholder’s interest in the property is subordinate to the rights of creditors — first of secured and then of unsecured creditors. And any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation.” (Emphasis added.)

In Northern Pacific Railway Co v Boyd, the Supreme Court further clarified that the absolute priority rule operated “even in the absence of fraud”. In an opinion delivered by Justice Lamar, the Supreme Court said, at pp 504–505:

“For, if purposely or unintentionally a single creditor was not paid or provided for in the reorganization, he could assert his superior rights against the subordinate interests of the old stockholders in the property transferred to the new company. They were in the position of insolvent debtors who could not reserve an interest as against creditors. Their original contribution to the capital stock was subject to the payment of debts. The property was a trust fund charged primarily with the payment of corporate liabilities. Any device, whether by private contract or judicial sale under consent decree, whereby stockholders were preferred before the creditor, was invalid. Being bound for the debts, the purchase of their property by their new company for their benefit put the stockholders in the position of a mortgagor buying at his own sale. If they did so in good faith and in ignorance of Boyd’s claim, they were nonetheless bound to recognize his superior right in the property when, years later, his contingent claim was liquidated and established. That such a sale would be void, even in the absence of fraud in the decree, appears from the reasoning in Louisville Trust Co.” (Emphasis added.)

The corporate trust doctrine that underlies part of the reasoning in these decisions has no parallel in English law. Although English law has used the law of trusts and trustees to develop by analogy the duties of directors, English judges recognised relatively early on in the development of English company law that a company owned its own property and was not a trustee for its members or creditors (see, e.g., Re Lands Allotment Co (1894) 1 Ch 616 at 631 per Lindley LJ, and Belmont Finance Corp v Williams Furniture Ltd (No 2) (1980) 1 All ER 393 at 405 per Buckley LJ). There is nonetheless a strong parallel between the emphasised words above and the common law doctrine of fraudulent preference developed by Lord Mansfield. He stated the law in Alderson v Temple (1768) 4 Burr. 2235, 2239–2240:

“All acts to defraud creditors or the public laws of the land are void; and if the nature of the act be a conveyance or grant, ‘tis not only void, but an act of bankruptcy.’ It has been determined ‘that a conveyance by a trader, of all his effects, for the payment of one or more bona fide creditors of the most meritorious kind, though his effect do not amount to half what is due, is void; because it is not an act in the ordinary course of business; it is not such an act as a man could do, but it must be followed by an immediate act of bankruptcy, and it is defeating the equality that is introduced by the Statutes of Bankruptcy, and the criminal (for the bankrupt is considered as a criminal) is taking upon himself to prefer whom he pleases.’” (Emphasis added.)

So described, the “fraudulent” aspect of the “absolute priority rule” at common law was the voluntary act to defeat the result intended by the Statutes of Bankruptcy. It involved no actual fraud by the debtor, just as the violation of the absolute priority rule described in Northern Pacific Railway Co v Boyd involved no actual fraud.

Accordingly, in each system of law, the priority accorded to creditors against shareholders, and the equality as between creditors, are derived from the antecedent rights that are respected in a distribution under statute in a winding up or in a bankruptcy. Unsecured creditors rank ahead of shareholders because shareholders’ rights under the statutory contract are limit shareholders’ entitlements to a share of any surplus against creditors in a winding up. Unsecured creditors have equal entitlements in a winding up because each has a right in personam against the debtor and all such rights are subject to the collective execution in a winding up. It is not for the debtor acting alone (Lord Mansfield’s fraudulent preference) or in combination with a senior creditor (Justice Clifford’s conveyance in breach of the corporate trust) to defeat those rights which statute has said are to be respected in a bankruptcy or winding up.

The absolute priority rule is not, therefore, as alien as might first appear. Its importance lies in the recognition that a plan that conforms to the absolute priority rule is, in general, considered to be “fair and equitable”, whereas a plan that deviates from that rule is unlikely to be confirmed.

In Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC) 478 F.3d 452 (2d Cir. 2007), the US Court of Appeals for the Second Circuit ruled that the most important consideration in determining whether a pre–plan settlement of disputed claims should be approved as being “fair and equitable” is whether the terms
of the settlement comply with the Bankruptcy Code’s distribution scheme.

The appeal concerned the lower court’s approval of a pre-plan settlement between the official committee of the unsecured creditors, on the one hand, and the secured lenders, on the other hand. The settlement accepted the secured creditors’ liens and distributed the estate’s cash to the lenders and to a litigation vehicle set up to sue Motorola. Motorola – a priority creditor – objected to the settlement on the grounds that it took a portion of the estate’s property and distributed it to lower priority creditors (i.e. the litigation vehicle and the unsecured committee) before any payments were made to Motorola (p.462):

“Motorola claims that a settlement can never be fair and equitable if junior creditors’ claims are satisfied before those of more senior creditors.”

In response, the court said (p.465):

“In the Chapter 11 context, whether a settlement’s distribution plan complies with the Bankruptcy Code’s priority scheme will often be the dispositive factor. However, where the remaining factors weigh heavily in favor of approving a settlement, the bankruptcy court, in its discretion, could endorse a settlement that does not comply in some minor respects with the priority rule if the parties to the settlement justify, and the reviewing court clearly articulates the reasons for approving, a settlement that deviates from the priority rule.” (Emphasis added.)

However, the court was careful to observe that the case before it was a pre-plan settlement in which many variables, including the rights that claimed priority, were disputed and uncertain. In that context, which was distinct from a confirmation hearing under Chapter 11, the court said:

“It is difficult to employ the rule of priorities in the approval of a settlement in a case such as this when the nature and extent of the Estate and the claims against it are not yet fully resolved. In our view, a rigid per se rule cannot accommodate the dynamic status of some pre-plan bankruptcy settlements.”

On the facts, the court held that the departure from the absolute priority rule was justified to fund the litigation but that it was not justified in respect of the distribution of a residual amount to the unsecured creditor committee. In respect of that residual amount, the court remitted the matter to the lower court for further assessment. The absolute priority rule was so important that a minor deviation from it in a pre-plan settlement required remission for specific explanation.

So assessed, the significance of the Motorola case for present purposes is its recognition that, provided the priorities are clearly established, adherence to those priorities by the terms of a plan will “often be the dispositive factor”. This emphasis is underlined by the actual decision in the case, which required specific and sufficient justification for any deviation.

The observations in the Motorola case are not far removed from the description of the vertical comparator test developed in the context of CVAs. “Vertical comparison is with the position on winding up (or, in the case of individuals, bankruptcy)”15. Prudential Assurance Co Ltd v PRG Powerhouse Ltd [2007] BCC 500, at [75]. Of this comparator, Etherton J, continued, at [81], to approve David Richard J’s statement of the law in his judgment in Re T & N Ltd [2005] 2 BCLC 488, at [82]:

“While I am wary of laying down in advance of a hearing on the merits of any scheme or CVA any particular rule, there is one element which can be mentioned at this stage. I find it very difficult to envisage a case where the court would sanction a scheme of arrangement, or not interfere with a CVA, which was an alternative to a winding up but which was likely to result in creditors, or some of them, receiving less than they would in a winding up of the company, assuming that the return in a winding up would in reality be achieved and within an acceptable time-scale.” (Emphasis added.)

Of this statement, Etherton J said, at [82] of his judgment in Powerhouse:

“A linked principle is that, on an application under LA 49, s.6, it is not for the court to speculate whether the terms of the proposed CVA were the best that could have been obtained, or whether it would have been better if it had not contained all the terms it did contain.” (Emphasis added)

The principles are “linked” because the Court should not speculate as to what the “best” or “better” arrangement might have been proposed if the arrangement in fact approved does confer a non-speculative benefit relative to.
to that in a liquidation. The satisfaction of the vertical comparator test is, for this reason, often dispositive of an unfair prejudice challenge in the context of CVA.

Whilst care is needed in relying on CVA cases in which liquidation is the relevant vertical comparator (as it is expressly not the necessary comparator under Part 26A), both the CVA cases and the Chapter 11 absolute priority cases suggest that the Court might usefully bring greater certainty to the operation of Part 26A by developing a rule to the effect that a compromise or arrangement that respects the basic scheme of priorities in the relevant comparator is presumptively a fair one.

The converse is implied, as is apparent from the CVA cases also. A divergence from the basic scheme of priorities in the relevant comparator is one that must be sufficiently justified. Etherton J said, at [83]–[90] (with reference to Ferris J’s earlier decision in Re a Debtor (No.101 of 1999)) that:

“Differential treatment, which is not assented to by a creditor who considers that he has been less favourably treated, may well give cause for an enquiry, but it does not necessarily prove unfair prejudice.”

Differential treatment may also be necessary to secure the continuation of the company’s business which underlies the voluntary arrangement, for example where it is necessary to pay suppliers in full in order to ensure that the company can continue to trade.”

The recognition that differential treatment might be permitted “where it is necessary” chimes with certain of the Government’s observations. In its response to the consultation, the Government wrote (at §5.164–5.165):

“The Government wants to inject flexibility into the APR, given the criticisms of US Approach. The ability to act flexibly and pragmatically are not just desirable features in a restructuring procedure, but essential ones if the framework is to facilitate business rescue. The Government intends to permit the court to confirm a restructuring plan even if it does not comply with this rule where noncompliance is:

• necessary to achieve the aims of the restructuring; and

• just and equitable in the circumstances.”

This two-stage test for permitting non-compliance creates a high threshold. The basic principle that a dissenting class of creditors must be satisfied in full before a more junior class may receive any distribution will, in most cases, be followed. But there is sufficient flexibility to allow departure from it (with the court’s sanction), where the departure is vital to agreeing an effective and workable restructuring plan. This will provide adequate protection for creditors while also achieving the best outcome for stakeholders as a whole.”

There is no explanation as to why this proposal has been dropped from Part 26A. It did not even make it into the bill. An explanation is that the Government took the view that, as indicated above, there is ample legal material for the court to act to fashion an appropriately principled and flexible standard.

To conclude this section, an example of a derogation from the basic rule of priorities that might prove acceptable is the allocation of an equity interest to the existing shareholders whose efforts are required for the successful future operation of the restructured business, notwithstanding the impairment of junior creditors. This is, on its face, a breach of the absolute priority rule and it would fail the vertical comparator test unless sufficiently justified. A potential justification is that the equity is gifted from what would otherwise have been the senior creditors’ share, and this analysis has been adopted in previous scheme of arrangement cases. So far as Chapter 11 is concerned, in Official, Unsecured Creditors’ Comm. v. Stern (In re SPM Mfg. Corp.), 984 F.2d 1305, 1307, 1312 (1st Cir. 1993) in a Chapter 7 case, the First Circuit accepted the proposition that “if the cash on hand...was perfected collateral of the Secured Lenders for valid debt, the Secured Lenders had the right to dispose of such cash in any manner that they chose so long as the cash did not exceed the debt owed to the Secured Lenders.” In Motorola, the Second Circuit declined to rule on whether SPM could be relied on in a Chapter 11 case to derogate from the absolute priority rule. The rule in SPM is however, in its effect, the equivalent to the rule in In re Tea Corp Limited described above. From the perspective of the English court, such a derogation is therefore likely to prove less controversial than has been the case in Chapter 11. The hard case will be the justification of an equity allocation to former shareholders in circumstances in which the senior creditors are not prepared to gift that value from what would otherwise have been their entitlement and it is instead to be taken from value that might otherwise be enjoyed by junior creditors.

Cram ups of senior creditors by junior creditors?

To explore the potential for Part 26A to change the practice of UK restructuring, we end by considering certain forms of proposal likely to be of interest in the post–COVID–19 world and which would be likely to prove difficult to implement using the current range of restructuring tools. In particular, in what circumstances can the company or its junior creditors impose a plan on the senior creditors in order to sustain the company until its economic recovery is complete?
Cram up plans under Chapter 11 involve the restructuring of secured debt without the lenders’ consent by repaying the debt in full over time. There are two common forms of cram up plans. The first is a reinstatement of the pre-default terms by a deemed cure of the events of default and the reversal of any acceleration. The second is a restructuring of the pre-default terms to provide different terms albeit terms that the court is satisfied have “indubitable equivalent” value. The first technique is attractive in circumstances in which a debtor considers that market interest rates will rise relative to the terms of the existing secured financing. In contrast, if interest rates are likely to remain low for the longer term, it is in the interests of the debtor to compel lenders to refinancing using interest rates that are lower than the existing applicable rate. Which kind of cram up the debtor or junior creditors might wish to implement is, accordingly, likely to be sensitive to how interest rates are likely to play out in the longer term in the light of the stimulus measures in response to Covid-19. An important initial question for UK lawyers, therefore, is whether Part 26A permits a cram up in the forms recognised under Chapter 11. This question is considered below first by the assessment of what a cram up under Chapter 11 involves and, secondly, by a review of Part 26A.

Reinstatement cram up

§1124 of the Bankruptcy Code provides a description of the concept of impairment. §1124(2) includes the cure of default and reinstatement of maturity terms, and so on, within that description. The reinstatement of defaulted debt is, as such, expressly contemplated by Chapter 11.

In re Charter Communications, 419 BR 221 (Bankr SDNY 2009) is an example of a reinstatement cram up following the 2008 global financial crisis. The senior creditors were owed in excess of $11.8 billion and the reinstatement of the pre-default terms provided a saving in interest expense, relative to then current market rates, of $500 million. The plan was unsuccessfully opposed on the grounds that certain of the defaults were said to be non-curable and, thus, the proposed reinstatement not viable. The senior creditors argued, in particular, that (i) the company was over-indebted and so a re-set of the covenants would result in a second default immediately, and (ii) that the upstreaming of dividends to fund the interests payments under the re-set facility was not permitted and thus a second default was inevitable for that reason also.

The court disagreed with the senior creditors. It held that the relevant over-indebtedness covenant should be read as a present inability to pay covenant only, and it held further that, in the turbulent market of 2008 and 2009, it could not be said that the directors, based on the valuation advice they had received, could not up-stream the required cash to service the reinstated debt. On this basis, the court found that the defaults were curable. By emphasising the decision that the directors had to make as regards the upstreaming of cash, the court did not need to resolve the heavily contested enterprise value in dispute between the parties. Judge Peck said, at pp.235-236:

“Valuing a business such as Charter’s is neither simple nor objective, and no single generally accepted standard exists for measuring value. Valuation of an enterprise as complex as this one calls for using multiple approaches to value, comparing the business to be valued with others having similar characteristics, making appropriate adjustments and reasoning by analogy. The art of valuing a business requires the exercise of well-informed judgment.

... Depending on the weight given to the testimony of these witnesses, the Court could conclude that Charter’s business was worth more than $21 billion in November 2008 or as little as $35.4 billion in September 2009. The swing in value is major and hard to reconcile. The challenge in fairly valuing Charter is also illustrated by the fact that conflicting indications of value were offered by Charter itself.

... What this demonstrates is that valuation is a malleable concept, tough to measure and tougher to pin down without a host of explanations, sensitivities and qualifiers. Because point of view is an important part of the process, outcomes are also highly dependent on the perspectives and biases of those doing the measuring. When it comes to valuation, there is no revealed, objectively verifiable truth. Values can and do vary, and consistency among valuation experts is rare, especially in the context of high stakes litigation.

... Given the inherent unpredictability of future events and Charter’s multiple strategies for moving cash within the corporate family, it is not practical for a lender to declare a default based on what may seem to be well-founded presumptions as to the ability of a holding company to pay debts in the future. Those presumptions could well be wrong.”

In a related later part of the judgment, Judge Peck explained that, at p.247:

“There are sufficient facts presented here for the Court to defer to the Charter board... The board also reviewed information that sensitized the financial projections, utilizing substantially lower levels of assumed EBITDA growth, and still concluded that there would be sufficient surplus for a dividend... Given the foregoing, there is no showing of bad faith or fraud, and the Court will not substitute its judgment for that of the board.”

The margin of business judgement accorded to company directors under (in that case Delaware) company law thereby provided a means for the court to confirm the plan without resolving a difficult and contested valuation dispute. It is far from clear whether the English court would adopt such a technique in assessing whether defaults were curable as part of its assessment of the viability of a cram-up to reinstated pre-default financing terms. The English court is more likely to separate the construction of the financing terms from the directors’ duties and, as a consequence, have to resolve any valuation dispute.

Indubitable equivalent cram up

As explained above, §1129(b)(2)(A) (i) defines the concept of “fair and equitable” as regards a class of secured creditors to include: (i) the retention of their security (liens) and (ii) the receipt of deferred cash payments with a present value equal to the amount due, or equal to the value of the security, whichever is less. §1129(b) (2)(A)(iii) however provides for an alternative (“or”). “for the realization by such holders of the indubitable equivalent of such claims” The provision of the “indubitable equivalent” accordingly
allows for greater latitude as to what a cram-up might involve than the deferral of cash payments (with an equivalent present value to the original covenants) contemplated by §1129(b)(2)(A)(i).

In re DBSD North America Inc, 419 BR 179 (Bankr SDNY 2009) is an example of a cram up under §1129(b)(2)(A)(iii). The plan involved an injection of new money and was supported by the second lien creditors, whose prior second lien debt was to be equitized. It was opposed by the holder of the first lien debt. Under the plan the first lien debt was to be stripped of its (worthless) equity security and to be restructured under an amended facility with a four-year term and PIK interest at 12.5%. The amended terms negated all cash interest that would otherwise have been paid in the meantime to the first lien creditor. This freed up further working capital to fund the development and launch of a satellite.

The question for the court was whether the first lien creditor’s claim was protected to the same extent it was preconfirmation, in particular, as to the amount it was over-collateralized. Based on the enterprise valuation evidence before it, the court was satisfied that the assets securing the debt had an enterprise value six times the obligations due at maturity. The court further held that PIK interest at 12.5% was appropriate for a four-year term given the then prevailing low rate on US Treasury Bills. In explaining why the new rights amounted to an “indubitable equivalent”, Judge Gerber said:

“Although the developmental nature of the Debtors’ business and absence of present revenue would at first blush suggest uncertainty as to repayment under the Amended Facility, I find that the risk is not new, or increased, to warrant awarding DISH an interest rate higher than the one proposed under the Amended Facility. Rather, the risks associated with the Debtors’ business existed (to a substantially similar degree) at the time the original holders of the First Lien Debt entered into the Prepetition Facility and certainly in July 2009, when DISH purchased the First Lien Debt at par.

Most significantly, upon Plan confirmation, the Debtors will have deleveraged by over $600 million. The Plan currently contemplates that the Debtors will have $81 million in total debt at the Effective Date, and the total indebtedness can be projected to be in the range of $260 million by 2013. This major change in the Debtors’ debt load resulting from the Debtors’ reorganization considerably reduces the risk on First Lien Debt.”

On the question of valuation, and in contrast to the approach taken in In re Charter Communications above, Judge Gerber was required to make a finding of value based on his assessment of the rival experts and their opinions based variously on competing comparable and DCF analyses. He concluded:

“I find that the value of the reorganized Debtors’ business is in the range of $492 million to $692 million. That valuation provides the First Lien Lender with liens on assets that (on an enterprise valuation basis) are worth more than approximately 6 to 8.44 times the amount (approximately $82 million) that the First Lien Lender will be owed under the Amended Facility at maturity, based on the Debtors' lowest and highest estimated enterprise values, respectively.

That leads me to find, and I do find, that the First Lien Lender’s principal and interest will be safe over the next four years, and that the proposed interest rate for the Amended Facility is satisfactory.”

The DBSD case is therefore a useful example of a junior creditor-led cram-up which recapitalised a business and which required the court to assess the present value of that business in order for it to be imposed upon the senior creditors. There are many other examples, including as to the appropriate interest rate for restated senior debt, a live and lively question that is sensitive to the market for the debt in question and which has built up a substantial body of case law.

Cram ups under Part 26A?

As explained above, section 901G removes the bar on sanction under section 901F if one or more classes should dissent provided that (reversing the specified Conditions) (B) a class with a genuine economic interest in the relevant alternative votes for the proposal; and (A) no members of the dissenting class(es) “would be any worse off than they would be in the event of the relevant alternative”, which is: “whatever the court considers would be most likely to occur in relation to the company if the compromise or arrangement were not sanctioned under section 901F”

The words “if the compromise or arrangement were not sanctioned” likely exclude a comparator based on the success of the very proposal under consideration. As already explained above, those words do not however exclude as a matter
of language or logic other factual comparators that would support an enterprise valuation. The basic premise for a cram up of the kinds encountered in Charter Communications and DBSD, therefore, appears to be present within Part 26A.

The viability of a cram up as a matter of law is likely to turn on how narrowly or broadly the Court interprets the directions in Condition A that the members of the dissenting class should not be “any worse off”. If this is construed narrowly with the emphasis on “any”, the prospect of a cram-up is limited because even a reinstatement cram-up involves a change to the pre-default rights, reversing the existing rights to accelerate and enforce which have (and would remain) accrued in the relevant alternative.

Such a narrow construction is unattractive because it would dramatically diminish the potential utility of the new provisions, and presumably the Government intended to change the law to make a significant improvement to the UK restructuring regime, given that its spur was to improve the standing of the UK as compared to competitor regimes. This broader construction also finds support in the language and logic of the new provisions. The purpose of a “compromise” or “arrangement” is to vary the antecedent rights in some way, and the purpose of Condition A is to permit the Court to undertake an assessment of the varied rights relative to those antecedent rights in “the relevant alternative”. The product of that comparison is an overall judgement as to whether the member or members of the class in question are “any worse off than they would be in the relevant alternative”. The fact that the antecedent rights are changed is therefore the starting point for the enquiry towards that judgement, not the end point.

In more concrete terms, there is nothing in the expression “any worse off than they would be in the event of the relevant alternative” that is inconsistent with the conclusion in Charter Communications or that in DBSD. In the former case, the evidence as to the enterprise value entitled the Bankruptcy Court to conclude that the reinstated debt terms would be serviced by the debtor according to the reset covenants. In the latter case, the finding as to what the enterprise value was entitled the Bankruptcy Court to conclude that the first lien creditor would enjoy the same level of overcollateralization post-confirmation as pre-confirmation. On the findings made in each case, and as a matter of ordinary language, the secured creditor was not “any worse off”.

Conclusion

There may be a temptation, given the terms of certain parts of the Government’s initial explanation of its first proposals, to construe the legislation as an efficiency saving that permits a single process to achieve what might otherwise only be achieved by a scheme of arrangement and a pre-pack administration. There is however nothing in the legislation that confines it to the emulation of the result in Bluebrook and, indeed, the Government’s aim appears to have been much broader than a mere efficiency saving. Part 26A as enacted is far broader in its potential effect than the Government’s initial proposals.

Part 26A provides an opportunity for the English court and restructuring profession to develop restructuring proposals hitherto unseen in the English courts. Whether the new legislation will develop in this way will depend to a great extent on how the legislation is first received and explained by the court and to what extent the profession as whole is willing to accept a cultural change in which a proposal is advanced purposively to impose it on an entire dissenting class and, potentially, where that proposal is led by junior creditors against senior creditors.

Part 26A will provide challenges and opportunities for companies, creditors, the court and all restructuring professionals. The selection of issues considered above suggests that the existing tests and principles developed in the context of Part 26 may not be appropriate or adequate in the inter class context of a cram down. The development of new and appropriate principles is unlikely to be straightforward and, as with Chapter 11, the law itself may undergo amendments to fine tune the process.

The recent crisis brought on by the COVID-19 pandemic is likely to provide an immediate test of Part 26A and of the numerous potential ways in which it may reshape restructuring in the UK.
Ipso Facto Reform

Why now, and does it go too far (or not far enough)?

Felicity Toube QC and Georgina Peters consider the CIGA reform to *ipso facto* (termination) clauses
“England and the US are two countries united by the common law but divided by their approach to anti-deprivation principles.” When the late Gabriel Moss QC wrote these words in 2017, the world looked rather different. Robustness of commercial supply chains of toilet paper was not headline news. Legal debate on the UK’s ipso facto divergence from other jurisdictions centred on the flexibility of our anti-deprivation principle. Practitioner opinion was weighted in favour of the view that a US-style ban on ipso facto clauses in executory contracts would never be implemented in this jurisdiction – underscored by the generous approach of the courts to permitting contractual clauses which deprive the insolvency estate of assets and the firmly entrenched principle of freedom of contract into which English insolvency law had made the most limited of inroads.

Fast-forward to 2020. “Never say never” should be our current buzzphrase. A new law – the Corporate Insolvency and Governance Act (CIGA) – has been legislated at accelerated pace, and the COVID-19 pandemic has infected the debate. The CIGA contains an ipso facto ban with regard to supplier contracts. In this article, we summarise the amendments to existing law, consider the practical impact of the reform and issues likely to arise, and question the policy objectives underlying the change.

In particular, we ask whether the mindset has really changed, and if so why? We also consider whether the reform is really that radical: is it a timid extension of existing law, or a virulent interference with long-held contractual principles? And given the potential for sustained economic damage (absent significant government intervention), do age-old debates about interference with contractual freedom now look rather quaint, and can a principled case for the reform still be made?

**Ipso facto clauses**

At their simplest, ipso facto clauses apply on the occurrence of an insolvency event or on the potential insolvency of one party. They will either terminate the contract (constituting an event of default) or impose altered terms. Contractual termination may be automatic or (more usually) may occur at the other party’s election. *Ipso facto* clauses apply regardless of whether the distressed party has otherwise breached any contractual terms or remains capable of fully discharging its obligations, and are of widest import in executory contracts (contracts where either or both parties have outstanding performance obligations).

In the wake of the Lehman collapse, the courts (both UK and US) were presented with complex clauses found in finance agreements. However, *ipso facto* clauses do not just raise issues for large companies, but will be relevant for companies of any size. They will also relate to a whole range of supplies, including distribution rights, intellectual property, and insurance.

Plainly, these clauses work to the advantage of the terminating party and to the disadvantage of the party in financial distress. The terminating party can decide whether it wishes to become entangled in the affairs of the latter, or abandon the contract without concern. More particularly, the terminating party need have no concern about the consequences for the viability of its counterparty’s business, or for its survival.

*Ipso facto* clauses also pose significant challenges to formal insolvency processes. The insolvent company becomes vulnerable to ransom creditors (holding-out for payment of arrears) or loss of supply. The operation of these clauses can therefore undermine rescue efforts and (if supply is lost) may prevent the company from remaining operational.

Given the (usually adverse) effect of *ipso facto* clauses on the insolvent party’s ability to restructure and survive, many jurisdictions have prohibited (to a greater or lesser extent) the operation of the *ipso facto* clause. In particular, we find such prohibitions enshrined in the US insolvency laws: when the late Gabriel Moss QC wrote these words in 2017, the world looked rather different. Robustness of commercial supply chains of toilet paper was not headline news. Legal debate on the UK’s ipso facto divergence from other jurisdictions centred on the flexibility of our anti-deprivation principle. Practitioner opinion was weighted in favour of the view that a US-style ban on ipso facto clauses in executory contracts would never be implemented in this jurisdiction – underscored by the generous approach of the courts to permitting contractual clauses which deprive the insolvency estate of assets and the firmly entrenched principle of freedom of contract into which English insolvency law had made the most limited of inroads.

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**Sanctity of freedom of contract**

The main justification for protection of *ipso facto* clauses is that since at least the 19th century, it has been a fundamental principle of English law that parties are free to contract as they may think fit. In entering into contracts, parties have been free to decide when, and in what circumstances, the contract will come to an end: whether that is upon breach by one party of one or more of their contractual obligations, or simply by virtue of the fact that a given event or state of affairs comes to pass.

Two judicial statements, from 1874 and 2011 (at the highest appellate levels), show how firmly entrenched the principle of freedom of contract has been:

“...if there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by Courts of justice. Therefore, you have this
paramount public policy to consider – that you are not lightly to interfere with this freedom of contract” (Printing and Numerical Registering Co v Sampson5, per Sir George Jessel MR)

“Despite statutory inroads, party autonomy is at the heart of English commercial law … It is desirable that, so far as possible, the courts give effect to contractual terms which parties have agreed. And there is a particularly strong case for autonomy in cases of complex financial instruments such as those involved in this appeal” (Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd6, per Lord Collins) (emphasis added)

Current position

In this context, reform in 1986 and 2015 had been limited and incremental – and when a ban on ipso facto clauses was proposed in the standing committee stage of (what became) the Enterprise Act 2002, it was rejected.

Prior to the CIGA, the only restrictions were on insolvency–related terms in contracts for the supply of “essential goods or services” – being gas, water, electricity, communications services and certain other (identified) electronic supplies (e.g. Wi-Fi, and chip-and-pin devices). For these supplies:

- During the course of any insolvency procedure under the Insolvency Act 1986 (the IA), a supplier is entitled to make it a condition of continued supply that the officeholder personally guarantees payment of any charges (s 233(2)(a)), but cannot demand payment of pre-insolvency arrears as a condition of supply (s 233(2)(b))7.
- This was a 1986 reform instituted by the IA, to prevent suppliers holding officeholders to ransom (a threat to cut-off essential supply), and stealing a march on other creditors (even preferential) by demanding priority payment of pre–insolvency arrears in return for continued supply.

A first, limited, turning–point came in 2015. by the Insolvency (Protection of Essential Supplies) Order 20158, which introduced a new s 233A into the IA. Under that section:

- If a company enters administration or is subject to a CVA, “an insolvency–related term of a contract” for the supply of “essential” goods or services ceases to have effect (s 233A(1)). This includes a contractual provision triggered by the company entering administration or being subject to a CVA (s 233A(8)),

  (1) Providing for the contract or supply to terminate, or “any other thing to take place”,

  (2) Entitling a supplier to terminate the contract or supply, or “do any other thing”.

- It also includes a contractual provision which entitles a supplier to terminate the contract or supply “because of an event that occurred” before the company enters administration or a CVA takes effect (s 233A(8)). However, it does not include a term which entitles termination “because of an event that occurs, or may occur” after the company enters administration or a CVA takes effect (s 233A(2)(c)).

- There are two sets of carve–outs:

  (1) First, the supplier is still allowed to terminate the contract with the consent of the administrator or supervisor, with court permission, or if any charges for post–insolvency supply are not paid within 28 days

5. (1874-1875) L.R. 19 Eq. 462, 465.
6. [2012] 1 AC 383 (SC), [103].
7. Similar provision is made for cases of personal insolvency or an IVA under s 372 of the IA, primarily designed to stop utility providers blackmailing the trustee in bankruptcy or supervisor into paying pre–insolvency arrears.
8. (S.I. 2015/989), articles 2 to 4, implementing the Enterprise and Regulatory Reform Act 2013, ss 92 and 93.
9. Again, with a counterpart for IVAs (but not personal insolvency) under s 372A of the IA.
of becoming due (s 233A(3) and (4)). The test for court permission is that continuing the contract “would cause the supplier hardship”.

(2) Secondly, the supplier is still allowed to terminate the supply if the administrator or supervisor (upon written request) fails to give a personal guarantee of post-insolvency charges (being given a 14-day period to do so) (s 233A(3) and (5)).

- Significantly, the ban on s 233A clauses does not apply to contracts entered into before 1 October 2015 (when it was introduced).

As a move towards a US-style ban on ipso facto clauses, it was rather thin gruel. First, it was restricted to supplies which s 233 had deemed “essential”, focusing on utilities and electronic supplies. This ignored the fact that there will inevitably be other supplies that are “essential”, as a matter of fact, to continued operations that do not fall into the s 233 list. Secondly, suppliers were protected by their ability to demand a personal guarantee from the officeholder for post-insolvency charges (failing which the supply can be terminated), or where post-insolvency charges are not paid within 28 days of becoming due (in which case the entire contract can be terminated) – posing a risk to longer term rescue or restructuring strategies, where immediate liquidity is constrained. Thirdly (and most obviously), the limitation to administration and CVAs meant that ipso facto clauses were preserved in respect of companies going into liquidation.

New position

Reforms were proposed by the Insolvency Service in 2016, but they were limited. Rather than a blanket prohibition on termination clauses, an expansion of the scope of ss 233 and 233A was proposed – allowing a company in administration or subject to a CVA to designate as ‘essential’ any of its suppliers, by filing a notice to this effect with the court.

By 2018, however, it was clear from the Government’s response to its consultation that more radical reform was on the legislative agenda, and the CIGA goes much further than the proposed 2016 reforms.

Section 14 of the CIGA introduces a new s 233B into the IA, titled “Termination clauses in supply contracts: Protection of supplies of goods and services” – the ambit of which is far-reaching:

- In the first major departure from s 233A, it applies where a company enters any (existing) insolvency procedure under the IA (thereby including liquidation and provisional liquidation), and also applies where a company becomes subject to the two new procedures introduced by the CIGA: a Part A1 moratorium, and a restructuring plan under (new) Part 26A of the Companies Act 2006. It still does not apply where a company is subject to a scheme of arrangement.

- In the second major departure, it is not restricted to ‘essential’ goods and services, but applies generally to any contract for the supply of goods or services. It is not as extensive as the US prohibition, which applies to any executory contracts, and not simply those with suppliers.

Next (and using s 233A as the template):

- It contains a blanket prohibition on any (automatic or elective) termination clause continuing to have effect when the company becomes subject to the relevant insolvency procedure (s 233B(3)(a) and (b)). Specifically, one that:
  
  (1) Provides that the contract or supply would terminate, or “any other thing would take place”, because the company becomes subject to the insolvency procedure; or

  (2) Entitles the supplier to terminate the contract or supply, or “do any other thing”, again because the company becomes subject to the insolvency procedure.

- It also prohibits the supplier from exercising any contractual entitlement to terminate the contract or supply “because of an event occurring” before “the start of the insolvency period”, where the entitlement has arisen before the start of that period (s 233B(4)).

- The ‘insolvency period’ (for s 233B(4) purposes) is defined by s 233B(8) as beginning when the company becomes subject to the relevant insolvency procedure, and ending at the times identified by reference to each individual procedure.

- The carve-outs to the prohibitions are the giving of officeholder consent, company consent (in the case of a Part A1 moratorium, CVA or Part 26A restructuring plan), or court permission – the latter remaining subject to the test that “continuation of the contract would cause the supplier hardship” (s 233B(5)). If any one of these apply, the supplier is entitled to terminate the contract in accordance with its terms.

In addition, any supplier is now prohibited from making it a condition of continued (post-insolvency) supply that outstanding charges are paid (s 233B(7)): i.e. the ‘ransom’ issue which had been addressed by s 233 in relation to essential supplies.

By s 233C, the Government retains powers to amend the new provisions so as to (i) exclude any of the insolvency procedures identified in s 233B(2) (which are currently exhaustive of all possible procedures to which it might apply, save in relation to schemes of arrangement), and (ii) further
exclude certain kinds of company, supplier, contract, goods or services from s 233B, or remove any current exclusions (known as a Henry VIII power).

Despite its generality, there are already significant exclusions from the s 233B ban on termination clauses. These are:

- First, exclusions for those essential supplies which already fall within s 233A(1), and continue to be governed by that regime (in administration or a CVA) (Part 1 of Schedule 4ZZA to the IA).

- Secondly, exclusions for (debtor) companies or suppliers who are persons involved in financial services, enumerated in Part 2 of Schedule 4ZZA to the IA (paras 3 to 10) – meaning that the reforms will, for the most part, affect only trade creditors. The excluded entities include insurers, banks, electronic money institutions, investment banks and investment firms, payment institutions, recognised investment exchanges or clearing houses, and securitisation companies. The exclusions also extend to any company or supplier operating outside the UK, if the relevant activities would bring it within the Part 1 exclusions had they been done in the UK (para 11).

- Thirdly, exclusions where the termination clause forms part of a contract involving financial services, including financial contracts, derivatives, spot contracts, capital market arrangements, etc. (all identified in Part 3 of Schedule 4ZZA to the IA), or relates to the financial markets and set-off and netting exclusions which already receive protection in insolvency (Part 4 of Schedule 4ZZA)\(^1\).

- Fourthly, temporary exclusions for small suppliers (defined as a “small entity”). These exclusions will stay in effect until 30 September 2020 (s 15 of the CIGA), although indications from the Insolvency Service are that this time-limit is likely to be extended by the Government for a further period up to April 2021. At least two of the default conditions for being categorised as a small entity must be met in relation to the most recent financial year\(^1\), being: (i) turnover not more than £10.2 million; (ii) balance sheet total not more than £5.1 million; and (iii) employees not more than 50 (s 15(4), though there are modifications in relation to suppliers in their first financial year of trading).

What will it mean?

Although the provisions are modelled on the existing s 233A template, there are a number of elements which we expect will give rise to issues (or disputes) between the officeholder or company and its supplier:

- First, the prohibition on ‘any other thing’ taking effect if it is triggered by the insolvency (s 233B(3)) is extremely broad, but nevertheless leaves room for dispute as to its ambit. Obvious instances of ‘things’ caught by s 233B(3) would include altering the terms of the supply, compelling the insolvent party to make higher payments, or switching to payment on delivery. However, there are likely to be a raft of ambiguously drafted clauses in everyday supplier contracts which might (at least arguably) not be triggered by the insolvency procedure. We have in mind, in particular, where something is triggered by events connected with the insolvency, but not the company ‘becoming subject’ to the procedure itself.
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<td>• Extremely wide, small suppliers at increased risk in long-term</td>
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<tr>
<td>All supplies of goods or services</td>
<td>✗</td>
<td>✓</td>
<td>• Formal insolvency trigger, not actual insolvency – may lead to suppliers terminating pre-insolvency</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Puts onus on suppliers to monitor counterparties’ financial position, so not left with short time to act</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Suppliers may want earlier triggers in new contracts</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Suppliers at increased risk where no likely rescue and poor or no liquidity (e.g. liquidation) (subject to payment terms)</td>
</tr>
<tr>
<td>CVA or administration only</td>
<td>✓</td>
<td>✗</td>
<td>• Suppliers (other than essential) do not have this added protection</td>
</tr>
<tr>
<td>All insolvency procedures</td>
<td>✗</td>
<td>✓</td>
<td>• Court approach tbc, and Government guidance suggests strict approach to detriment of suppliers</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Unclear if factors relevant to insolvent party (as opposed to supplier) will be taken into account</td>
</tr>
<tr>
<td>Ability to terminate if post-insolvency charges not paid within 28 days</td>
<td>✓</td>
<td>✗</td>
<td>• Suppliers need to review existing contracts now</td>
</tr>
<tr>
<td>Ability to terminate if no personal guarantee</td>
<td>✓</td>
<td>✗</td>
<td>• Will catch wide range of modifications (e.g. concerns where group subject to single supply arrangement)</td>
</tr>
<tr>
<td>Ability to terminate with officeholder consent</td>
<td>✓</td>
<td>✓</td>
<td>• Potential for dispute as to when right to terminate arises</td>
</tr>
<tr>
<td>Ability to terminate with court permission (hardship test)</td>
<td>✓</td>
<td>✓</td>
<td>• Especially where continuing breaches, and/or cure period</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Extremely wide, will affect e.g. cross-default provision</td>
</tr>
<tr>
<td>Extends to termination, or “any other thing”</td>
<td>✓</td>
<td>✓</td>
<td>• What about serious breaches? e.g. breach for fraud or wilful default</td>
</tr>
<tr>
<td>Extends to termination for any pre-insolvency breach</td>
<td>✓</td>
<td>✓</td>
<td>• Suppliers need to review existing contracts now</td>
</tr>
<tr>
<td>Applies retrospectively</td>
<td>✗</td>
<td>✓</td>
<td>• Suppliers need to review existing contracts now</td>
</tr>
</tbody>
</table>
Secondly, it is notable that the ban extends to a contractual right to terminate because of any event occurring before the start of the insolvency period (s 233B(4)) or as a result of the company becoming subject to the insolvency process (s 233B(3)). In particular, if the pre-insolvency event gives rise to the contractual right to terminate, it does not matter whether or not the event is insolvency-related, as long as it occurred, and the entitlement to terminate was exercisable, before the start of the insolvency period (s 233B(4)). This might be thought to catch all relevant defaults. For example, not all non-payment is caused by insolvency but it will still be caught. Similarly, many breaches or events which give rise to an entitlement to terminate will be unconnected with the company’s insolvency (e.g. cross-default triggered by insolvency of a group company), but they will still be caught. Certain of these breaches may be serious, such as breach for fraud or wilful default.

However, there is nothing in s 233B that prevents termination for breach occurring during the insolvency period, as long as that breach is not merely the fact that the company has become subject to the relevant insolvency procedure. As a result, a supplier wishing to terminate might argue that a particular event occurred post-insolvency, or that the entitlement to terminate arose post-insolvency, and thereby take advantage of this limitation. In particular, disputes can be anticipated where a breach is a continuing breach (rather than a fresh, post-insolvency occurrence), or where a contractual term is ambiguous as to when the entitlement to terminate arises. In relation to breaches where there is a notice period, and/or a cure period, suppliers may also find the entitlement to terminate arises post-insolvency. Is such an event something that gives rise to an “entitlement” before the start of the insolvency process (the original breach), or does the “entitlement” only occur for the first time after insolvency (the failure to cure)?

Thirdly, given the generality of the ‘hardship’ test which the court will apply in assessing whether to permit withdrawal of supply (s 233B(5)(c)), it is inevitable that there will be a developing body of case law on the principles to be applied in granting permission. Most obviously, the court will need to assess the economic position of the supplier. The fact that the test is formulated by reference to the supplier suggests that the court will not take into account matters relating solely to the position of the insolvent company: e.g. the viability of its business, or whether the supply is truly critical to the ongoing operations of the company.

Fourthly, s 233B is silent as to whether it will have extra-territorial effect. This has also been the case for ss 233 and 233A, though it has been held (at first instance) that there was a serious issue to be tried as to whether a s 233 request (for continued supply of essential services) could be made to an overseas supplier. Finally, despite its breadth of application to contracts for the “supply of goods or services”, it is possible that questions will arise as to whether a particular contract falls within the ambit of that definition. It seems unlikely, given the familiarity with which such terms are used in contract law, but cannot be ruled-out.

Additionally, there are a number of practical matters to which suppliers will now have to give consideration:

First, suppliers will need to be particularly vigilant in monitoring the financial position of counterparties, and act swiftly in decision-making if formal insolvency is in prospect. Suppliers may have a short opportunity to act when preliminary steps for certain procedures have occurred, being notice of a meeting to consider a CVA, filing a notice of intention to appoint an administrator, or the presentation of a winding-up petition. The opportunity will be much reduced, however, in the case of a Part A1 moratorium, which is commenced by the directors filing the relevant documents with the court (with creditors subsequently notified) – potentially increasing the incentives for use of this procedure where supplies are critical to the debtor’s rescue.

Secondly, what is especially significant (from a supplier perspective) is that the ban is triggered by formal insolvency, rather than actual insolvency. A termination clause based simply on the company’s inability to pay its debts (cash flow or balance sheet insolvent) remains exercisable before the company enters a formal insolvency process. Suppliers may seek to negotiate the variation of existing clauses, or new contracts, by reference to an earlier termination trigger (i.e. a state of insolvency falling short of a formal procedure) – notwithstanding the scope for dispute (as to insolvency) to which this might give rise, and the limited timeframe which a supplier might have to exercise its termination right. Perversely, it might also encourage nervous suppliers to exercise termination clauses at the first sign of a company’s distress, accelerating the company’s descent into insolvency (which would evidently undermine its rescue objective).

Thirdly, and related to this, it is possible to conceive of contractual termination clauses which are triggered by events which will occur around the time of insolvency, but are not the entry into the insolvency procedure.
itself: e.g., for a retail business, a cessation of the company’s trading (whether temporary or permanent), or the closing of some or all of its retail stores. If the cessation of trading occurred the evening before the company entered into the formal insolvency process, such as (for example) the appointment of an administrator, should it be viewed as part of the company ‘becoming subject’ to the insolvency process, or (which seems the better view) as a separate and independent event? And if such events would constitute a repudiatory breach of contract, then it may be that a supplier seeking to terminate the contract will, in any event, be able to fall back onto its common law rights (although that is, of course, not as clear-cut as exercising a straightforward right of contractual termination).

• Fourthly, given that the reforms apply to all existing contracts (even, retrospectively, to those predating their coming into force), suppliers will need to review their commercial contracts on an urgent basis.

In the cross-border context, the reform ought to expand the additional relief which an English court is able to grant under article 21(1)(g) of the Cross-Border Insolvency Regulations 2006 (CBIR). More particularly, in cases where recognition is sought of a foreign proceeding taking place in a jurisdiction which prohibits ipso facto clauses, and the foreign officeholder seeks to obtain equivalent relief in England (under English law), the courts will now be able to grant this relief (at least to the extent that it is consistent with the prohibition in s 233B). That is a result which was not hitherto permitted – see the Pan Ocean decision of 2014.

Why now?

It is unsurprising that the ipso facto debate has gained traction in recent years, given the existence of prohibitions in other common law jurisdictions, the EU Restructuring and Insolvency Directive, and the increasing desire (fuelled in part by the CBIR) to ensure that the UK is seen as a debtor-friendly jurisdiction. With US Chapter 11 proceedings often cited as a gold standard for restructuring procedures, the ipso facto extension was perhaps to be expected in the context of the CIGA reforms which, as a whole, seek to extend the UK’s rescue culture to equal prominence.

Having said that, parcelling the reform into fast-tracked legislation to address the COVID-19 pandemic, has inevitably restricted the legislative scrutiny which such far-reaching reform would otherwise have attracted. Given that practitioners have been debating these issues for some time, a mature understanding of them by MPs who scrutinised the Bill seems unlikely in the short time which they had. For example, during the Bill’s second reading in the House of Commons on 3 June, an amendment was tabled by a Liberal Democrat MP for these measures to be temporary, precisely to “allow their effect to be properly analysed” – and voicing a particular concern that the reform would lead to (unacceptable) risk-shifting that:

“transfers the risk from the struggling company to the supplier, which, whether in an economic crisis or not, is unacceptable. … Suppliers should retain the right to choose to withdraw their services if they perceive that their resources will face a lower risk return elsewhere. … I accept that there is a balance to be struck between the needs of customers and suppliers, and that during these difficult times supply chains are critical and need
to be supported, but we need to take time to consider the long-term risks of introducing such a change to our insolvency procedures, and the introduction of emergency legislation is not that time” 17.

Such concerns seem unlikely to have had time for proper scrutiny. We ask, for example, to what extent can these reforms really be justified by both principle and policy? As a matter of principle, the statutory balance is now to come down in favour of the incursion into the principle of contractual freedom. For prospective contracts, this is easier to accept – the legitimate expectations of parties as to the meaning of the contract will be informed by the current law (including the CIGA). But what about pre-existing contracts? How can contracting parties really be said to have had their legitimate expectations met by a retrospective change in the law such as this?

**Does it go too far (or not far enough)?**

Does this matter, and is the inroad into the freedom of contract really that substantial? The answer can only be yes. It is true that the new law does not apply to all executory contracts, only to supplier contracts: but that will cover a lot of executory contracts. Moreover, the only protection offered to suppliers by the carve-out is that of the “hardship test”. The Government seems to view this as a “safeguard of last resort”, stating that: “the threshold would be high; a supplier would only be able to seek an exemption from the court if continued supply threatens its own insolvency”.

Further, in considering the hardship application, the Government has suggested that the court must assess:

“whether the supplier would be more likely than not to enter an insolvency procedure as a result of being compelled to continue supply,” and

“whether exempting the supplier from the obligation to supply would be reasonable in the circumstances having regard to the effect of non-supply on the debtor company and the prospects of rescue.”

Of course, the legislation affords the courts a discretion, and these statements are just what the Government has said. Whether this restrictive approach is borne out by the courts’ approach to their discretion remains to be seen. It may be that the “hardship” safeguard will put the court in the position of balancing competing commercial considerations, a role which is usually reserved to the officeholder. Will a court really take on that role?

And even in cases where the courts are willing to lift the ipso facto ban, the new law places a significant burden on the supplier (apparently, at its own risk as to costs) to commence court proceedings in short order and to provide evidence of the economic effect of continued supply on its own financial position. In particular, the supplier’s concerns are most likely to relate to the risks of non-payment – over which the supplier will have no or little visibility when making the permission application (and which the Government guidance suggests may in any event be irrelevant to the court’s assessment unless it would give rise to the supplier’s own insolvency).

Even accepting that the statutory balance has come down against freedom of contract, there is a further balance to be struck between the suppliers, on the one hand, and the creditors of the company as a whole. Viewed from this angle, it is more difficult to decide whether this is, in fact, principled reform, and whether it is desirable in policy terms.

The Explanatory Notes expressly identify the protection of supplies as one of the measures designed to achieve the overarching objective of the CIGA (para 2), the objective itself being solely framed in terms of supporting businesses, for continued trading, “during this period of economic uncertainty” (para 1). In other words, the purpose is to ensure that distressed businesses remain operational and maximising the chances of rescue. When dealing specifically with the ipso facto reforms, it is said (at para 32):

“The policy intention is to help companies trade through a restructuring or insolvency procedure, maximising the opportunities for rescue of the company or the sale of its business as a going concern. The measures will complement the policy for a new moratorium and restructuring plan procedure, which are aimed at enhancing the rescue opportunities for financially distressed companies”.

There are problems with this as a general policy objective. The fact that the prohibition will apply in relation to all insolvency processes – including liquidation – raises serious questions over whether the stated rescue objective can, in truth, be said to underpin the reform. At one end of the spectrum, there will cases of “light touch” administration, CVAs, or the new Part A1 moratorium, where the aim is complete rescue (or eventual sale as a going concern). In these cases, the role played by the ipso facto ban in ensuring that the company remains operational is clear, in the interests of the company’s survival and of creditors as a whole. By contrast, in cases of liquidation or of a distributing administration, where there is no rescue objective or where risk to the supplier is high, the stated policy foundations for the reforms appear shaky.

It also seems likely that the policy objective will be raised when hardship applications make their way to the courts. Despite the fact that the court’s power to permit supply withdrawal is focussed on the position of the supplier (hardship test), it seems inevitable that suppliers will seek to persuade the court to take the question of whether a rescue rationale exists into account.
on a permission application. More particularly, it will likely be contended that the supplier risk is not justified when it cannot be said that a rescue, or preservation of the business for purposes of a sale, is likely. It may also be that the Government is cognisant of this: notably, the Henry VIII power (under s 233C) to exclude any of the relevant insolvency procedures (though the justification for this power is not adequately described, focussing instead on the potential damage to trade in particular areas of business or supply). In policy terms, the reforms can readily be seen as desirable on a temporary footing (as a pandemic response). By contrast, making these changes permanent is less capable of policy justification, at the very least in cases where the likelihood of rescue is open to debate. The extent to which the supplier bears an ongoing risk (in insolvency) is likely to depend on a range of differing circumstances, depending on factors relating to the particular insolvency process involved and the financial position of the distressed company, as well as on factors relating to the terms of the supply contract itself (i.e. duration of payment terms). In particular, as the responses to the Government’s consultation process highlighted, the length of certain normal commercial payment terms (90 or 120 days) is a long period of time during a restructuring. Further, in CVAs or Part 26A cases, the supplier will be subject to the payment terms which form part of the restructuring plan (as opposed to being an expense in cases of administration and liquidation, or a payment which must be made under the Part A1 moratorium). This will to some extent be mitigated if there is a contractual right to terminate for non-payment of supplies post-insolvency, but the supplier’s unpaid debt will nevertheless have increased. Subjecting the supplier to this risk might be said to be justified, because value preservation (or maximisation), or the future viability of the business, is in the interests of the company’s creditors as a whole. But, of course, this can equally be said to give rise to unfairness as between different creditors of a company (non-supplier creditors not facing the risk of ongoing debts). This is a situation which could be viewed as an anathema to the principles of insolvency law, most obviously manifest in the pari passu rule of distribution, and also underpinning the avoidance powers in relation to preferences (under s 239 of the IA). Viewed through the lens of intra-creditor unfairness (as to risk), it is less easy, on policy grounds, to justify its desirability. To conclude, the ipso facto reforms undoubtedly mark a dramatic departure from the long-held principle of contractual freedom (particularly as regards pre-existing contracts). The balance has now come down firmly in favour of promoting rescue and rehabilitation of business. It seems likely that the courts will be asked to revisit the existing common law on the anti-deprivation principle, where particular clauses effect a contractual alteration on insolvency (‘any other thing’), which might previously have been saved by the courts’ more generous approach in past cases. This is no timid extension of existing law. Whether it is right is another question altogether.
Winding down
winding up:
the temporary restrictions

HILARY STONEFROST  DANIEL JUDD
Introduction

As a consequence of the far-reaching economic and financial effects of Covid–19, Parliament, by way of Schedule 10 of the Corporate Insolvency and Governance Act 2020 (“CIGA”) has put a number of temporary obstacles in the way of creditors wanting to wind up debtor companies. The new legislation has received Royal Assent, and is in force from 26 June 2020.

The courts have been making decisions on applications to restrain winding up proceedings by reference to the Government’s legislative intentions notwithstanding that the provisions were not yet in force. Any creditor considering whether to serve a statutory demand or present a winding up petition needs to take into account the obstacles to winding up in the CIGA.

In summary, the key obstacles, which will be regarded as having come into force on 27 April 2020 are:

1. Paragraph 1 of Schedule 10.
2. Sub-paragraphs (2) and (4) of Schedule 10.
3. This paragraph applies to registered companies. The restrictions in winding up petitions relating to unregistered companies are in substance the same: paragraph 3 of Schedule 10.
4. There are two grounds relevant to the law of England and Wales: the service of a statutory demand (section 123(1)(a)) and execution or other process issued on a judgment, decree or order in favour of the creditor that has not been satisfied (section 123(1)(b)).
5. If it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.
6. If it is proved to the satisfaction of the court that the value of the company’s assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.
7. Paragraph 20(3) of Schedule 10.

(a) Company has not had a financial effect on the company\(^a\).

(b) Where the petition is presented on a ground in section 123(1)(a) to (d) of the 1986 Act, the facts by reference to which the relevant ground applies would have arisen even if coronavirus had not had a financial effect on the company. Coronavirus is defined as having 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”\(^b\).

(c) Even if the petitioning creditor can overcome these obstacles, the court may only wind up the company if the court is satisfied that the facts by reference to which that ground applies would have arisen even if...
sectors of economic activity relating to statutory demands and petitions based on claims by landlords for arrears of rent. This would not have covered the debts in this case.

Irrespective of the scope of the protection to companies that the legislation was intending to provide, the judge also noted that there was no financial information provided and that still less “was there any explanation of the complete volte face” in the companies’ case in circumstances where the skeleton argument on behalf of the companies had expressly stated that the companies did not contend that they faced “liquidity or operational challenges as a result of circumstances related to COVID-19”.

It was unsurprising that the judge saw no reason to exercise any discretion in favour of the companies based on the prospect that legislative measures were to be introduced. These provisions, he concluded, were intended to assist “more deserving companies experiencing genuine financial hardship caused by the effects of the COVID-19 pandemic.”

Since this decision, there have been three reported cases in which the Court has granted interim injunctions restraining winding up proceedings by reference to future legislation.

At the hearing of Travelodge Hotels Limited v Prime Aesthetic Ltd and Others [2020] EWHC 1217 (Ch), on 6 May 2020, there was no draft legislation, but Birss J, like Snowden J, was referred to the Government’s 24 April 2020 announcement. The petition in Travelodge was presented by a landlord, and the company was in the hospitality business. Birss J took the view that future legislation would cover this type of situation.

The judge accepted the submission made on behalf of the company that the court does not necessarily always have to make its decision only on the basis of the law as it stands but can, in a proper case, take account of imminent changes in the law. One of the cases relied on in Travelodge was Sparks v Harland [1997] 1 WLR 143 in which Sedley J stated that:

“...there is, in my judgment, no rule of law that impending legislative change is never a material consideration in the exercise of the court’s powers and discretions. Everything, it seems to me, turns on the subject matter and relevance of the pending legislation or possibility of change to the issues which the court has before it.”

The decision in Travelodge on this point was followed by Morgan J in Re: a Company (Injunction to Restrain Presentation of Petition) [2020] EWHC 1406. As at the date of this hearing (1 June 2020) there was a draft of the Bill. The judge concluded from the ministerial statements that he had a high degree of confidence that Schedule 10 of the
A statutory demand ... cannot be relied on for the purpose of showing that a company is unable to pay its debts ...

Bill would be enacted in more or less its current form. He decided that when a court is considering whether to grant relief, and in particular relief which involves the court managing its own processes, that it can take account of the likelihood of a change in the law that would be relevant to its decision.

The issue as to whether the Court could take into account the provisions of the Bill, having been considered by two judges of the High Court, was not an issue at the hearing before ICC Judge Barber in Re: a Company (Application to Restrain Advertisement) (2020) EWHC 1551 (Ch); at that hearing it was common ground that the court should take into account the provisions of the Bill in the exercise of its discretion in relation to the Company’s application in circumstances where it had not yet been enacted. The position at the present time is now clear. From 26 June 2020 onwards, the CIGA is in force.

The obstacles to winding up

Obstacle 1: the restrictions on statutory demands

A statutory demand served in the relevant period on a company cannot be relied on for the purpose of showing that a company is unable to pay its debts pursuant to section 123(1)(a) of the 1986 Act.

If, however, a statutory demand is only one of the grounds on which the creditor contends the company is unable to pay its debts, a creditor may be permitted to amend the petition to include another definition within section 123(1) or (2) in order to allow the petition to proceed.

In Re: a Company (Application to Restrain Advertisement) a winding up petition was presented on 1 May 2020, which is in the relevant period, in reliance on a statutory demand served on 27 March 2020, also in the relevant period. The petitioner accepted that the petition could not have proceeded on the basis that the company’s inability to pay its debts was established by reason of the failure to pay the undisputed sum in the statutory demand. ICC Judge Barber, who clearly considered it important to address the other issues raised in this application, held that although the petition did not unequivocally rely on a further ground, namely section 123(1)(e) of the 1986 Act, it could be read either way, and that in any event permission to amend would be likely to be given. Similarly, Morgan J, in the application to restrain presentation, who knew that a statutory demand had been served but had not seen a copy of the petition, was prepared to assume that the petitioner may also have relied on sections 123(1)(e) and 123(2) of the 1986 Act.

As a petition can proceed on the basis that a company is deemed unable to pay its debts on additional grounds under sections 123(1) and (2) of the 1986 Act, other than section 123(1)(a) of the 1986 Act, the purpose of this restriction on statutory demands appears to be to prevent creditors using statutory demands as a means of bringing pressure on creditors, and is not a means of preventing petitions being presented. In any event, most petitions presented in the relevant period and founded on a statutory demand are likely to be capable of being amended to refer to sections 123(1)(e) or 123(2) of the 1986 Act.

Obstacle 2: the coronavirus conditions

The coronavirus conditions, set out above, are substantially the same irrespective of the grounds on which the creditor alleges the company is unable to pay its debts pursuant to sections 123(1) and (2) of the 1986 Act.

The burden is on the petitioner to show, at the date of the presentation of the petition, that the petitioner had reasonable grounds for the belief that either coronavirus did not have a financial effect on the company or, if it did have such an effect, the company would be unable to pay its debts even if coronavirus did not have a financial effect on the company.

The Bill was in draft form when Morgan J heard the application to restrain presentation of a winding up petition on 1 June 2020. He considered that the question for the court was whether coronavirus had had a financial effect on the company before the presentation of the petition and concluded that there was a substantial body of evidence to support the conclusion that there was a strong case that this was so. The judge granted an injunction restraining presentation of the petition.
On 8 and 9 June 2020, ICC Judge Barber heard an application to restrain advertisement of a petition[9]. The judgment notes that in this case, as in most cases, it would be difficult for a petitioner to show a reasonable belief that coronavirus had not had a financial effect on the company. The focus in this case was on whether the petitioner reasonably believed at the date of the presentation of the petition that the company would have been unable to pay its debts even if coronavirus had not had a financial effect.

The petitioner was found to have had a reasonable belief that the company would have been unable to pay its debts even if coronavirus had not had a financial effect on the company. In summary, this was because the debt had originally fallen due in January 2019, the company had failed to adhere to an agreement to pay by instalments and letters and demands from the petitioner had largely been ignored.

**Obstacle 3: would the court make a winding up order on the petition**

Even where a petitioner has overcome the obstacle of the coronavirus conditions, as in the case before ICC Judge Barber, it does not follow that the petition can proceed. The court will consider whether there is a real prospect of the court making a winding up order.

A court can only make a winding up order on a petition presented in the relevant period where “it appears to the court that coronavirus had a financial effect on the company before the presentation of the petition.”[9] 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.”[9]

The company provided business and property management services. The company’s evidence was that it was “solvent for day to day operations but relies on rolling over corporate debt and fund raising by the issue of equity for its long-term financing.”

The evidence also stated that in early 2020 the company had been in the process of raising funds but this had been stopped by the Covid–19 situation, which had prevented the acquisition of new finance as the international capital markets had frozen.

The company’s evidence on fundraising was poor. The judgment records that the company had adduced virtually no financial documents to demonstrate its financial position either before or after Covid–19 hit. There were very few documents showing any agreements in principle for funding, and certainly there were none showing the level of funding the company said had been agreed in principle. There were no documents showing the funding to have been withdrawn.

The judge nevertheless considered the company had provided enough evidence for her to conclude that the threshold requirement of paragraph 5(1)(c) had been met. The wording suggested it was intended to be “a low threshold” because:

1. All the company is required to show is “a financial effect”, there was no requirement to show that the pandemic was “the or even a cause of the company’s insolvency”.

2. The question is whether it “appears” to the court that there has been such an effect, the court is not required to “be satisfied” of that matter.

On this approach, the courts are likely to take into account the impact of the Covid–19 pandemic on the company’s ability to raise funds to resolve its pre–Covid–19 pandemic cash flow problems.

The issue as to whether there was a real prospect of the company being wound up was considered by ICC Judge Barber in the context of an application to restrain advertisement. The courts considering whether to restrain presentation of a petition would also be expected to take into account the prospect of a winding up order being made; Morgan J reached his decision to grant an injunction to restrain presentation, in part, on the basis of his view that it was improbable that the court would make a winding up order.

The temporary amendment to the Insolvency Rules 2016 regarding advertisements of petitions (see below) will require the issue as to whether it was likely the court would be able to make a winding up order to be determined prior to advertisement.

**Obstacle 4: void winding up orders**

ICC Judge Barber also made her decision by reference to her conclusion that, if a winding up order were made on the evidence as it stood at the hearing before her, the winding up order would be void. This assumed that paragraph 7 of Schedule 10 would be brought into force, which it duly was. A proposed amendment to the Bill, which would have removed this provision, was rejected.

The CIGA has a built-in protection for the official receiver, liquidators and provisional liquidators in circumstances where a winding up order is void[10]; they are not liable in any civil or criminal proceedings for anything done pursuant to the winding up order. The court may give directions to the officeholder as it thinks fit for the purpose of restoring the company to the position it would have been in immediately before the petition, on which the order was made, was presented[11].

**The date of the commencement of the winding up and section 127 of the 1986 Act**

For the purposes of the provisions in the CIGA the winding up is deemed to commence on the date of
the making of a winding up order and not at the time of the presentation of the petition. The effect of this change means that section 127 of the 1986 Act, pursuant to which any disposition of the company’s property in the period from the time of the presentation of the petition to the date of the winding up order is void, will be of no effect on petitions presented in the relevant period. This change means that companies faced with a winding up petition presented in the relevant period do not face having their bank accounts frozen and do not need to obtain validation orders to continue to trade in the period from the date of the presentation of the petition. Where a company’s business is hit financially as a consequence of coronavirus, the decision as to whether or not such an order is in the interests of the company’s creditors as a whole would have been extremely difficult in these times of extraordinary financial uncertainty.

That said, this change to the legislation does remove an important provision underpinning the principle of pari passu distribution to creditors in circumstances where the only companies that are likely to be wound up are those that are insolvent for reasons unconnected with coronavirus.

Changes to the Insolvency Rules 2016

Restraining advertisement

ICC Judge Barber decided that it would be oppressive and unfair to allow the petition to be advertised. She took into account the fact that the company was engaged in a restructuring exercise with unsecured creditors by way of a scheme of arrangement, and that adverse publicity from the presentation of a winding up petition at this stage would be detrimental to the company. She also took into account her decision that advertisement would serve no purpose because there was no real prospect of a winding up order being made. An injunction restraining advertisement was granted and the petitioner was given liberty to apply to lift the restraint on advertisement on the production of further evidence demonstrating that the company would have been insolvent even if coronavirus had not had a financial effect on the company.

In reaching her decision, ICC Judge Barber’s decision to restrain advertisement by reference to the likelihood of a winding up order being made foreshadowed the new temporary changes to the Insolvency Rules 2016 (“the 2016 Rules”) on the advertisement of winding up petitions.

The CIGA adds a new procedural requirement for petitions presented in the period between the date on which the CIGA came into force, 26 June 2020, and the end of the relevant period by way of amendment to the 2016 Rules. The new temporary rules require that no petition presented in this period can be advertised until the court has determined whether it is likely the court will be able to make an order to wind up the company. The effect of this appears to be that, where such a petition has been presented, companies will no longer need to apply to restrain advertisement of the petition. Unless the issue as to whether a winding up order is likely to be made on the petition has already been determined on a company’s application to restrain presentation of a petition, the creditor will need to apply to the court for such a determination before proceeding to advertise the petition.

Content of winding up petitions

The content of the winding up petition has been changed to reflect the grounds on which a petition may be brought. Rule 75(1) of the 2016 Rules is amended to provide that the petition is required to contain a statement that the petitioner considers the relevant coronavirus conditions are met.

Access to the court file

The right to inspect the court file that is accorded to the office-holders, creditors and others pursuant to rule 12.39 of the 2016 Rules are not exercisable without the permission of the court until the court has made a determination in relation to the question as to whether or not the court will make a winding up order. The purpose of this would appear to be to ensure that the restriction on advertisement, to prevent publicity before the court has decided a winding up order is likely to be made, is not circumvented by creditors gaining access to information about the proceedings on the court file.
Comment

These temporary changes to insolvency law relating to proceedings to wind up a company are plainly directed at preventing liquidation of companies whose finances have been damaged by coronavirus. There are very few companies where it will be clear that they do not fall within this category.

Statutory demands cannot be used to exert pressure to pay because they cannot be used for the purpose of winding up the company.

The majority of companies are to be expected to rely on the presence of coronavirus to defend winding up proceedings, the consequence of which is likely to be court hearings on the effect of coronavirus on the company’s financial position.

Furthermore, as a consequence of the change to the rules on advertisement of petitions, the petition cannot proceed to a winding up order without a court having determined whether it is likely that the court can make an order to wind up the company, because the petition cannot be advertised prior to the determination of this question. Such a determination will require, at the very least, consideration of whether coronavirus had a financial effect on the company and, as is clear from the decision of ICC Judge Barber, the threshold for this test is very low.

Unless it is clear that the company was insolvent before the coronavirus pandemic, and probably also clear that the company was not thwarted in fundraising to address a cash flow problem, a creditor who commences winding up proceedings is likely to incur costs of court proceedings with a highly uncertain outcome for the creditor.

Creditors should, therefore, consider alternatives to winding up, and if agreement with the company cannot be reached, the obvious alternative insolvency process is administration. That in turn depends on whether any of the objectives of administration could be achieved.

In addition, directors will have the ability to obtain a moratorium to explore rescue and restructuring, and the company will also have the option of proposing a reconstruction plan, in addition to the long-established options of company voluntary arrangements and schemes of arrangement. Any creditor considering whether to embark on winding up proceedings or an administration application will, therefore, also need to consider how the directors are likely to respond to such proceedings, and the impact of this on the creditor’s position.
“Sometimes knowing what to do is knowing when to stop”: wrongful trading and COVID-19
Richard Fisher QC and Roseanna Darcy consider the “suspension” of wrongful trading provisions introduced in the Corporate Insolvency and Governance Act (“CIGA”) as one of the temporary measures aimed at avoiding and reducing insolvencies of companies that would have otherwise been viable but for the impact of COVID–19.

Introduction

It is not an easy time to be the director of a limited liability company. Business for many companies is tough, and directors should be considering how they can best fulfil their duties to the company and those interested in it.

English law seeks to regulate the conduct of directors in the twilight period before formal insolvency intervenes through a number of different tools. The principal provision of relevance for current purposes is that of “wrongful trading”. Under the Insolvency Act 1986 (the “Act”), directors of a company that has entered insolvent liquidation or administration can be ordered to make a contribution to the company’s assets if, at some time before the commencement of the relevant process, they knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation or insolvent administration, and failed to take every step with a view to minimising the potential loss to the company’s creditors. Failing to minimise such losses and causing a worsening of the company’s financial position is what is known as “wrongful trading”.

However, wrongful trading is not the only provision that is relevant. Directors must also be mindful of the common law duty (retained through Section 172(3) Companies Act 2006) to have regard to the interests of creditors from the point at which a director knew or should have known that the company was or was likely (in the sense of probable) to become insolvent: BTI v Sequana [2003] EWA Civ 112. Once insolvent, the interests of the creditors are paramount (ibid at [222]).

Equally, directors need to be aware of the risk posed by Sections 213 and 246ZA of the Act. Causing a company to carry on business with intent to defraud creditors, or for any fraudulent purpose, will amount to fraudulent trading. Whilst most directors will dismiss out of hand the suggestion that they might be engaged in fraudulent trading, some caution is needed. It is correct that Sections 213 and 246ZA require evidence of actual dishonesty. But that requirement can be satisfied if there was reckless indifference to whether creditors are being defrauded (Bernasconi v Nicholas Bennett & Co [2000] BCC 921) and, most importantly, it has been held that there is a sufficient intent to defraud for these purposes if credit is obtained at a time when the person knows that there is no good reason for thinking that funds will become available to pay the debt when it becomes due or shortly thereafter (R v Grantham [1984] QB 675). Faced with the crisis posed by COVID–19, and the desire to keep businesses trading for as long as possible until immediate impact of the lockdown has passed, the risk that credit will be incurred in circumstances where it cannot be justified is likely to have increased. As observed in Lightman & Moss 6th ed. at [2–010] and [2–013]: “the real problem posed for management by the fraudulent trading rules is how far and how long the company can continue to incur credit when the directors realise that the outcome of future trading is uncertain and that there is a real risk that things may not improve so that creditors may not be paid .... It is at least theoretically possible, albeit unlikely in practice, for a director to incur liability for fraudulent trading in circumstances where he would not be liable for wrongful trading. This could happen where a director had a legitimate expectation that his company would escape liquidation through some form of restructuring but meanwhile caused the company to incur new debts that he knew would not be paid in full.”

The protection for creditors created by these provisions, along with those that enable transactions prejudicing creditors to be challenged, and the provisions in the companies legislation that prevent capital from being returned to shareholders or dividends paid in certain circumstances, offsets the risk inherent in conducting business with a limited liability entity. Directors’ conduct in the period before formal insolvency intervenes is regulated by the need to take into account the requirements of these provisions, and the risk of liability being imposed (or disqualification proceedings being brought) in due course. There are notably few successful cases of wrongful or fraudulent trading claims being brought: but the principal power of the provisions is in the way that they regulate the conduct of directors (and the advice given to those directors) in the period before formal insolvency proceedings intervene.

The COVID–19 pandemic has had a terrible and painful impact on individuals and society at large. The lock–down has in turn had a very serious impact on the economy. Faced with a potentially disastrous drop in business, many directors have looked to the Government for a response as to how they can balance the need to comply with obligations imposed by existing law with the need to try and keep companies afloat whilst the impact of the pandemic is assessed.

The response has been to focus on the wrongful trading provisions (and only the wrongful trading provisions) in order to try and give comfort to directors. But is this enough to provide comfort to directors?

What is the Government trying to achieve?

The Government first announced that they would be suspending the wrongful trading regime on 28 March 2020, the purpose being “to give company directors greater confidence to use their best endeavours to continue to trade during..."
the pandemic emergency without the threat of personal liability should the company ultimately fall into insolvency.”

The explanatory notes accompanying the Corporate Insolvency and Governance Bill (“CIGB”) as introduced in the House of Commons on 20 May 2020 explain the introduction of the relevant provisions on the following basis:

27: The current crisis caused by the COVID-19 pandemic means that there is a great deal of uncertainty around trading conditions, both in the immediate and longer term future. Directors are having to make decisions about the future viability of their companies and whether it is appropriate for trading to continue.

30: The objective of this measure is to remove the deterrent of a possible future wrongful trading application so that directors of companies which are impacted by the pandemic may make decisions about the future of the company without the threat of becoming liable to personally contribute to the company’s assets if it later goes into liquidation or administration. This will in turn help to prevent businesses, which would be viable but for the impact of the pandemic, from closing.”

They continue by describing the proposed legislation as a “suspension of liability for wrongful trading” (see paragraph 223 onwards of the explanatory notes), which is to be achieved by altering how the relevant sections of the Act will be applied in relation to the company’s financial position during the relevant period.

What changes are being made?

Relatively few. There is no amendment of the provisions relating to wrongful trading in the Act. Whilst Section 12 of the CIGA is titled “Suspension of liability for wrongful trading: Great Britain”, what is in fact being introduced is a form of retrospective legislative assumption in the following terms:

“In determining for the purposes of section 214 or 246ZA of the Insolvency Act 1986 (liability of director for wrongful trading), the contribution (if any) to a company’s assets that it is proper for a person to make, the court is to assume that the person is not responsible for any worsening of the financial position of the company or its creditors that occurs during the relevant period.”

(The relevant period being defined in Section 12(2) of the CIGA).

The jurisdiction to make a declaration by reason of Section 214(2) or 246ZA(2) being satisfied (i.e. because the director knew or ought to have concluded that there was no reasonable prospect that the company would avoid insolvent liquidation or administration) is not altered. However, the Court is required to assume that “any worsening of the financial position of the company or its creditors that occurs during the relevant period” is not something for which the relevant director is responsible. The effect therefore is that a director ought to avoid financial liability for any wrongful trading that occurred during the relevant period, even if the requirements of Sections 214(2) or 246ZA(2) are satisfied.

There are express limitations on the effect of Section 12. In particular, the assumption provided for by Section 12(1) does not apply if any point of time during the relevant period the company concerned was excluded from being eligible by reason of falling within any of the paragraphs of Schedule ZA1 to the Act listed in Section 12(4) of the CIGA (which include insurance companies, banks, electronic money institutions and (notably) parties to capital market arrangements). For directors acting in respect of companies conducting complicated business of this type, Section 12 is therefore irrelevant. One can understand why, politically, the directors of these companies may not be the most attractive targets to seek to assist. But they are involved in businesses where assessing the risk of wrongful trading may be particularly difficult, and where the impact of a premature filing for insolvency proceedings would be likely to have a more significant impact.

Is Section 12 likely to achieve its intended purpose?

Having announced the intended “suspension” of wrongful trading, the effect of Section 12 is in large part retrospective. Anecdotal evidence would suggest that there has not been a wave of unnecessary or premature filings for administration or liquidation as a consequence of the pandemic and it may be that the proposed legislation (combined with the furlough scheme) has given directors the comfort that they required. Section 12 of the CIGA ought to be effective to prevent wrongful trading claims being made in respect of the “relevant period”. Two
points are worthy of emphasis in terms of the approach adopted.

First, the nature of the assumption that the Court is required to make. The drafting of Section 12 does not make clear whether the assumption is intended to be rebuttable if there is evidence that the director is responsible for a worsening of the financial position of the company during the relevant period. However, it would appear that this is not the case, and that the Court is required to apply the assumption whatever the underlying reason for the deterioration of the company’s position during the relevant period. An amendment clarifying this point was proposed as the Bill moved through the House of Lords by Lord Hope. The House of Lords’ Select Committee suggested that “[c]reditors should not be precluded from taking legal action against directors for wrongful trading during that period if they can discharge any burden of proving that the instance of wrongful trading has no connection to financial distress induced by the pandemic”.

The Government’s response of 19 June 2020 to the House of Lords’ Select Committee’s recommendations (the “Response”) indicated that it would not be adopting or supporting any such modification, on the basis that: “It would result in directors still facing the possibility of complex legal proceedings and the risk of personal liability if those proceedings were not resolved in their favour. Faced with that risk many directors may still adopt a precautionary approach and choose to close the company. If that was replicated across the economy it would result in significant additional loss of employment and damage to the economy as a whole.” Section 12 is therefore meant to operate (by way of assumption) as a bar on any claim being made for wrongful trading during the relevant period.

Secondly, Section 12 refers to an assumption regarding “any worsening of the financial position of the company or its creditors that occurs during the relevant period”. The jurisdiction to make a declaration to contribute where wrongful trading has occurred is framed in wide terms: “such contribution (if any) to the company’s assets as the court thinks proper”. This has been interpreted as being limited to a compensatory jurisdiction, where any contribution is limited to the net deficit in the company’s affairs caused during the period of wrongful trading: see, for example, Re Produce Marketing Consortium Ltd (1989) 5 BCC 569 at 597; Re Ralls Builders Ltd [2016] BCC 293 (an approach that has been the subject of significant criticism, in that it enables the payment of an old creditor at the expense of new creditors (robbing Peter to pay Paul) but without risk of wrongful trading liability if the net position of the company does not alter: see Moss [2017] 30 Insol Int 49).

However, whatever the rights and wrongs of that analysis, the language of Section 12(1) is wide enough to protect directors from any loss suffered by the company or particular creditors during the relevant period.

So far so good. But, as noted above, there are other provisions of the Act and common law that regulate the conduct of directors. They have not been altered by the CIGA. In fact, the Response has made clear that it is only wrongful trading liability that is its focus, stating: “The temporary suspension of personal liability will not mean that directors will be able to avoid other protections afforded to creditors and the wider business community. Directors must continue to comply with their normal duties as clearly set out in the Companies Act, and various other remedies remain available where directors do not meet acceptable standards of behaviour. For example, fraudulent trading provisions provide both a civil recovery remedy as well as a criminal element where trading is continued with intent to defraud creditors. We believe that the provisions as drafted strike the right balance in responding to this extraordinary crisis.”

So the Government’s intention appears to be that potential personal liability for breach of duty, and fraudulent trading, is to continue without modification.

In practice, this may be more problematic, and rob directors of a large degree of the comfort that they thought that the suspension of wrongful trading was going to provide. It is unclear whether, and to what extent, the application of these other legal concepts can or should take into account the changes made to the wrongful trading regime. The Response suggests that those provisions continue as “normal” such that there is no attenuation of the standards to be applied to recognise the changes made by Section 12 during the relevant period. One cannot help but think that the Court will be slow to find a director liable for anything other than the most egregious and unjustifiable breaches of duty occurring during the pandemic period, or obvious fraudulent trading. Identifying conduct that is unreasonable and not in the best interests of creditors (and other stakeholders) is likely to be difficult against the exceptional background...
Section 12 seems to render the director immune from liability for wrongful trading. But it is not a universal panacea that avoids any other liability

1. Our government is not alone in taking such steps. Governments around the world have introduced measures to give some breathing space to directors with the aim of avoiding pre-emptive insolvency proceedings. In Germany, there is a temporary suspension of the duty to file for insolvency until 30 September 2020, removing the threat of criminal sanction against directors. Similarly, in France a company’s legal representative will not be liable for a late filing if cash flow insolvency occurs between 12 March 2020 and 23 August 2020. In Australia a six-month moratorium on insolvency trading liability for directors in respect of debts incurred “in the ordinary course of business” has been introduced, and in Singapore, the Covid-19 (Temporary Measures) Act also suspends wrongful trading rules as long as debts incurred by directors are done so “in the ordinary course of business”. This list of measures is by no means exhaustive. How successful they will be remains to be seen.

Conclusion

The “suspension” of wrongful trading combined with other steps taken by the Government may well have avoided precautionary formal insolvency filings as a result of the COVID-19 pandemic. However, directors should respond cautiously and consider their position with care in light of their other duties. Whilst in the short term, the relaxation of this one form of potential personal liability may provide some much needed breathing space, it does not mean that directors are exempt from taking necessary steps to act in the best interests of the company, and importantly, in the best interests of creditors should insolvency appear to be on the cards.

Ultimately, it is not clear that removing the risk of liability for wrongful trading means the decision-making process for the director has been made (or should have been made) materially easier, or that a cautious director is less likely to put a company into a formal process just because one aspect of the risk of personal liability has been removed. As noted above, a particular area of concern may be the incurring of new creditors/the payment of existing creditors using funds borrowed from new creditors. The idea of “swapping creditors” may not necessary result in liability for directors under the usual wrongful trading rules if there is no increase in the net deficiency of the company (again see Re Ralls Builders where there was no net loss to the company or creditors in circumstances where continued trading allowed old creditors to be repaid despite new debts being incurred), but whether such actions could result in any particular case in an actionable preference or breach of duty (or even fraudulent trading claim) remains to be seen (as hinted at by the judge in Re Ralls Builders at [251]). Cases such as In re Continental Assurance Co of London plc [2007] 2 BCLC 287, as followed by Mr Justice Snowden in Re Ralls Builders, have made it clear that any defences under the wrongful trading provisions should not be used to provide a defence for directors for any preferential treatment given to some creditors, at the expense of others.

Directors’ conduct during this exceptional period is likely to come under increased scrutiny as the pandemic ends, and the decisions made by directors can be assessed in the clear light of day. The relaxation of liability for wrongful trading does not avoid the need for a director to take care in considering whether a company really should continue to trade through this exceptional period.
South Square "continues to dictate the standard to which others must pitch." LEGAL 500