



INSOL
INTERNATIONAL

A Collection of Short Papers by INSOL Early Research Academics (INSOL ERA)

November 2021

CONTENTS

Acknowledgement	i
Foreword	ii
Protection for homes in South African insolvency law Reghardt Brits, University of Pretoria, Republic of South Africa	1
The tax priority in Australian corporate insolvency: A Dworkinian approach Catherine Brown, Queensland University of Technology, Australia	11
The parable of corporate rescue in the United Kingdom - survival of the company, business rescue or preventive restructuring? Pride Chanakira, PhD candidate, University of Wolverhampton, United Kingdom.....	19
Personal Insolvency and COVID-19: Brief analysis of the measures adopted in Spain Paloma Corbal, Lawyer and PhD candidate, Spain.....	31
The impact of the EU Restructuring Directive on the Belgian collective plan: “To class or not to Class”, that is the question for the Belgian legislator Jente Dengler, DLA Piper, Belgium	40
Tax obstacles to the effectiveness of the Brazilian insolvency legal framework Catarina Ferraz, PGMBM, United Kingdom and Rodrigo Numeriano Dubourcq Dantas, Castro & Numeriano Dantas Advogados, Brazil.....	56
The Corporate Insolvency and Governance Act 2020: A statute to mitigate the rise in zombie companies in England and Wales? Marcus Greet, Future Trainee Solicitor at Jones Day LLP, United Kingdom	66
A “Model Law” for cross-border Insolvency and resolution of financial institutions Shuai Guo, China University of Political Science and Law, People’s Republic of China.....	83

Take the money and fly! A critical analysis of insolvency practitioner remuneration in South African corporate rescue (the case of South African Airways)	
Lézelle Jacobs, University of Wolverhampton, United Kingdom	96
A divided Kingdom? Insolvency law in Scotland	
Alisdair D J MacPherson, University of Aberdeen, United Kingdom.....	114
A reconsideration of directors' liability for wrongful trading in the United Kingdom and the EU in the COVID-19 era	
Hamiisi Junior Nsubuga, Middlesex University London, United Kingdom.....	128
Corporate governance challenges facing the chief restructuring officer	
Mary Plahouras, Canada.....	139
The modern role of insolvency practitioners amidst globalisation and the changing concept of the "professional"	
Elizabeth Streten, Queensland University of Technology, Australia.....	149
Pension reforms in England: Should insolvency practitioners be concerned?	
Eugenio Vaccari, Royal Holloway and Bedford Colleges, University of London, United Kingdom...	164
Using artificial intelligence in financial distress: Opportunities and obstacles in the implementation of AI / ML-based methods as early warning tools	
Annika Wolf, University of Applied Sciences Emden / Leer, Germany	177
Insolvency and arbitration in the United Kingdom: Predictable and efficient?	
Gustavo Adriano Yanez Ruales, United Kingdom	191



Copyright © No part of this document may be reproduced or transmitted in any form or by any means without the prior permission of INSOL International. The publishers and authors accept no responsibility for any loss occasioned to any person acting or refraining from acting as a result of any view expressed herein.

Copyright © INSOL International 2021. All rights reserved. Registered in England and Wales, No 0307353. INSOL, INSOL International, INSOL Globe are trademarks of INSOL International.

ISBN 97 81 90776429 5

Published November 2021

Acknowledgement

INSOL International is delighted to be supporting the members of INSOL ERA (Early Research Academics) by publishing this collection of short papers. The INSOL ERA Committee, under the able leadership of Dr Eugenio Vaccari, is to be congratulated on this fine initiative which is aimed at providing early research academics with exposure and support in developing and honing their research and publication skills in the field of restructuring and insolvency.

The papers included in this collection cover a wide range of topics, many of which reflect the tumultuous times we live in under the disruptive cloud of COVID-19. However, not all the papers are COVID-19-related; there are also papers covering important topics such as homestead protection in insolvency, tax priorities in corporate insolvency, aspects of corporate insolvency in light of the European Directive on preventive insolvency, insolvency practitioner remuneration, the failure of financial institutions, zombie companies, pension reforms in England and the role of arbitration in insolvency. There are also two forward-looking papers that deal with the role of artificial intelligence in situations of financial distress and the modern role of insolvency practitioners amidst globalisation and the changing concept of the “professional”.

INSOL International would like to sincerely thank the INSOL ERA Committee, and the authors whose papers appear in this publication, for the time and effort they have invested in sharing their thoughts and insights with the INSOL International membership.

November 2021

Foreword

INSOL ERA (Early Research Academics) is a sub-committee of the INSOL Academic Group. It was established in November 2019 with the aim of integrating and supporting early research academics in the wider academic community of INSOL International. INSOL ERA brings together postgraduate students and early career scholars with interest in the field of insolvency and restructuring law. Since its establishment, I have had the pleasure and honour of being its chairperson.

The INSOL ERA sub-committee (consisting of myself, Dr Jennifer L L Gant, Dr Lézelle Jacobs, Mr Ilya Kokorin and Dr Elizabeth Streten) has actively promoted opportunities for learning from each other and for sharing experiences, despite the limits imposed by the Covid-19 pandemic.

With our sister organisation, the Younger Academics Network of Insolvency Law (YANIL) at INSOL Europe, we have organised a series of monthly virtual meetings for our members. These gatherings feature presentations from our members, discussions with practicing lawyers and academics specialising in insolvency law, and workshops designed at developing the research and academic writing skills, publication strategies and networking opportunities for our members.

These regular virtual meetings have been complemented by a series of podcasts featuring some big names in the insolvency world. These podcasts, known as "INSOL Talks", are one-to-one conversations with established scholars and practitioners on topics such as path to the insolvency law, writing routines, sources of inspiration, networking, academic collaboration, teaching / research balance, favourite books, etcetera.

Last, but not least, we had the pleasure of co-ordinating the work on this publication. From its inception, this publication project aimed at showcasing the ability, professionalism, dedication and enthusiasm of our members. It has resulted in an edited collection of 16 contributions on hot topics, including insolvency during Covid-19, regulatory reforms and the treatment of certain categories of debtors (groups of companies, consumers) and creditors (employees, insurance companies).

The papers included in this collection represent an invaluable contribution to the insolvency law debate and identify the issues that future generations of academics and practitioners will be working on. We are extremely grateful for the support, comments and suggestions that we have received during the course of this project. In particular, we are indebted to the Chair of the INSOL Academic Group, Prof Juanitta Calitz, for her unwavering support of each and every initiative suggested by INSOL ERA, as well as to Dr David Burdette (Senior Technical Research Officer, INSOL International) and Dr Sonali Abeyratne (Technical Director, INSOL International) for their assistance in conceiving this project as well as in preparing the various manuscripts for publication.

Dr Eugenio Vaccari
Chair of INSOL ERA
November 2021

Protection for homes in South African insolvency law

By Reghard Brits, University of Pretoria, South Africa*

Abstract

This paper analyses the treatment of homes in South African insolvency law in light of the constitutional significance of housing rights in the country. Four aspects of the broader legal system are considered, namely the sequestration procedure in terms of the Insolvency Act 24 of 1936; the normal debt enforcement and judicial-sale procedure; evictions in terms of the Prevention of Illegal Eviction from and Unlawful Occupation of Land Act 19 of 1998; and debt review in terms of the National Credit Act 34 of 2005. The conclusion is reached that, when considering the system as a whole, a debtor's home probably receives adequate protection in South African insolvency law.

1. Introduction

Sequestration under the Insolvency Act 24 of 1936 (the Act or the Insolvency Act) is the primary asset liquidation procedure available to consumers (natural persons) in South Africa. When an insolvent debtor's estate is sequestrated under the Act, the general rule is that the debtor is divested of all his assets. The assets are transferred first to the Master of the High Court and thereafter to the trustee of the debtor's insolvent estate.¹ The purpose is for the assets to be sold and for the proceeds to be distributed amongst the creditors according to their ranking. However, some assets are exempted from the sequestration process, meaning that they will be protected and thus not sold to satisfy the claims of creditors.

There is no single list of exempt assets in, for instance, a dedicated section of the Insolvency Act. Instead, the exemptions are scattered throughout both the Insolvency Act and a number of other statutes. The main rationale underlying most exemptions is to ensure that an insolvent debtor is not left completely destitute and a burden on society. An example is that the debtor's "wearing apparel and bedding" cannot be sold by the trustee at all, while the debtor may also keep as much of his "household furniture, and tools and other essential means of subsistence" as the creditors may allow.² Other examples include certain pension, life insurance and unemployment benefits.³ However, neither the Insolvency Act nor any other statute makes provision to exempt the debtor's

* Associate Professor, Department of Mercantile Law, Faculty of Law, University of Pretoria, <https://orcid.org/0000-0002-2416-4339>.

¹ Insolvency Act, s 20(1)(a).

² *Idem*, s 83(6).

³ For other examples and a more detailed discussion of such exemptions, see E Bertelsmann *et al*, *Mars The Law of Insolvency in South Africa* (10th ed, Juta & Co Ltd, Cape Town, 2019) at 212-227; Kunst *et al*, *Meskin, Insolvency Law and its Operation in Winding Up* (loose-leaf ed, Issue 53, LexisNexis, Durban, 2019) at para 5.3.

home from the sequestration process.⁴ In fact, the Act makes no special arrangements regarding the debtor's and his family's residential situation. In light of this, the purpose of this paper is to ascertain how serious this failure to take cognisance of the debtor's home is, if at all, and whether it indicates that South African personal insolvency law is in need of reform.

This paper begins with an overview of the constitutional importance of homes and housing rights in the broader South African legal system, followed by an explanation of the ways in which the law currently extends special protection to persons facing the loss of their homes in eviction and judicial-sale proceedings. Thereafter, the relevance of the debt review procedure under the National Credit Act 34 of 2005 (the National Credit Act) will be considered and it will be demonstrated that the latter statute possibly fills the gap that currently exists in the sequestration procedure as far as protecting a debtor's housing rights is concerned.

2. The constitutional importance of housing in South Africa

The Constitution is the supreme law of South Africa and any law or conduct inconsistent with it, is invalid.⁵ The Bill of Rights, contained in Chapter 2 of the Constitution, applies to all law. It binds all organs of state, including the executive, legislative and judicial branches.⁶ Additionally, the Bill mostly also binds natural and juristic persons.⁷ However, none of the rights are absolute and thus each of them may be limited provided that the requirements in section 36 (the limitations clause) are satisfied.⁸ Without going into detail, it has been confirmed that section 36 requires there to be strict proportionality between the means and ends of the limitation of a right.⁹

Among its provisions, the Bill of Rights contains a housing clause in section 26, which provides as follows:

"(1) Everyone has the right to have access to adequate housing.

(2) The state must take reasonable legislative and other measures, within its available resources, to achieve the progressive realisation of this right.

⁴ One partial exception is that state-subsidised housing may not be sold as part of a debt collection process unless the property has first been offered to the relevant provincial housing department at a price not greater than the subsidy amount: Housing Act 107 of 1997, s 10B.

⁵ Constitution of the Republic of South Africa 1996, s 2.

⁶ *Idem*, s 8(1).

⁷ *Idem*, s 8(2).

⁸ *Idem*, s 7(2)-(3).

⁹ *S v Makwanyane* 1995 (3) SA 391 (CC) (at para 104); *De Lange v Smuts NO* 1998 (3) SA 785 (CC) (at paras 86-88).

(3) No one may be evicted from their home, or have their home demolished, without an order of court made after considering all the relevant circumstances. No legislation may permit arbitrary evictions.”

Subsection (1), read with subsection (2), is primarily aimed at the state’s positive duty to provide housing to the homeless. However, it is generally accepted that subsection (1) also has a negative dimension in that a person’s existing access to housing is protected against interference by both the state and private parties.¹⁰ If a legal process has the effect of limiting a person’s right in subsection (1), it will be unconstitutional unless the justification test under section 36 is satisfied. In other words, someone’s housing right may only be limited if there is a proportionate relationship between the purpose of the limitation and the effects thereof.

Subsection (3) is focussed on due process and therefore requires that a person may only be evicted from his home on the authority of a court order that was granted after considering all relevant circumstances. The subsection also seeks to avoid arbitrary evictions. As explained below, the protection of housing rights has had a significant impact on the legal procedure in terms of which a home is sold to settle a debt as well as when eviction proceedings are instituted to evict an unlawful occupier from residential property. The question is whether the housing clause should also afford protection to the home of a debtor whose estate has been sequestrated under the Insolvency Act.

3. Protection of housing rights during foreclosure and other judicial-sale proceedings

The Insolvency Act makes no provision to protect a debtor’s housing rights during insolvency proceedings. However, in individual debt enforcement cases in which a creditor seeks to sell a debtor’s home to collect a debt – such as in mortgage foreclosure proceedings – far-reaching legal developments have occurred in response to the need to give effect to the constitutional housing rights of debtors.¹¹ The impetus for this development was the 2004 judgment of the Constitutional Court in *Jaftha v Schoeman*.¹² The court essentially found that, whenever a home is sold in execution of a judgment debt, it entails a limitation of the right to adequate housing and therefore it must pass the proportionality test in the limitations clause.¹³ The court also explained that, if the property is mortgaged to the creditor, a sale in execution will be justified in most instances unless the outcome is grossly disproportionate or if there is an abuse of process.¹⁴ Moreover, the court emphasised the need to seek alternative ways to satisfy the creditor’s rights before

¹⁰ *Government of the Republic of South Africa v Grootboom* 2001 (1) SA 46 (CC) (at para 34); *Jaftha v Schoeman*; *Van Rooyen v Stoltz* 2005 (2) SA 140 (CC) (at para 34); *Maphango v Aengus Lifestyle Properties (Pty) Ltd* 2012 (3) SA 531 (CC) (at para 32).

¹¹ For a more detailed discussion of these developments, see R Brits, *Real Security Law* (1st ed, Juta & Co Ltd, Cape Town, 2016) at 68-100 and other sources cited there.

¹² *Jaftha v Schoeman*; *Van Rooyen v Stoltz* 2005 (2) SA 140 (CC).

¹³ *Idem*, at para 34.

¹⁴ *Idem*, at para 58.

resorting to the drastic measure of selling the debtor's home. Effectively, the sale of a home should only be permitted as a last resort.¹⁵

The facts in *Jaftha* involved the enforcement of unsecured debt before the Magistrate's Court, but the Constitutional Court subsequently confirmed, in *Gundwana v Steko Development*,¹⁶ that the principles laid down in *Jaftha* also apply to typical mortgage foreclosure cases brought before the High Court.¹⁷ The court in *Gundwana* confirmed that all courts faced with such applications have a duty to ensure that homes are only sold as a last resort and that disproportionality is avoided.¹⁸ In the meantime, the High Court Rules¹⁹ were amended to expressly require courts to consider all relevant circumstances before granting an execution order against residential property.²⁰

Numerous other judgments were handed down in subsequent years and it became clear that there were many remaining uncertainties regarding, amongst others, how courts are to decide when it is justifiable to have a home sold in execution.²¹ As a result, a further amendment was made to the High Court Rules by the addition of a new rule, Rule 46A, to deal more extensively with exactly how such cases are to be treated.²² Without going into detail, Rule 46A provides relatively clear rules regarding the process to be followed, the information to be provided to the court, the powers of the court and so forth. The rule also emphasises the main principle underlying the process, namely that an execution order may only be granted if there are no alternative ways to give effect to the creditor's rights.²³ A common practice of the courts, when faced with a complicated application for an execution order, is to postpone the application for at least six months so as to allow the parties some time to seek an alternative solution to the dispute.²⁴

Although the above developments occurred outside of the insolvency context, several authors have raised the question whether the developments in the mortgage foreclosure context should also influence the treatment of a debtor's home in sequestration

¹⁵ *Idem*, at paras 41-42, 56 and 59.

¹⁶ 2011 (3) SA 608 (CC).

¹⁷ *Idem*, at paras 38-41. Previously there had been some uncertainty in this regard. See eg *Nedbank Ltd v Mortinson* 2005 (6) SA 462 (W); *Standard Bank of South Africa Ltd v Saunderson* 2006 (2) SA 264 (SCA).

¹⁸ *Gundwana v Steko Development* 2011 (3) SA 608 (CC) (at paras 51-53).

¹⁹ General Notice R48 in *Government Gazette* 999 of 12 January 1965, as amended most recently by General Notice R1272 in *Government Gazette* 41257 of 17 November 2017.

²⁰ General Notice R981 in *Government Gazette* 33689 of 19 November 2010.

²¹ Prominent examples include *Standard Bank of South Africa Ltd v Bekker* 2011 (6) SA 111 (WCC); *Nedbank Ltd v Fraser* 2011 (4) SA 363 (GSJ); *FirstRand Bank Ltd v Folscher* 2011 (4) SA 314 (GNP); *Mkhize v Umvoti Municipality* 2012 (1) SA 1 (SCA); *Absa Bank Ltd v Petersen* 2013 (1) SA 481 (WCC); *FirstRand Bank Ltd v Mdletye* 2016 (5) SA 550 (KZD); *FirstRand Bank Ltd t/a First National Bank v Zwane* 2016 (6) SA 400 (GJ). See also *ABSA Bank Ltd v Ntsane* 2007 (3) SA 554 (T).

²² General Notice R1272 in *Government Gazette* 41257 of 17 November 2017.

²³ High Court Rules, r 46A(2).

²⁴ See eg *FirstRand Bank Ltd v Mdletye* 2016 (5) SA 550 (KZD); *FirstRand Bank Ltd t/a First National Bank v Zwane* 2016 (6) SA 400 (GJ).

proceedings.²⁵ For instance, one might ask whether the time has come to amend the Insolvency Act so that, before a trustee sells the debtor's residential property, a court must, based on all the circumstances, evaluate whether the loss of the debtor's home would be constitutionally justified.

Another question is whether it might be necessary to introduce some kind of homestead exemption in the Insolvency Act so that the home – or at least a portion of the equity – is excluded from the estate. A similar argument was made in the *Jaftha* case discussed above. The argument was that the debt enforcement procedure was unconstitutional because it did not exempt the debtor's home from the process. However, the Constitutional Court rejected this argument by reasoning that exempting homes (for instance, those below a certain value) from the execution process would create a "poverty trap" for persons owning such properties or wishing to purchase such properties. The reason for this is that banks would be unwilling to lend money to persons with (or planning to acquire) such properties because such properties would not be suitable as collateral.²⁶ As pointed out above, the court's preferred solution was to introduce a proportionality test to determine whether or not a home should be sold.

4. Protection of housing rights during eviction proceedings

If a debtor's estate is sequestrated pursuant to the Insolvency Act and the trustee exercises his duty to realise the debtor's home, the trustee may evict the debtor (and other occupiers) so as to give vacant possession to the purchaser. Alternatively, if the property is sold with the debtor still in occupation (which is possible in South African law), the purchaser (new owner) may evict the debtor.

In all evictions from residential property in South Africa (regardless of the context or cause of the eviction), the occupier will enjoy special procedural and substantive protection so as to ensure that the eviction is constitutionally justified and executed in a fair manner. As explained above, the constitutional norms – as set out in the housing clause²⁷ – specify that (1) no one's right of access to adequate housing may be limited unless it is justifiable by a proportionality test and (2) no one may be evicted from their home other than on the authority of a court order, which should only be granted after considering all relevant circumstances.

²⁵ See eg L Steyn, "Treatment of a Debtor's Home in Insolvency: Comparative Perspectives and Potential Developments in South Africa", *International Insolvency Review* (2013) 22(3) 144; R G Evans, "Does an Insolvent Debtor have a Right to Adequate Housing?", *South African Mercantile Law Journal* (2013) 25(2) 119; C van Heerden, A Borraine and L Steyn, "Perspectives on Protecting the Family Home in South African Insolvency Law" in P Omar (ed), *International Insolvency Law: Reforms and Challenges* (1st ed, Ashgate Publishing, Surrey, 2013); A Borraine and R Evans "The Law of Insolvency and the Bill of Rights" in Y Mokgoro and P Tlakula (eds), *Bill of Rights Compendium* (1st ed, Issue 34, LexisNexis, Durban, 2014) at para 4A8(g).

²⁶ *Jaftha v Schoeman; Van Rooyen v Stoltz* 2005 (2) SA 140 (CC) (at para 51).

²⁷ Constitution of the Republic of South Africa 1996, s 26. See para 1 above.

In the context of evicting someone from his home, the above-mentioned constitutional norms find expression in the Prevention of Illegal Eviction from and Unlawful Occupation of Land Act 19 of 1998 (commonly known as “PIE”).²⁸ The rules in the Act must be followed whenever an “unlawful occupier” is sought to be evicted from the property he occupies for residential purposes.²⁹ An unlawful occupier includes a person who previously occupied the property lawfully (such as a former owner) but whose title to that property has come to an end.³⁰ The person empowered to apply for the eviction order is the owner or any person in charge of the property.³¹ In other words, when a debtor has lost ownership of his home during the sequestration procedure and has therefore become an unlawful occupier of the property, PIE will be applicable should the new owner or the trustee wish to obtain an eviction order.³² It should be noted that PIE does not protect ownership of the property, but instead occupation thereof for residential purposes.

In addition to stipulating the procedural rules for evicting an unlawful occupier, PIE establishes the important rule that a court “may grant an order for eviction if it is of the opinion that it is just and equitable to do so, after considering all the relevant circumstances, including the rights and needs of the elderly, children, disabled persons and households headed by women”.³³ If the person has been in occupation for more than six months at the time when the eviction proceedings are initiated, the court must additionally consider “whether land has been made available or can reasonably be made available by a municipality or other organ of state or another land owner for the relocation of the unlawful occupier”.³⁴ Although the Act provides that this additional factor is not relevant “where the land is sold in a sale of execution pursuant to a mortgage”,³⁵ it is not clear whether this would include instances where mortgaged property is sold during insolvency proceedings. Assuming that it would, it appears that the exception is not, however, relevant where unencumbered property is sold during an insolvency proceeding.

If the relevant requirements have been satisfied and if the occupier has not raised a valid defence, the court is required to grant the eviction order.³⁶ Moreover, considering all relevant factors (including how long the occupier has lived on the premises), the court must set a just and equitable date on which the property should be vacated as well as the

²⁸ See *Port Elizabeth Municipality v Various Occupiers* 2005 (1) SA 217 (CC) (at para 11).

²⁹ An “unlawful occupier” is defined in the Prevention of Illegal Eviction from and Unlawful Occupation of Land Act 19 of 1998, s 1 as “a person who occupies land without the express or tacit consent of the owner or person in charge, or without any other right in law to occupy such land”.

³⁰ See especially *Ndlovu v Ngcobo*; *Bekker v Jika* 2003 (1) SA 113 (SCA).

³¹ Prevention of Illegal Eviction from and Unlawful Occupation of Land Act 19 of 1998, s 4.

³² See eg *Absa Bank Ltd v Murray* 2004 (2) SA 15 (C); *Oelofsen NO v Gwebu* [2010] JOL 25493 (GNP); *Botha NO v Kies* [2014] ZAGPPHC 809; *Starbuck NO v Halim* [2015] ZAGPPHC 839; *Murray NO v Rayman* [2016] ZAGPPHC 459; *Mayekiso v Patel NO* 2019 (2) SA 522 (WCC). See also *Morrison v Vaughn* [2008] ZAGPHC 171.

³³ Prevention of Illegal Eviction from and Unlawful Occupation of Land Act 19 of 1998, s 4(6).

³⁴ *Idem*, s 4(7).

³⁵ *Ibid.*

³⁶ *Idem*, s 4(8).

date on which the eviction order should be executed in the event that the occupier has not vacated voluntarily.³⁷ The court may also make the eviction subject to reasonable conditions.³⁸

PIE does not protect a debtor's home in the sense that the property is exempted from being lost as a consequence of, for instance, the debtor's insolvency. Instead, the Act provides rules that ensure that the debtor and his family are not left homeless without due process or without a court establishing that the loss of housing would be constitutionally acceptable. There appear to be no reported judgments in which a court denied an eviction order against an insolvent debtor based on the provisions of PIE. In most instances it would also be unrealistic, in view of the purpose of sequestration, to allow a situation where the debtor cannot be evicted due to his personal circumstances. The risk of this happening would discourage prospective purchasers, which would in turn seriously undermine the sequestration process. Therefore, probably the most significant implication of PIE for the sequestration process is that it authorises the court to set a date for the eviction that would be fair and reasonable in light of all the circumstances. For instance, the court can allow the debtor a reasonable amount of time to find alternative accommodation. Presumably, such an order could provide adequate protection for the residential situation of a debtor without undermining the sequestration process.

5. Protection of housing rights during debt review

From the above it is clear that there is no specific protection for a debtor's home in the sequestration procedure but that, if the home is sold as a result of sequestration, the eviction will be conducted according to special rules designed to ensure that constitutional housing rights are not limited unjustly. Furthermore, with regard to foreclosures and other judicial-sale cases, extensive rules have been developed to ensure that homes are only lost as a last resort. Usually, when a debtor's affairs are so dire that he is insolvent, sequestration is available as an alternative (both for the debtor and the creditor(s)) to normal debt enforcement proceedings. However, as a possible solution to their financial troubles, and in addition to the traditional asset-liquidation procedure set out in the Insolvency Act, consumer debtors also have access to the payment plan procedure – known as “debt review” – in terms of the National Credit Act.³⁹

³⁷ *Idem*, s 4(8)-(9).

³⁸ *Idem*, s 4(12).

³⁹ For a comprehensive discussion of debt review, see C van Heerden, “Over-indebtedness and Reckless Credit” in J W Scholtz, J M Otto, E van Zyl, C M van Heerden and N Campbell (eds), *Guide to the National Credit Act* (1st ed, Service Issue 12, LexisNexis, Durban, 2020) at Ch 11. For the role of debt review in protecting housing rights in mortgage foreclosure proceedings, see R Brits, “Compulsory Debt Reorganisation in South African Mortgage Law: A ‘Sharing’ Remedy”, *South African Law Journal* (2018) 135(4) 737.

If a debtor (referred to as a “consumer” in the National Credit Act) is “over-indebted”,⁴⁰ he may apply to a debt counsellor to be placed under debt review.⁴¹ If a creditor has already commenced with enforcement proceedings, that particular debt will be excluded from debt review.⁴² However, in such a case the court has a discretion to refer the matter (that is, the debt that is in the process of being enforced) to a debt counsellor or to provide relief itself.⁴³ When conducting the review, the debt counsellor must evaluate the debtor’s affairs and arrive at a conclusion regarding the debtor’s level of indebtedness.⁴⁴ If the counsellor concludes that the debtor is over-indebted, a recommendation must be made to the Magistrate’s Court regarding how the debt can be rearranged.⁴⁵ The available options are extending the period of the agreement but reducing the amount of each instalment; postponing the date on which the instalments are due; extending the period of the agreement and postponing the instalments; or recalculating the consumer’s obligations.⁴⁶ A hearing must be conducted and, upon considering the counsellor’s recommendation and any other information, the Magistrate’s Court may grant an order rearranging the consumer’s obligations.⁴⁷ The National Credit Act does not permit a discharge of any portion of the debtor’s obligations, unless it is found that the credit was granted recklessly.⁴⁸

The National Credit Act does not contain any express reference to the debtor’s home, but the debtor’s property is nevertheless protected in the sense that debt review does not involve the sale of any assets. In other words, if a debtor enters debt review and is granted a debt rearrangement order, he can keep his home. During the currency of debt review, the debtor’s assets are also protected against any debt enforcement action.⁴⁹ Mortgage debt will be included in the payment plan, and thus any mortgaged property (such as the debtor’s home) will also be protected. However, should the debtor default on the terms of the debt rearrangement order, the creditors can continue with normal debt enforcement action, which could include the sale in execution of the debtor’s home.⁵⁰

When comparing the sequestration procedure in terms of the Insolvency Act with the debt review process in terms of the National Credit Act, the most striking difference for present purposes is that debt review does not necessitate the sale of the debtor’s home (or any

⁴⁰ The concept of “over-indebtedness” is defined in the National Credit Act, s 79(1). Without going into detail, it is very similar to being insolvent, except that it only relates to debts created in terms of credit agreements that fall within the scope of application of the NCA.

⁴¹ National Credit Act, s 86(1).

⁴² *Idem*, s 86(2).

⁴³ *Idem*, s 85.

⁴⁴ *Idem*, s 86(6).

⁴⁵ *Idem*, s 86(7)(a)(i)-(ii), s 86(8)(b). If the debt counsellor rejects the application, the debtor can apply directly to the Magistrate’s Court: National Credit Act, s 86(9).

⁴⁶ National Credit Act, s 86(7)(a)(ii)(aa)-(bb).

⁴⁷ *Idem*, s 87(1)(a) and (b)(i)-(ii).

⁴⁸ For more information on the situation where there is reckless credit present, see eg R Brits, “The National Credit Act’s Remedies for Reckless Credit in the Mortgage Context”, *Potchefstroom Electronic Law Journal* (2018) 21 1.

⁴⁹ National Credit Act, s 88(3).

⁵⁰ *Idem*, s 86(3)(b)(ii). See eg *Ferris v FirstRand Bank Ltd* 2014 (3) SA 39 (CC).

assets for that matter), while sequestration requires the sale of almost all assets, including the debtor's home. In other words, for a struggling debtor wishing to enjoy some relief from his over-indebtedness / insolvency but who does not want to lose his home, debt review is the preferred option. On the other hand, many creditors (especially secured creditors) might prefer to follow the sequestration route. The question is whether the debtor will necessarily have a choice to opt for the procedure that would be most beneficial when it comes to safeguarding his home.

This speaks to a larger issue regarding the interaction between the National Credit Act and the Insolvency Act, which has caused some uncertainty ever since the former was enacted.⁵¹ For example, in *Ex parte Ford*⁵² the court refused – within its wide discretion – to grant the three sequestration orders applied for because the applicants (the debtors) failed to explain why they did not apply for debt review under the National Credit Act instead, since the latter option would potentially be more beneficial for both them and their creditors.⁵³ Accordingly, *Ford* and certain other subsequent cases⁵⁴ suggest that, before granting a sequestration order, a court might consider whether there are less severe options available, such as debt review.⁵⁵

Although the decision of the court in *Ford* was not based on protecting the debtors' homes as such, one can foresee a situation where a court detects (or is presented with evidence) that a sequestration order would result in a constitutionally unacceptable loss of the debtor's home. Thus, faced with this prospect, the court might decide to exercise its discretion against granting a sequestration order, while advising that the parties should resort to the less invasive option of debt review instead. Nevertheless, it is important to note that there is no formal rule that a court should only grant a sequestration order after determining that debt review is unsuitable.⁵⁶ All of this depends on the exercise of the court's wide discretion based on the facts of each case.

6. Conclusion

Although the Insolvency Act does not contain any mechanism whereby a debtor's residential property is protected during the sequestration process, there are other measures in place in the broader legal system to protect the important constitutional right associated with a person's home.

⁵¹ See, eg, C van Heerden and A Boraine, "The Interaction Between the Debt Relief Measures in the National Credit Act 34 of 2005 and Aspects of Insolvency Law", *Potchefstroom Electronic Law Journal* (2009) 12 22.

⁵² 2009 (3) SA 376, 383 (WCC).

⁵³ See also *Crafford v Crafford* [2014] ZAWCHC 14.

⁵⁴ *Ex parte Cloete* [2013] ZAFSHC 45; *Ex Parte Fuls* 2016 (6) SA 128 (GP); *Ex parte Connaway* [2016] ZAWCHC 62; *Botha v Botha* [2016] ZAFSHC 194; *Ex Parte Oberholzer*; *Ex Parte Nchabeleng*; *Ex Parte Van der Walt* [2017] ZAGPPHC 566; *Eksteen v Van der Merwe* [2018] ZAFSHC 131; *JJ v AJ* [2020] ZAFSHC 4.

⁵⁵ See C van Heerden, "Over-indebtedness and Reckless Credit" in J W Scholtz, J M Otto, E van Zyl, C M van Heerden and N Campbell (eds), *Guide to the National Credit Act* (1st ed, Service Issue 12, LexisNexis, Durban, 2020) at para 11.7.

⁵⁶ *Ibid.*

Firstly, when faced with an application for a sequestration order, a court may determine that the order should not be granted because pursuing a normal debt enforcement and judicial-sale procedure would be more suitable. The latter procedure provides extensive protection for a debtor's home⁵⁷ and thus this route is preferable to sequestration in situations where it appears that the sale of a home will infringe the constitutional rights of the debtor. In fact, it appears that a court will not easily allow a creditor to pursue sequestration proceedings as a way to bypass the protection measures available in other procedures.⁵⁸

Secondly, in cases where neither sequestration nor the normal judicial-sale procedure appears to be appropriate, the court can deny the application for a sequestration order if it appears that debt review, being a less severe procedure, would be a better solution – also because it would avoid the loss of the debtor's home. Alternatively, the court hearing the sequestration application can refer the matter directly to a debt counsellor or grant a debt rearrangement order.⁵⁹

Thirdly, in cases where the court holds that sequestration is indeed the appropriate course of action, the debtor's home will be sold as part of the normal asset-liquidation process. However, the debtor will receive a degree of protection when he is evicted from the property, because the requirements of PIE must be complied with.⁶⁰ The latter Act was designed to ensure that an eviction from a home would not violate the constitutional housing clause and, therefore, presuming that the Act is followed and the court exercises its oversight role correctly, one can probably assume that the protection afforded to the debtor will be sufficient in most instances. Most significantly, PIE allows a court to set a reasonable date for the evictions, which means that the court would be empowered to ensure that the debtor has sufficient time to find alternative accommodation.

In conclusion, therefore, the sequestration procedure set out in the Insolvency Act – being the main insolvency procedure available for consumer debtors in South Africa – does not contain any specific mechanisms (such as a homestead exemption) to protect a debtor's home. However, the overall system – comprising sequestration, debt review, judicial sale and eviction – probably caters sufficiently for a struggling debtor's constitutional housing rights. The facts of each case will dictate how the matter should progress through the available procedures. Sometimes sequestration followed by eviction would be appropriate. At other times, debt review should be pursued, while it may sometimes be better to avoid insolvency law altogether in favour of the normal debt enforcement (judicial-sale) procedure.

⁵⁷ See para 3 above.

⁵⁸ See eg *Body Corporate of Redberry Park v Sikude NO* [2015] ZAKZDHC 51.

⁵⁹ National Credit Act, s 85. See para 5 above.

⁶⁰ See para 4 above.

The tax priority in Australian corporate insolvency: A Dworkinian approach

By Catherine Brown, Queensland University of Technology, Australia*

Abstract

In 1988, the Australian General Insolvency Inquiry (Harmer Report) recommended that the principle of *pari passu* should be maintained as a fundamental policy objective underpinning Australian insolvency laws. On this basis, it was recommended that the preferential treatment for Australian taxation debts be abolished. In the 30 years following the Harmer Report, Australian taxation and insolvency legislation is increasingly complex and inconsistent. As the Australian government grapples with its response to the economic impact of COVID-19, the issue of whether taxation should be given preferential treatment in corporate insolvency will inevitably arise. This paper argues Dworkin's rights thesis and equality theories provide a framework for determining whether any departure from *pari passu* can be justified in the context of Australian taxation and corporate insolvency law.

1. Introduction

The Crown prerogative in relation to taxation debts in insolvency was substantially abolished in Australia in 1980¹ following the recommendations of the Senate Standing Committee on Constitutional and Legal Affairs (Missen Committee).² Despite this reform, the Commissioner of Taxation retained a statutory priority over certain unpaid withholding and unremitted deductions taxation debts,³ and it was not until 1993, when the recommendations of the Australian Law Reform Commission (ALRC) General Insolvency Inquiry (Harmer Report) were enacted, that these remaining statutory priorities were removed.⁴ The Harmer Report recommendations were premised on the view that the *pari passu* principle should form the underlying objective of Australian insolvency law.⁵ This view was subject to the proviso that the *pari passu* principle would not unnecessarily intrude on property rights and security interests and would operate in a manner that encouraged effective administration of insolvent entities.⁶ Importantly, it was the Harmer Report's recommendation that any departure from the *pari passu* principle should be

* Dr Catherine Brown, Lecturer, Queensland University of Technology, Australia. This paper has been extracted from C Brown "Revisiting the Priority of Taxation in Corporate Insolvency: An Application of Dworkin's Rights Thesis and Equality Theories" (Thesis), available at <https://eprints.qut.edu.au/134140/>.

¹ Bankruptcy Amendment Act 1980 (Cth), Taxation Debts (Abolition of Crown Priority) Act 1980 (Cth), Crown Debts (Priority) Act 1980 (Cth).

² Senate Standing Committee on Constitutional and Legal Affairs, *Priority of Crown Debts* (Parliamentary Report, June 1978) 8-9.

³ Crown Debts (Priority) Act 1981 (Cth), s 4.

⁴ Insolvency (Tax Priorities) Legislation Amendment Act 1993 (Cth); Taxation Laws Amendment Act (No 3) 1995 (Cth).

⁵ Australian Law Reform Commission, *General Insolvency Inquiry* (Report No 45, 1988), at para 713.

⁶ *Idem*, at para 733.

“countenanced by reference to clearly defined principles or policies which enjoy general community support.”⁷

One of the more significant challenges in abolishing the statutory priority for taxation debts, as noted by the Missen Committee as far back as the late 1970’s, is the plethora of legal rules that determined the overall priority of the Commissioner, resulting in a legal position that has “undesirable consequences for all concerned in the administration of insolvent affairs.”⁸ Since that time, the rules that underpin Australian corporate insolvency and taxation laws have only become more complex, resulting in a *de facto* statutory priority in favour of the Commissioner for certain tax debts.⁹ This is in part due to post-Harmer Report developments in Australian taxation law.¹⁰ However, it is arguable that the inconsistency between corporate insolvency and taxation laws is largely due to competing policy objectives underpinning the different areas of law.¹¹

The policy approaches that have historically underpinned the development of taxation law are more generally aimed at the implementation of each new tax regime and the insolvency aspects of such reforms have been historically confined to collection mechanisms, rather than specific considerations of the Commissioner’s priority in insolvency.¹² Likewise, insolvency laws have also been subject to significant reform, including the major reforms to both the corporate and personal insolvency laws introduced by the Insolvency Law Reform Act 2016 (Cth) and, more recently, reforms aimed at anti-phoenix behaviour¹³ and the insolvency of small businesses post COVID-19.¹⁴ The policy underpinning these reforms more generally relate to the improvement of

⁷ *Idem*, at para 713.

⁸ Senate Standing Committee on Constitutional and Legal Affairs, *Priority of Crown Debts* (Parliamentary Report, June 1978) 3.

⁹ C Brown, C Anderson and D Morrison, “The Certainty of Tax in Insolvency: Where does the ATO fit?”, *Insolvency Law Journal* (2011) 19(2)108.

¹⁰ See eg Fringe Benefits Tax Assessment Act 1986 (Cth), introduced in 1986; A New Tax System (Goods and Services Tax) Act 1999 (Cth), introduced in 2000; *Reform of the Australian Tax System (Draft White Paper)* which recommended the introduction of a capital gains tax regime in 1985.

¹¹ C Anderson, J Dickfos and C Brown, “The Australian Taxation Office: What Role does it Play in Anti-Phoenix Activity?”, *Insolvency Law Journal* (2016) 24(2) 127; C Brown, C Anderson and D Morrison, “The Certainty of Tax in Insolvency: Where does the ATO fit?”, *Insolvency Law Journal* (2011) 19(2) 108; C Symes, *Statutory Priorities in Corporate Insolvency Law: An Analysis of Preferred Creditor Status* (Ashgate Publishing Ltd, Farnham, England, 2008); S Villios, “The Legislative Interface Between the Creation of a Liability to Tax and the Right to Challenge that Liability”, *Australian Tax Forum* (2014) 29(3) 551.

¹² For example, on enactment of A New Tax System (Goods and Services Tax) Act 1999 (Cth), the former Div 147 (now repealed) focused on ensuring that the appointed insolvency practitioner, rather than the insolvent entity, would be liable for payment. See C Brown, C Anderson and D Morrison, “The Certainty of Tax in Insolvency: Where does the ATO fit?”, *Insolvency Law Journal* (2011) 19(2) 108.

¹³ See, eg, Treasury Laws Amendment (Combating Illegal Phoenixing) Act 2020 (Cth) which extends the operation of Divs 268 and 269 of Sch 1 to the Taxation Administration Act 1953 (Cth) to enable the Commissioner to collect estimated GST liabilities from and render company directors personally liable for their company’s GST liabilities.

¹⁴ Corporations Amendment (Corporate Insolvency Reforms) Act 2020 (Cth).

insolvency procedures, the increasing focus on corporate rescue and innovation, and an implicit need to protect taxation revenue.¹⁵

In the absence of a cohesive policy framework, inconsistencies between Australian insolvency and taxation law are inevitable. This paper considers whether Dworkin's rights thesis and equality theories can be applied to determine whether a departure from *pari passu* in relation to the collection of taxation revenue can ever be justified and, if so, on what basis.

2. Achieving consistency: A matter of interpretation

There is an implicit assumption that the resolution of issues related to the priority of the Commissioner in insolvency can be resolved by the interpretation of a singular piece of legislation.¹⁶ However, as Hill points out, insolvency and taxation laws are not "systematically coordinated", thus neither insolvency nor taxation theory can provide a framework for this statutory co-ordination.¹⁷ Where there is no clear tie-breaker rule in the provisions of competing legislation, and the policy underpinning each statute suggests inconsistent Parliamentary objectives, reconciling inconsistent statutory provision to achieve unity of meaning is more challenging.

As indicated above, the view articulated in the Harmer Report is that the Commissioner's priority in insolvency should be abolished and that the *pari passu* principle should be retained as the underlying objective of insolvency law for all unsecured creditors, including the Commissioner. However, while the Harmer Report provided a sound policy basis for the removal of the statutory priorities existing at that point in time, it is arguable that this policy position did not extend to abolishing all forms of priority in favour of the Commissioner. Furthermore, the Harmer Report recommendations did not provide a specific policy framework for resolving inconsistencies between corporate insolvency and taxation laws that result in an indirect, or unintended, priority of payment for tax debts over other unsecured creditors in insolvency. Unsurprisingly, the Commissioner continues to argue in favour of a tax priority on the basis that taxation debts of an insolvent entity are owed to the broader community and not individual creditors.¹⁸ In other words, the tax revenue collected by the Commissioner for debts owed by an insolvent entity is for the overall benefit of the wider Australian community, and so priority of payment to the

¹⁵ For example, the Explanatory Memorandum, Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2019 (Cth) listed statutory bodies such as the ATO as "those impacted by illegal phoenix activity" (at para 1.5).

¹⁶ F R Hill, "Toward a Theory of Bankruptcy Tax: A Statutory Coordination Approach" (1996) 50(1) *Tax Lawyer* 103 at 105.

¹⁷ *Ibid.*

¹⁸ Australian Law Reform Commission, *General Insolvency Inquiry* (Report No 45, 1988), at para 734. See also Australian Taxation Office, *Enforcement measures used for the collection and recovery of tax-related liabilities and other amounts* (Practice Statement Law Administration PS LA 2011/18, 14 April 2011) at para 131.

Commissioner is justified.¹⁹ Another common argument in support of a tax priority is that the Commissioner, as an involuntary creditor, is not in the same bargaining position as commercial creditors.²⁰ These arguments were rejected by the Harmer Report.

A contrary and more persuasive view is that if taxation laws are interpreted only in the context of tax policy and not in the broader context of insolvency law, then it is very likely the *pari passu* objective will be undermined. Furthermore, if legislators are not consciously taking the *pari passu* objective in insolvency into account when drafting taxation laws, then the usual rules of statutory interpretation, which take into account text, context and purpose,²¹ are even more likely to result in a watering down of the *pari passu* principle when applied to the Commissioner as a creditor in insolvency.

In Australia, the *pari passu* principle is enshrined in section 555 of the Corporations Act 2001, which provides:

“Except as otherwise provided by this Act, all debts and claims proved in a winding up rank equally and, if the property of the company is insufficient to meet them in full, they must be paid proportionately.”

As a matter of statutory interpretation, the only exceptions to the *pari passu* rule are those provided for by the Corporations Act 2001. Accordingly, any tie-breaker rule between corporate insolvency and taxation laws must be specifically incorporated in the relevant taxation provision to avoid potential inconsistencies. With approximately 125 different taxes identified in the 2009 Australia’s Future Tax System Review,²² this approach would simply be unsustainable.

Dworkin argues that the resolution of inconsistent and incoherent laws (referred to as “hard cases”) is more than a mere process of bridging gaps in statute and precedent through the exercise of judicial discretion. As Dworkin points out, discretion is a relative concept which “like a hole in a doughnut, does not exist except as an area left open by a surrounding belt of restriction.”²³ Dworkin contends that the resolution of hard cases is achieved by the application of legal principles.²⁴ He further contends that legal principles are not made valid by some “rule of recognition”, but rather because they are considered appropriate by society and the courts. As such, conflicting legal principles can be resolved by reference to their relative weight or importance.²⁵ A legal principle might be

¹⁹ Australian Law Reform Commission, *General Insolvency Inquiry* (Report No 45, 1988) at para 734. See also B K Morgan, “Should the Sovereign be Paid First? A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy”, *American Bankruptcy Law Journal* (2000) 74 461 at 463.

²⁰ Australian Law Reform Commission, *General Insolvency Inquiry* (Report No 45, 1988) at para 734.

²¹ M Kirby, “Statutory Interpretation: The Meaning of Meaning”, *Melbourne University Law Review* (2011) 35(1) 113 at 116.

²² Australia Government, *Australia’s Future Tax System* (Final Report - Overview, December 2009) at 11.

²³ R Dworkin, *Taking Rights Seriously* (Bloomsbury Publishing, Revised ed, 2013) at 48.

²⁴ *Ibid.*

²⁵ *Idem*, at 43.

understood more clearly as the basis on which an inconsistent statutory provision is to be interpreted.

Applying Dworkin's reasoning, this means that where taxation laws are either inconsistent with section 555 of the Corporations Act 2001, or incoherent in their application, they will need to be resolved by the courts on the basis of Dworkin's legal principles rather than matters of policy. There are, in fact, two competing arguments that could be applied in resolving inconsistency of laws relevant to the Commissioner as a creditor in insolvency; the first being the *pari passu* principle and the second being a public policy argument that relates to revenue retention and moral obligations to pay taxes. Whereas the *pari passu* principle can be supported on the basis that it is a requirement of justice or fairness, and so arguably a legal principle in a Dworkinian sense, the revenue retention argument is better understood as policy relating to improvement in economic, political, or social features of the community.²⁶

Support for this view can be found in the High Court decision of *International Air Transport Association v Ansett Australia Holdings Limited* ("*Ansett Australia Holdings*").²⁷ While the Court rejected the argument that *pari passu* plays a broad role in relation to the construction of contracts and the interaction of those contractual terms with the provisions of the Corporations Act 2001, the basis on which the High Court reached this decision was that the legislative provisions prevailed. More importantly, it is arguable that the issue in *Ansett Australia Holdings* did not involve legal issues that amount to a "hard case" in a Dworkin sense. This is because the reasoning applied by the High Court was based on the application of legal rules that were neither inconsistent nor incoherent. That is, the legal rules applicable in this case were those provided by statute, being the Corporations Act 2001, and the common law rule that statute will generally prevail over contractual terms, applied.²⁸ Therefore, the mere fact that the High Court did not recognise a public policy argument that *pari passu* should prevail does not preclude it from being a legal principle. Furthermore, Kirby J (in dissent) argued that the public policy principle put to the Court was confined to the "protection of the *pari passu* settlement of creditor claims" was "altogether too narrow a reading" of the *British Eagle* decision.²⁹

The *pari passu* principle was, more relevantly, applied in *Ackers (as joint foreign representative) v Saad Investments Company Limited; In the matter of Saad Investments Company Limited (in official liquidation) (Ackers v Saad)*.³⁰ In that case, the Federal Court

²⁶ *Idem*, at 58.

²⁷ [2008] HCA 3.

²⁸ *International Air Transport Association v Ansett Australia Holdings Limited* [2008] HCA 3, at para 78. The Court relied on *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1 and *Foots v Southern Cross Mine Management Pty Ltd* [2007] HCA 56.

²⁹ *Ibid* at para 168, citing R Mokal, "Priority as Pathology: The *Pari Passu* Myth", *Cambridge Law Journal* (2001) 60(3) 581 at 597 as authority.

³⁰ [2013] FCA 738.

acknowledged the competing corporate insolvency and taxation laws,³¹ but ultimately determined that the “Commissioner’s advantage of Crown priority over unsecured creditors in domestic insolvencies” had been removed in order to “enlarge the debtor’s estate that was available for distribution to unsecured creditors.”³²

Accordingly, when interpreting statutes, the better view is that inconsistencies between section 555 of the Corporations Act 2001 and taxation laws should be interpreted by reference to *pari passu* as a legal principle. The alternative argument, being that “the general body of taxpayers [should not be] called upon unnecessarily to shoulder the added burden of having to bear tax that was not remitted by defaulting taxpayers,”³³ is a policy argument that should be left to the legislature.

3. Determining a consistent policy approach: Notions of equality

While *pari passu* should form the fundamental basis for interpreting inconsistencies between corporate insolvency and taxation law, the issue remains as to whether, and in what circumstances, legislative policy should provide a direct, or indirect, priority in favour of the Commissioner in insolvency. More specifically, the question is whether a departure from the *pari passu* approach can be justified “by reference to clearly defined principles or policies which enjoy general community support” as intended by the Harmer Report.³⁴

Achieving a consistent and coherent approach to issues related to the priority of taxation debts in insolvency arguably requires a framework that aligns both the *pari passu* principle and the maxims of tax law. While there exists some divergence as to which maxims of tax should underpin the development of Australian taxation law, the common themes are equality and fairness, certainty, simplicity and efficiency.³⁵ In determining the most appropriate policy approach, it may be that one maxim of tax law should prevail over the others. By way of example, on the implementation of Australia’s capital gains tax regime, the Asprey Committee Report recommended that horizontal and vertical equity should prevail over simplicity.³⁶ However, while this assists in determining where the burden of a given tax policy should lie, it does not assist in determining the appropriate policy to apply to the intersection of taxation and insolvency law.

The *pari passu* principle relates to equal distribution of scarce resources. Likewise, tax systems are often viewed as mechanisms for achieving economic equality in society

³¹ *Ackers (as joint foreign representative) v Saad Investments Company Limited; In the matter of Saad Investments Company Limited (in official liquidation)* [2013] FCA 738 (at paras 44 - 45).

³² *Idem*, at para 31.

³³ Australian Law Reform Commission, *General Insolvency Inquiry* (Report No 45, 1988) at para 734.

³⁴ *Idem*, at para 713.

³⁵ A Smith, *The Wealth of Nations: An inquiry into the Nature and Causes of the Wealth of Nations* (Dent, London, 1910) at 307-308; C Alley and D Bentley, “A Remodelling of Adam Smith’s Tax Design Principles” *Australian Tax Forum* (2005) 20(4) 579 at 586-588.

³⁶ See generally Australia Government, *Reform of the Australian Tax System* (Draft White Paper, June 1985) at para 23.12. See also Commonwealth Taxation Review Committee (Commonwealth), *Full Report (Asprey Report)* (Parliamentary Paper).

through the redistribution of wealth.³⁷ However, what is considered an equitable tax system is ultimately determined by reference to individual perspectives and various social norms.³⁸ In his series on theories of equality, Dworkin examines several theories of distributional equality to show that differing theories of equality will result in diverse legal recommendations.³⁹ Dworkin contends that “[e]quality is a popular but mysterious political idea” and therefore “requires that we distinguish various conceptions of equality, in order to decide which of these conceptions (or which combination) states an attractive political idea, if any does.”⁴⁰ Reconciling competing notions of equality and achieving consistency in relation to the priority of taxation in corporate insolvency thus becomes a question of determining whether the burden of the loss of taxation revenue in corporate insolvency should be borne by the general body of taxpayers at the expense of individual creditors.

The Commissioner’s priority argument is essentially a social utility one; namely that the welfare of all individuals in society will increase if the Commissioner’s priority distribution increases, even if that means that the benefits accruing to unsecured creditors in an insolvency proceeding are reduced. Dworkin’s view is that individual rights “are best understood as trumps over some background justification for political decisions that states a goal for the community as a whole.”⁴¹ Applying Dworkin’s reasoning, this social utility rationale is as an “external preference” that corrupts the utilitarian values underpinning the concept of *pari passu*. Dworkin’s argument is that governments cannot simply override rights by legislating on the basis of some utilitarian goal. Individual rights can only give way to greater community good where it can be justified on “special grounds”. While a matter of debate, the special grounds suggest some measure of morality. Accordingly, any policy based on the Commissioner’s “external preference” of maximising the welfare of society should give way to the rights of individual creditors in insolvency. Furthermore, any departure from *pari passu* should only be on the basis of some special, or moral, ground.

On this basis, it is argued that any tax reform that results in the rights of individual creditors in corporate insolvency giving way to the community goal of revenue raising, can only be justified on Dworkin’s special (moral) grounds. By way of example, it may be that measures aimed at illegal phoenixing behaviour could be a justifiable exception to *pari passu* on the basis that tax compliance is considered a form of moral obligation. However, it would be insufficient for policy makers to merely point to the tax revenue retained by such measures, as is the current practice. Specific consideration of *pari passu* should be required.

³⁷ J E Meade, *Meade Report on The Structure and Reform of Direct Taxation* (Allen & Unwin, 1978) at 12; Australian Government, *Re:Think Tax Discussion Paper* (Discussion paper, March 2015) at 24; Australia Government, *Australia’s Future Tax System* (Final Report - Overview, December 2009) at 12.

³⁸ D Elkins, “Horizontal Equity as a Principle of Tax Theory”, *Yale Law & Policy Review* (2006) 24(1) 43.

³⁹ R Dworkin, “What is Equality? Part 1: Equality of Welfare”, *Philosophy and Public Affairs* (1981) 10(3) 185; R Dworkin, “What is Equality? Part 2: Equality of Welfare” *Philosophy and Public Affairs* (1981) 10(4) 283.

⁴⁰ R Dworkin, “What is Equality? Part 1: Equality of Welfare”, *Philosophy and Public Affairs* (1981) 10(3) 185 at 185.

⁴¹ R Dworkin, “Is There a Right to Pornography?”, *Oxford Journal of Legal Studies* (1981) 1(2) 177.

4. Conclusion

A comprehensive review of the priority for taxation claims in favour of the Commissioner of Taxation has not been undertaken since the Harmer Report. Given that “Australia is now facing a different set of economic, social and environmental circumstances to those that have shaped tax and transfer policy since federation”,⁴² it is likely that the same changing circumstances will also drive changes to the Commissioner’s obligation to protect and collect tax revenue in insolvency.⁴³ This is exacerbated by the fiscal pressures facing the Australian economy as the result of COVID-19 and the consequential reforms to insolvency laws.⁴⁴

The advantage of excluding the Commissioner’s “external preference”, as defined in Dworkin’s equality theories, is that it ensures that legislation is drafted on policy grounds which balances the competing objectives of insolvency and taxation law. That is, this approach removes the impasse that arises in relation to conflicting policy objectives by making clear that arguments, such as the need to protect taxation revenue, are not sufficient justifications for an exception to the *pari passu* principle. Furthermore, where policy objectives are clearly articulated, particularly when drafting taxation laws, it is less likely that an interpretation stalemate will occur. This is because the policy underpinning both insolvency and taxation laws will be more consistent, allowing the courts to adopt a statutory interpretation approach that incorporates the *pari passu* principle and clearly articulated justifications for departures from that approach.

In practice, this would require that any legislative reform that has a direct, or indirect, impact on section 555 of the Corporations Act 2001 to ensure that any exception, not just those provided by the Corporations Act itself, must explicitly state the grounds on which the exception to *pari passu* can be justified. Whether the Australian government is incentivised to enact such a reform is an entirely different question.

⁴² Australia Government, Canberra, *Australia’s Future Tax System* (Final Report - Overview, December 2009) at 3.

⁴³ See, eg, recent reviews examining the probity of the Australian Tax Office’s debt collection practices, more notably the Australian Small Business and Family Enterprise Ombudsman, *Australian Taxation Office – Enforcement of Debt Recovery* (Report, April 2019) and Inspector-General of Taxation and Taxation Ombudsman, *Review into the Australian Taxation Office’s use of Garnishee Notices: Tax Administration Management Report* (March 2019). The Australian Tax Office’s mandate to collect tax revenue can be seen in Australian Taxation Office, Commissioner of Taxation Annual Report 2017-18, (online) <https://www.ato.gov.au/About-ATO/Annual-report-2017-18/Commissioner-s-review/>, where the Commissioner reported that “[i]n]et tax collections were almost \$397 billion, up \$37.4 billion (10.4%) over the previous year, with the biggest driver being growth in company collections, up \$16 billion on 2016-17”.

⁴⁴ See in general <https://treasury.gov.au/sites/default/files/2020-04/Fact-sheet-Providing-temporary-relief-for-financially-distressed-businesses.pdf>.

The parable of corporate rescue in the United Kingdom - survival of the company, business rescue or preventive restructuring?

By Pride Chanakira, PhD candidate, University of Wolverhampton, United Kingdom*

Abstract

In the United Kingdom (UK), under the Insolvency Act 1986, the primary legislative purpose of administration is to rescue a company as a going concern. Yet, only a few cases of successful company rescue have been observed in practice. The most common outcome attained is business rescue under the second legislative purpose. The statutory purposes of administration form a hierarchy and this means that the second purpose can only be adopted if company rescue is not reasonably practicable. The rationale of the second purpose is to achieve a better result for the creditors than would be likely in a winding up. The third purpose permits an administrator to realise the company's assets to make a distribution to one or more preferential or secured creditors and thereafter the administration may be converted to a liquidation or move directly to dissolution. The administrator's function of making distributions and the ability to move the administration into winding up or dissolution, it is argued, undermines the primary objective of company rescue. In contrast, the corporate rescue approach adopted in the European Union (EU) fosters a more inclusive regime that is primarily focused on preventing insolvency and preserving viable businesses. The purpose of this paper is to evaluate the effectiveness of the corporate rescue approach adopted in the UK and to compare it to the approach promoted in the EU, against a backdrop of the fundamental principles endorsed by the World Bank.

1. Introduction

The rehabilitation of financially distressed businesses is a key element of an efficient insolvency regime. If stakeholders have confidence in the rescue provisions, that confidence supports lending which in turn promotes economic growth.¹ The primary purpose of the administration provisions is to rescue a company as a going concern.² This implies that a company must remain intact and retain the whole or a part of its business after an administration.³ The corporate rescue approach adopted under administration is

* PhD candidate at the University of Wolverhampton Law School (ORCID iD: 0000-0001-6634-8446). Researcher profile available at: <https://elements.wlv.ac.uk/default.html>.

¹ Graham Review into Pre-pack Administration (2014) available at: <https://www.gov.uk/government/publications/graham-review-into-pre-pack-administration#:~:text=The%20report%20was%20carried%20out,Government%20response%20to%20the%20Review>.

² Insolvency Act 1986 (hereinafter referred to as IA 1986), Sch B1, para 3(1)(a).

³ In *Davey v Money & Anor* [2018] EWHC 766 (Ch), Snowden J decided that a decision not to pursue the primary purpose could only be attacked where it was made in bad faith or was clearly perverse in the sense that no reasonable administrator would have thought that it was not reasonably practicable to rescue the company as a going concern.

comparable to the “judicial management”⁴ procedure under the company law⁵ of South Africa since 1926 and the Australian “official management”⁶ introduced in 1961.⁷ In contrast, the preventive restructuring approach adopted in the EU is focused on preventing insolvency and ensuring the viability businesses⁸ where there is a likelihood of insolvency.⁹ Similarly, the United States Bankruptcy Code (USC) provides a reorganisation procedure¹⁰ that places emphasis on the survival of the business.¹¹

Research in the UK shows that the survival of the company is only achieved in a minority of administrations.¹² More often, such an outcome is achieved outside formal insolvency proceedings.¹³ The prevalent outcome observed is business rescue¹⁴ which is normally achieved under the second purpose.¹⁵ This is because the majority of administrators¹⁶ attempt to achieve a better result for the creditors either through a pre-packaged administration (pre-pack) or going concern sale of the company’s business.¹⁷ The third purpose allow the assets to be realised to make a distribution to one or more secured or

⁴ An order could only be made with a view to the financial rehabilitation of the company, see, eg, *Tenowicz v Tenny Investments* 1979 (2) SA 680.

⁵ However, the regime has since been replaced by the business rescue procedure under Ch 6 of the Companies Act No 71 of 1978.

⁶ The procedure was rarely used in practice and was superseded by the voluntary administration procedure which was introduced in 1993 by the Corporate Law Reform Act 1992.

⁷ For a more detailed discussion of the procedures, see L S Sealy and D Milman, *Annotated Guide to the Insolvency Legislation* (4th ed, CCH Edition Limited, Oxfordshire, 1994), at 40.

⁸ The internationally recognised approach encourages the reorganisation of viable businesses through formal or informal procedures. The World Bank, *Doing Business Report 2020* available at: <https://www.doingbusiness.org/en/reports/global-reports/doing-business-2020>.

⁹ Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132, art 4 (hereinafter referred to as the Preventive Restructuring Directive).

¹⁰ USC, Ch 11.

¹¹ It is more common for a reorganisation that provides for the survival of the business to be arranged between the incumbent management and the creditors. See P Carrington, “Reconciling UK administration and US Chapter 11 after Maxwell”, *International Finance Law Review* (1992) 20 11 at 22.

¹² Of the 166 administrations observed, only 8% were successfully restored to solvency compared with 36% going concern business sales, 43% subsequent liquidations, 11% voluntary arrangements and survival of the business and 2% voluntary arrangements followed by a liquidation. M Homan, *A Survey of Administrations under Insolvency Act 1986: The Result of Administration Orders made in 1987: A report for the Research Board of the Institute of Chartered Accountants in England and Wales* (1989).

¹³ J Armour, A Hsu and A Walters, *The Impact of the Enterprise Act 2002 on Realisations and Costs in Corporate Rescue Proceedings* (2006): A Report Prepared for the Insolvency Service, at 23.

¹⁴ M Phillips and J Goldring, “Rescue and Reconstruction”, *Insolvency Intelligence* (2002) 15 75 at 75-76; S Frisby, “In Search of a Rescue Regime: The Enterprise Act 2002”, *Modern Law Review* (2004) 67 247 at 249; P Walton and C Umfreville, “Pre-pack Empirical Research: Characteristic and Outcome Analysis of Pre-pack Administration” (2014) available at <https://www.gov.uk/government/publications/graham-review-into-pre-pack-administration>.

¹⁵ IA 1986, Sch B1, para 3(1)(b).

¹⁶ A preliminary *Study of Administration Cases* for the Insolvency Service (2006), by A Katz and M Mumford, observed that administrators adopted the first statutory purpose in less than 10% of administrations.

¹⁷ *Corporate Insolvency in the UK: A Decade of Change* available at: <http://www.r3.org.uk/publications>.

preferential creditors,¹⁸ which often precipitates a winding up¹⁹ or dissolution where all the assets are so liquidated.²⁰ The approach adopted under administration,²¹ it is argued, is inconsistent and obscures the distinction between corporate rescue and winding up.

The recast EU Regulation on insolvency proceedings defines “insolvency proceedings” as collective proceedings which include all the creditors of a debtor whose rights are affected.²² The two main corporate rescue procedures in the UK – administration and company voluntary arrangements (CVAs) – are compatible with this interpretation and included in Annex A. However, receivership is excluded because it is not a collective procedure and schemes of arrangement under Part 26 of the Companies Act 2006²³ are also omitted. The latest research conducted on the effectiveness of CVAs as a restructuring tool highlighted that over 65% of the arrangements were prematurely terminated without achieving the intended aims.²⁴ Hence, the analysis in this paper is primarily focused on the administration provisions²⁵ and some more recent legislative intervention.

The financial implications of the failure of corporate debtors and the significance of business restructuring have increasingly become prominent subjects in Europe²⁶ and beyond.²⁷ More recently, several legislative bodies have adopted measures in response to the economic impact of the COVID-19 global pandemic. In the UK, the Corporate Insolvency and Governance Act 2020 (CIGA 2020) was enacted to provide a pre-insolvency moratorium²⁸ and a new form of restructuring plan allowing for arrangements and reconstructions for companies in financial difficulty.²⁹ Both are explicitly intended to lead to the rescue of the company rather than merely business rescue. It is too early to consider whether these two new procedures will have a significant impact, but anecdotal evidence so far suggests their popularity may be limited.

¹⁸ IA 1986, Sch B1, para 3(1)(c).

¹⁹ *Idem*, para 83.

²⁰ *Idem*, para 84.

²¹ *Idem*, Sch B1.

²² Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings, art 2(1).

²³ Companies Act 2006, s 899.

²⁴ P Walton, C Umfreville and L Jacobs, *Company Voluntary Arrangements: Evaluating Success and Failure: Report to the Association of Business Recovery Professionals* (2018).

²⁵ IA, Sch B1.

²⁶ European Law Institute (ELI) Instrument: “Rescue of Business in Insolvency Law” available at: https://www.europeanlawinstitute.eu/fileadmin/user_upload/p_eli/Publications/Instrument_INSOLVENCY.pdf; Contractualised Distress Resolution (CoDiRe) in the Shadow of the Law: “Effective Judicial Review and Oversight of Insolvency and Pre-Insolvency Proceedings” project which published its Final Report in 2018 and which is available at <https://www.codire.eu/publications/> and the JCOERE (Judicial Co-Operation supporting Economic Recovery in Europe) available at: <https://www.ucc.ie/en/jcoere/>.

²⁷ Since 2006, more than 40 economies around the world have adopted reforms implementing or strengthening reorganisation procedures to resolve insolvency. *Doing Business 2020 Report* available at: <https://openknowledge.worldbank.org/bitstream/handle/10986/32436/9781464814402.pdf>.

²⁸ CIGA 2020, s 1.

²⁹ *Idem*, Sch 9.

The following discussion critically compares the corporate rescue approach adopted by companies in administration³⁰ with that endorsed in the EU.³¹ The comparative analysis is conducted in the light of the key principles³² and indicators of resolving insolvency³³ espoused by the World Bank.³⁴ The discussion initially explores the corporate rescue approach that was recommended in the UK by the *Report of the Insolvency Law and Practice Review Committee*³⁵ (hereinafter referred to as the Cork Report) and the original administration provisions under Part II of IA 1986 (the old regime). The analysis also endeavours to provide an evaluation of the impact of the Enterprise Act 2002 (EA 2002) reforms on corporate rescue and critical insight on the approach adopted under the CIGA 2020.

2. Genesis and scope of the corporate “rescue culture” in the United Kingdom

In 1982, the Cork Report recognised the social consequences and financial implications of the failure of a corporate debtor.³⁶ It was particularly observed that the failure of a company is not limited to the participants but that other wider interests, for example suppliers in chain, also take a financial hit.³⁷ Thus, a legitimate concern for the interests of all stakeholders and the likely impact of corporate failure on the wider community motivated the Cork Report to recommend an inclusive approach to corporate insolvency.³⁸ The Cork Report proposed that, as a fundamental principle, a modern corporate insolvency framework should provide a way of preserving viable businesses.³⁹ It is worth noting that the proposal was to preserve the viable business and not the company as later enacted by the UK legislature.⁴⁰ The Cork Report’s carefully considered policy of preserving the viable business⁴¹ was transmuted to the survival of the company during the legislative passage of the Insolvency Bill.⁴²

³⁰ IA 1986, Sch B1 .

³¹ Preventive Restructuring Directive.

³² *Principles for effective insolvency and creditor and debtor regimes*, World Bank Group, available at : <https://documents.worldbank.org/en/publication/documents-reports/documentdetail/518861467086038847/principles-for-effective-insolvency-and-creditor-and-debtor-regimes>. The World Bank collaborated with the UNCITRAL Working Group V: Insolvency Law.

³³ The resolving insolvency indicator set measures time, cost, outcome and recovery rate for a commercial insolvency and the strength of the legal framework for insolvency.

³⁴ World Bank Group *Doing Business 2020 Report*, available at <https://russian.doingbusiness.org/content/dam/doingBusiness/pdf/db2020/Doing-Business-2020.pdf>.

³⁵ Cmnd 8558 (1982).

³⁶ Cork Report, para 200.

³⁷ *Idem*, para 203.

³⁸ *Idem*, para 204.

³⁹ *Idem*, para 198(j).

⁴⁰ IA 1986, Pt II.

⁴¹ Cork Report, para 198(j).

⁴² For an exposition of some of the legislative meddling by vested power interests, see J Tribe, “Policy Subversion in Corporate Insolvency: Political Science, Marxism and the Role of Power Interests During the Passage of Insolvency Legislation”, *Insolvency Intelligence* (2019) 32 at 59.

2.1 Pre-Enterprise Act 2002 approach: The old regime

The introduction of administration⁴³ was anticipated to herald a shift from the non-collective proceedings under administrative receiverships⁴⁴ to a more collective and inclusive insolvency regime.⁴⁵ The absence of a legal duty to the general body of creditors makes an administrative receiver inadequately accountable.⁴⁶ Under the original version of administration, the administrator was appointed by the court on the grounds that the company was, or was likely to become, insolvent⁴⁷ and that a certain statutory aim or aims could be achieved.⁴⁸ This latter requirement arguably limited the administrator to act consistently with the collective objective.⁴⁹ The court was prepared to place a company into administration with a view to securing the survival of the company, the approval of a voluntary arrangement,⁵⁰ the sanctioning of a scheme of arrangement⁵¹ or a more advantageous realisation of the company's assets than would be effected on a winding up.⁵²

Although the purposes were not listed in order of priority, the primary focus of the regime was on company rescue. The purpose of realising the company's assets was intended to achieve a better return to the creditors than would be likely in a liquidation. It is worth noting that the aims adopted under the old regime did not make any provision for the preferential treatment of a particular class of creditors. The corporate rescue approach adopted under the original administration⁵³ procedure epitomised the inclusive approach to corporate insolvency that was recommended by the Cork Report.⁵⁴

Nonetheless, the regime was perceived as being procedurally complex and too costly due to the requirement of a court order⁵⁵ and was never fully utilised as a rehabilitation tool.⁵⁶ It was suggested that the provisions were not adequately focused on rescue⁵⁷ and as a

⁴³ IA 1986, Pt II.

⁴⁴ A receiver does not owe a direct duty to the general body of creditors or employees (*Lathia v Dronsfeld Bros* [1987] BCLC 321) but owes a primary obligation to the appointing party - see *Re B Johnson & Co (Builders) Ltd* [1995] 1 Ch 634 and *Downsview Nominees v First City Corporation* [1993] AC 295.

⁴⁵ The administrator is appointed to protect the interests of the company and general body of creditors - R Goode, *Principles of Corporate Insolvency Law*, (3rd ed, Sweet & Maxwell, London 1993) at 123. The making of an order under s 11 imposed a "freeze" on any enforcement actions, repossession of goods in the company's possession or under a hire purchase agreement and legal proceedings against the company or its property.

⁴⁶ *Davey v Money & Anor* [2018] EWHC 776 (Ch) at para 254, per Snowden J.

⁴⁷ IA 1986, s 8(1)(a).

⁴⁸ *Idem*, s 8(3).

⁴⁹ L S Sealy and D Milman, *Annotated Guide to the Insolvency Legislation* (4th ed, CCH Editions Ltd, Oxford 1994), at 44.

⁵⁰ IA 1986, Pt 1.

⁵¹ Companies Act 1985, s 425.

⁵² IA 1986, s 8(3).

⁵³ *Idem*, Pt II.

⁵⁴ See para 2 above.

⁵⁵ *Hansard*, HL Vol 637, 138-190 (2002) per Lord Sainsbury of Turville.

⁵⁶ P Walton, "Pre-packaged administrations - trick or treat?", (2006) 19 *Insolvency Intelligence*, at 115.

⁵⁷ S Frisby, "In Search of a Rescue Regime: The Enterprise Act 2002", *Modern Law Review* (2004) 67 247.

result the notion of promoting a “rescue culture” was not being fulfilled.⁵⁸ These and other criticisms identified in a series of consultations⁵⁹ and reports inspired the amendments enacted under the EA 2002.

2.2 The impact of the Enterprise Act 2002 reforms

The relevant provisions of the EA 2002⁶⁰ largely replaced the old regime with the Schedule B1 provisions⁶¹ (the new regime). The most significant change was to replace the power of a floating charge holder to appoint an administrative receiver with the power to appoint an administrator.⁶² A professed advantage of appointing an administrative receiver was the speed and low cost associated with the practice.⁶³ In order to make the new regime similarly expedient, the provisions⁶⁴ allow the holder of a qualifying floating charge⁶⁵ and the company or its directors to appoint an administrator out-of-court.⁶⁶ The purposes of administration are listed in order of primacy⁶⁷ and have been modified to include the objective of realising the company’s assets to make a distribution to preferential or secured creditors.⁶⁸ In further contrast to the old regime, the administrator is empowered to make a distribution to a creditor of the company (without the leave of the court)⁶⁹ if he thinks that doing so promotes the purpose of the administration.⁷⁰

The purpose of realising the company’s assets was originally intended to achieve a better outcome for the company’s creditors as a whole,⁷¹ as opposed to making a distribution to a minority.⁷² While there is a duty to act in the interests of the company’s creditors as a

⁵⁸ I F Fletcher, “UK Corporate Rescue: Recent Developments – Changes to Administrative Receivership, Administration and Company Voluntary Arrangement – The Insolvency Act 2000, The White Paper 2001 and the Enterprise Act 2002”, *European Business Organisation Law Review* (2004) 5 at 122.

⁵⁹ *A Review of Company Rescue and Business Reconstruction Mechanisms*, the Insolvency Service (London: HSMO, 1999); *A Review of Company Rescue and Business Reconstruction Mechanisms: Report by the Review Group*, the Insolvency Service (London: HSMO, 2000) and *Productivity and Enterprise: Insolvency – A Second Chance*, the Insolvency Service (London: HSMO, 2001) Cmnd 5234.

⁶⁰ EA 2002, s 248.

⁶¹ IA 1986, Sch B1.

⁶² *Idem*, s 72A and SI 2003/2093.

⁶³ R Goode, *Principles of Corporate Insolvency Law* (4th ed, Sweet & Maxwell, London, 2011), at 77; A Keay and P Walton, *Insolvency Law: Corporate and Personal* (4th ed, LexisNexis, Bristol, 2017), at 89.

⁶⁴ IA 1986, Sch B1 .

⁶⁵ A person holds a qualifying floating charge if the security relates to the whole or substantially the whole of the company’s property – IA 1986, Sch B1, para 14(3).

⁶⁶ *Idem*, Sch B1, para 22 .

⁶⁷ The primary purpose is to rescue the company as a going concern or, if not practicable, to achieve a better result for the company’s creditors than would be likely if the company were wound up (without first being in administration) – IA 1986, Sch B1, paras 3 (1) (a) and (b).

⁶⁸ *Idem*, Sch B1, para 3(1)(c).

⁶⁹ *Idem*, Sch B1, para 65(1). Nonetheless, a distribution to an unsecured creditor requires the permission of the court.

⁷⁰ *Idem*, Sch B1, para 66.

⁷¹ *Idem*, s 8.

⁷² *Idem*, Sch B1, para 3(1)(c).

whole,⁷³ the administrator can realise the company's assets to make a distribution to a secured or preferential creditor⁷⁴ if doing so does not unnecessarily harm the interests of unsecured creditors.⁷⁵ Despite the fact that the balance required by this provision is difficult to comprehend, let alone achieve, the approach contradicts the universal collective principle of protecting the interests of all stakeholders.⁷⁶ During the debates preceding the EA 2002, Lord Hoffmann suggested that the amendments render the courts powerless by virtue of leaving everything to the subjective opinion of the administrator.⁷⁷ The purpose and power to make distributions and the provisions that permit an administration to be converted to a liquidation or dissolution are counterintuitive to adopt in contemplation of corporate rescue. Increasingly, administration is being used inappropriately⁷⁸ as a terminal procedure⁷⁹ after the reforms introduced by the EA 2002.⁸⁰

The purpose of realising assets to make a distribution to a secured creditor is effectively a throwback reminiscent of the traditional receiverships that were primarily focused on the interests of a single secured creditor.⁸¹ The approach adopted under administration protects the rights of secured creditors at the expense of fostering an inclusive approach to corporate rescue.⁸² Although the appointment of the administrator is indeed flexible and quick,⁸³ on the other hand the supremacy of secured creditors is equally maintained. The primacy of receivership is preserved with administration under both the court⁸⁴ and out-of-court procedures.⁸⁵

⁷³ *Idem*, Sch B1, para 3(2).

⁷⁴ *Idem*, Sch B1, para 3(1)(c).

⁷⁵ *Idem*, Sch B1, para 3(4)(b).

⁷⁶ The World Bank Principles, available at <https://www.worldbank.org/en/topic/financialsector/brief/the-world-bank-principles-for-effective-insolvency-and-creditor-rights>.

⁷⁷ *Hansard*, House of Lords, Vol 639 (2002), col 1103.

⁷⁸ One of the hallmarks of an effective insolvency framework is its ability to prevent improper use of the insolvency procedures – the World Bank Principles, available at <https://www.worldbank.org/en/topic/financialsector/brief/the-world-bank-principles-for-effective-insolvency-and-creditor-rights>.

⁷⁹ *Re Kaupthing Singer & Friedlander Ltd (No 2)* [2010] EWCA Civ 518 [2011] 1 BCLC 12.

⁸⁰ A study by Katz and Mumford observed that a significant number of administrations under the new regime may be liquidations as opposed to corporate rescue – A Katz and M Mumford, *Study of Administration Cases*, Report Prepared for the Insolvency Service (2006).

⁸¹ The reformation of the old regime has produced a hybrid species of administration (a combination of the old regime and receivership) and not the projected abolition of administrative receivership – G McCormack, "Control and Corporate Rescue – An Anglo-American Evaluation", *International & Comparative Law Quarterly* (2007) 515.

⁸² I F Fletcher, "UK Corporate Rescue: Recent Developments – Changes to Administrative Receivership, Administration and Company Voluntary Arrangement – The Insolvency Act 2000, The White Paper 2001 and the Enterprise Act 2002", *European Business Organisation Law Review* (2004) 5 at 131.

⁸³ IA 1986, Sch B1, para 14(1).

⁸⁴ Under para 39 the court must dismiss an application where an administrative receiver is in office – IA 1986, Sch B1, para 39.

⁸⁵ Paragraph 17 prevents the appointment of an administrator where an administrative receiver is in office – IA 1986, Sch B1, para 17(a) and (b).

In 2016, the UK Government announced a consultation on options for reform of the corporate insolvency framework.⁸⁶ After further consultation, the Government advanced four main proposals in 2018, namely to create a restructuring moratorium, to develop a new restructuring procedure and cram-down mechanism, to create the availability of super-priority rescue financing and to expand the range of contracts deemed essential to businesses in financial difficulty.⁸⁷ These proposals were largely implemented under the framework introduced by the CIGA 2020.

3. New corporate insolvency toolkit

The corporate rescue approach adopted under the CIGA 2020 is a new development in English law. The directors of a company that is, or is likely to become, insolvent can obtain a moratorium if it is likely to result in the rescue of the company.⁸⁸ The restructuring framework applies where a company has experienced, or is likely to encounter, financial difficulties and a compromise or arrangement is proposed between the company and its creditors or members (or a class of each as the case maybe) to eliminate, reduce or prevent, or mitigate the effects of the financial difficulties.⁸⁹

Every creditor or member whose rights are affected by the compromise or arrangement must be allowed to participate in a meeting whose decision, if positive, must then be sanctioned by the court to become effective.⁹⁰ However, the provision may not be applied in regard to a class of creditors or members if the court is satisfied that none of the members of that class has a genuine economic interest in the company.⁹¹ If the compromise or arrangement is approved by a number representing 75 per cent in value of the creditors or class of creditors, or members or class of members, the court may sanction the compromise or arrangement.⁹² A compromise or arrangement sanctioned by the court is binding on all the creditors or members (or as the case maybe).⁹³

Where the compromise or arrangement is not agreed by a majority representing at least 75 per cent in value of a class of creditors or members, the court may still sanction the compromise or arrangement if it is satisfied that none of the members of the dissenting class would be any worse off than in the event of the relevant alternative,⁹⁴ provided that the compromise or arrangement has been agreed by an number representing 75per cent

⁸⁶ Corporate governance reform, available at <https://www.gov.uk/government/consultations/corporate-governance-reform>.

⁸⁷ *Ibid.*

⁸⁸ CIGA 2020, s 1.

⁸⁹ *Idem*, Sch 9.

⁹⁰ *Ibid.*

⁹¹ *Ibid.*

⁹² *Ibid.*

⁹³ *Ibid.*

⁹⁴ The relevant alternative is whatever the court considers would be most likely to occur if the arrangement or compromise is not sanctioned.

in value of a class of creditors or members who would receive a payment, or have a genuine economic interest in the company.⁹⁵

The approach adopted under the CIGA 2020 restructuring plan framework arguably promotes a more inclusive and effective approach to corporate rescue by providing a mechanism to bind secured creditors and cram-down any dissenting classes of creditors. Where reorganisation procedures have been adopted, the failure rates of small and medium-size enterprises (SMEs) are significantly reduced and the liquidation of financially distressed (and yet viable) businesses prevented.⁹⁶ In a novel way, the CIGA 2020 regime is designed to prevent (and mitigate) insolvency, albeit the thrust of the framework, like the administration provisions,⁹⁷ is on company rescue. Contrary to the international approach of preserving the viable business and as originally recommended by the Cork Report,⁹⁸ the approach adopted under the CIGA restructuring framework is intended to rescue the company as a going concern.

In comparison, the following discussion examines the approach promoted in the EU under the provisions of the Preventive Restructuring Directive.

4. The principles of restructuring under Directive (EU) 2019/1023

The provisions of the Preventive Restructuring Directive provide debtors with the benefit of early warning tools that can detect the likelihood of insolvency and signal the need to act without delay.⁹⁹ The availability of warning systems and easy access to information on restructuring¹⁰⁰ and discharge of debt¹⁰¹ is intended to encourage debtors to restructure early, with a view to preventing insolvency and ensuring their viability.¹⁰² The requirement of a viability test serves the purpose of excluding debtors that do not have a prospect of viability.¹⁰³ In the UK context, administration is commenced when a company is, or is likely to become, insolvent¹⁰⁴ and a person who appoints an administrator out-of-court¹⁰⁵ is required to file a statement by the administrator stating that the purpose of administration is reasonably likely to be achieved.¹⁰⁶

⁹⁵ CIGA 2020, Sch 9.

⁹⁶ *Doing Business 2020 Report*, available at <https://openknowledge.worldbank.org/bitstream/handle/10986/32436/9781464814402.pdf>.

⁹⁷ IA 1986, Sch B1.

⁹⁸ See para 2 above.

⁹⁹ Preventive Restructuring Directive, art 3(1).

¹⁰⁰ Restructuring is defined as "measures aimed at restructuring the debtor's business that include changing the composition, conditions or structure of a debtor's assets and liabilities or any other part of the debtor's capital structure, such as sales of assets or parts of the business and, where so provided under national law, the sale of the business as a going concern, as well as any operational changes, or a combination of those elements" - Preventive Restructuring Directive, art 2(1).

¹⁰¹ *Idem*, art 3(3).

¹⁰² *Idem*, art 4.

¹⁰³ *Idem*, art 4(3).

¹⁰⁴ IA 1986, Sch B1, paras 11 and 27(2)(a).

¹⁰⁵ *Idem*, Sch B1, para 14.

¹⁰⁶ *Idem*, Sch B1, para 18(3).

Where provisions limiting the involvement of the court are implemented,¹⁰⁷ analogous to the appointment of an administrator by the holder of a qualifying floating charge¹⁰⁸ or by the company or its directors,¹⁰⁹ the legislature must ensure that the rights of affected parties are adequately protected.¹¹⁰ As previously highlighted,¹¹¹ the interests of unsecured creditors are not satisfactorily protected when an administrator adopts the purpose of making a distribution to one or more preferential or secured creditors.¹¹² Where an administrator adopts the second purpose of achieving a better result for the creditors as a whole,¹¹³ frequently achieved through a connected pre-pack business sale,¹¹⁴ the administration does not necessarily result in a better outcome for unsecured creditors.¹¹⁵

In order to support effective restructuring it is internationally¹¹⁶ acknowledged that debtors should benefit from a stay of actions.¹¹⁷ It is imperative that a stay of actions encompass all types of claims including secured and preferential claims,¹¹⁸ with the exception of the employees' claims.¹¹⁹ It is submitted that the purpose of realising the company's assets to make a distribution to a secured creditor¹²⁰ undermines the rationale of the moratorium imposed during an administration.¹²¹ However, where it can be justified that enforcement is not likely to jeopardise a restructuring plan certain types of claims may be excluded.¹²²

A restructuring plan that is approved by a majority of 75 per cent in value of each class should be adopted by the affected parties.¹²³ Nonetheless, a plan that affects the claims or interests of affected parties, involves new financing or the loss of more than 25 per cent of the work force, is only binding if confirmed by a judicial or administrative authority.¹²⁴ Under the CIGA 2020 restructuring framework there is no provision for the informal adoption of an arrangement or compromise; in all cases an application must be filed with

¹⁰⁷ Preventive Restructuring Directive, art 4(5).

¹⁰⁸ IA 1986, Sch B1, para 14.

¹⁰⁹ *Idem*, Sch B1, para 22.

¹¹⁰ Preventive Restructuring Directive, art 4(6).

¹¹¹ See para 2.2 above.

¹¹² IA 1986, Sch B1, para 3(1)(c).

¹¹³ *Idem*, Sch B1, para 3(1)(b).

¹¹⁴ The sunset clause on potential pre-pack regulation under para 60A of Sch B1 (which expired in May 2020) was extended to June 2021 by s 8 of the CIGA 2020.

¹¹⁵ P Walton, "Pre-packaged administrations - trick or treat?", *Insolvency Intelligence* (2006) 19, pp 113-122.

¹¹⁶ The World Bank Principles, available at <https://www.worldbank.org/en/topic/financialsector/brief/the-world-bank-principles-for-effective-insolvency-and-creditor-rights>.

¹¹⁷ Preventive Restructuring Directive, art 6(1).

¹¹⁸ *Idem*, art 6(2).

¹¹⁹ *Idem*, art 6(5).

¹²⁰ IA 1986, Sch B1, para 3(1)(c).

¹²¹ *Idem*, Sch B1, para 43.

¹²² Preventive Restructuring Directive, art 6(4).

¹²³ *Idem*, art 9(6).

¹²⁴ *Idem*, art 10(1).

the court by the company, any creditor or member, the administrator, or the liquidator.¹²⁵ One of the conditions under which a restructuring plan can be confirmed is that the plan must satisfy the “best-interest-of-creditors” test.¹²⁶

A plan that has not been approved may be confirmed, upon the proposal or consent of a debtor,¹²⁷ provided the plan at least satisfies the “best-interest-of-creditors” test¹²⁸ and would have a reasonable prospect of preventing insolvency or ensuring the viability of the debtor.¹²⁹ Secondly, the plan must be approved by a majority of the classes of affected parties and one of those classes should be a secured creditors class or senior to the unsecured creditors class.¹³⁰ These three conditions largely resemble the two requirements under the CIGA 2020 equivalent cram-down mechanism.¹³¹ However, under article 11, the restructuring plan should also guarantee that dissenting classes are treated as favourably as any other class of the same rank and more favourably than any junior class (the relative priority rule)¹³² and that no class of affected parties may receive or keep more than its claims or interests.¹³³

5. Conclusion

The corporate rescue approach adopted in the UK under administration is not entirely inclusive and rarely achieves its intended objective in practice. The administration provisions prioritise the rights of secured creditors instead of fostering an inclusive approach to corporate rescue. The out-of-court appointments and the extensive powers bestowed upon the administrator,¹³⁴ more affiliated with those of a liquidator,¹³⁵ have led to the prevalent use of pre-packs¹³⁶ and administration being used as a substitute for liquidation. This is contrary to the inclusive approach to corporate insolvency that was

¹²⁵ CIGA 2020, Sch 9.

¹²⁶ Preventive Restructuring Directive, art 10(2).

¹²⁷ However, Member States may limit the requirement to obtain the debtor’s consent to cases where the debtors are SMEs.

¹²⁸ Preventive Restructuring Directive, art 10(2).

¹²⁹ *Idem*, art 10(3).

¹³⁰ If not, by at least one of the classes of the affected parties or impaired parties – Preventive Restructuring Directive, art 11(1).

¹³¹ See para 3 above.

¹³² By way of derogation, Member States may provide that where a more junior class is to receive any payment or keep an interest, the claims of the dissenting classes are to be satisfied in full by the same or equivalent means (the absolute priority rule) under art 11(2).

¹³³ Preventive Restructuring Directive, art 11(1).

¹³⁴ In their rebuttal to P Walton’s “Pre-packaged administrations - trick or treat”, *Insolvency Intelligence* (2006) 19, Bloom and Harris acknowledged that administrators enjoy exceptional powers in the administration of an insolvent company – A Bloom and S Harris, “Pre-packaged administrations – what should be done given the current disquiet?”, *Insolvency Intelligence* (2006) 19 at 123.

¹³⁵ T Robinson and P Walton (eds), *Kerr and Hunter on Receivers and Administrators* (20th ed, Sweet & Maxwell, London, 2018), paras 16-63.

¹³⁶ A preliminary review of pre-packs between 2001 and 2004 indicated that there were 40 pre-packs (33.9%) pre-EA 2002 and 78 (66.1%) post EA 2002 from a sample of 118 administrations – S Frisby, *A preliminary analysis of pre-packaged administrations*: Report to the Association of Business Recovery Professionals (2007).

envisioned when the idea of corporate rescue was recommended and subsequently introduced as administration. The influence of a floating charge holder has probably been heightened by the EA 2002 reforms to the detriment of promoting a “rescue culture”.

Unlike the early intervention approach to insolvency promoted in the EU, there is no preventive approach under administration. The preventive restructuring frameworks adopted in the EU promote a more inclusive approach which, arguably, represents a more balanced and effective rescue strategy.¹³⁷ Nonetheless, the real impact of the CIGA 2020’s similar restructuring framework is yet to be realised in this respect. Conceivably, the rights and interests of affected parties are better protected under the preventive restructuring frameworks in comparison to the protection provided under administration.

In line with the principles promoted by the World Bank, the corporate rescue strategy adopted in the EU is focused on rescuing viable businesses, which is unlike the inconsistent approach implemented in the UK. The concept of corporate rescue may be theorised in various interpretations.¹³⁸ The approach that was recommended in the UK involved the preservation of the viable business. The widespread outcome of business rescue and frequent use of pre-pack business sales indirectly supports the original theory of preserving viable businesses. Preserving the viable business of an insolvent debtor is perhaps a more practicable and effective corporate rescue strategy compared with attempting to rescue or restructure an insolvent company.

Policymakers in the UK do not seem to have made up their minds as to what they want the corporate rescue provisions to achieve. Although the original recommendation was to preserve the viable business, the primary legislative purpose of administration is to rescue a company as a going concern. However, research has consistently demonstrated that the survival of the company as a going concern is very rare and that the predominant outcome is business rescue. The administration provisions do not expressly provide for pre-packs, but the controversial practice is established and accepted by the courts.¹³⁹ Nonetheless, both the pre-insolvency moratorium and restructuring framework, under the CIGA 2020, are intended to rescue the company as a going concern. Not surprisingly, the inconsistent approach adopted by the policymakers leaves everyone confused.

¹³⁷ The highest recovery rates and higher lending to the private sector are recorded in economies where business reorganisation is the most common proceeding and is easily accessible - *Doing Business 2020 Report*, available at <https://openknowledge.worldbank.org/bitstream/handle/10986/32436/9781464814402.pdf>.

¹³⁸ S Frisby, “In Search of a Rescue Regime: The Enterprise Act 2002”, *Modern Law Review* (2004) 67 247 at 248.

¹³⁹ *DKLL Solicitors v HMRC* [2008] 1 BCLC 112, *Re Kayley Vending Limited* [2009] BCC 578, *Re Johnson and Machine Tool Co Ltd* [2010] BCC 382 and *Re Hellas Telecommunications (Luxembourg) II SCA* [2009] EWHC 3199 (Ch).

Personal Insolvency and COVID-19: Brief analysis of the measures adopted in Spain

By Paloma Corbal, lawyer and PhD candidate, Spain*

Abstract

This paper addresses the measures adopted by the Spanish Government to mitigate the effects of the COVID-19 crisis affecting personal insolvency proceedings. The second chance regime, adopted in 2013 and modified in 2015, has been a measure long demanded by academics and legal operators. In Spain, where 99.8 per cent of businesses are small and medium enterprises and individual entrepreneurs, a well-designed second chance regime is essential to provide a fresh start if the business fails. In the context of the COVID-19 crisis, the reform of this regime called for in recent years has become urgent and the well-intentioned measures taken by the Spanish Government seem insufficient. Furthermore, this paper considers within this analysis two other developments affecting the regulation of personal insolvency in Spain: the surprise approval of the consolidated text of the Spanish Insolvency Law and the forthcoming transposition of the EU Directive on Restructuring and Insolvency.

1. Introduction

The COVID-19 crisis has had a huge effect in European economies. In Spain, where 99,8 per cent of businesses are small and medium enterprises (SMEs) and individual entrepreneurs,¹ the effects of the shutdown to mitigate the pandemic were drastic: during the five months following the declaration of Spain's nationwide State of Alarm on 14 March 2020, it is estimated that 90,000 businesses closed.²

In this context, the Spanish Government took some urgent insolvency measures by adopting Royal Decree-Law 16/2020 of 28 April on procedural and organisational measures to deal with COVID-19 in the field of administration of justice (hereinafter referred to as RDL 16/2020),³ in force since 30 April 2020. According to Spanish legislative procedure for the emergency rules adopted by the Government, this regulation was

* Lawyer and PhD Candidate at Complutense University of Madrid.

¹ Ministry of industry, trade and tourism of Spain, *Data of SMEs*, September 2021, available at https://industria.gob.es/es-es/estadisticas/Cifras_PYME/CifrasPYME-septiembre2021.pdf.

² "During the first two months of the pandemic (March and April), a total of 142,000 companies stopped paying social security contributions, a disaster never seen before in history. As the de-escalation phases progressed in different parts of Spain, in May, June and July, business activity began to reactivate and during this period the Social Security Treasury recovered around 55,644 contributing companies. This means that the system has lost almost 90,000 companies compared to those it had in February, the month before the pandemic was declared." See S Alcelay, "La pandemia arrasa con 90.000 empresas en cinco meses en España" *ABC* (Madrid 4 September 2020), available at https://www.abc.es/economia/abci-pandemia-arrasa-90000-empresas-cinco-meses-espana-202008232135_noticia.html?ref=https:%2F%2Fwww.google.com%2F.

³ See the full text of the regulation available in Spanish at <https://www.boe.es/buscar/act.php?id=BOE-A-2020-4705>.

validated by Law 3/2020 of 18 September on procedural and organisational measures to deal with COVID-19 in the field of administration of justice (hereinafter referred to as Law 3/2020).⁴

In addition, these measures have to be applied with due consideration of the (surprising) approval of the consolidated text of the Spanish Insolvency Law by Royal Legislative Decree 1/2020 of 5 May (hereinafter referred to as the Consolidated Insolvency Law or CIL), in force since 1 September 2020, a draft that has been pending adoption for years. This novelty added even more confusion among legal practitioners considering that the new text doubles the number of articles and introduces some slight but important changes. Moreover, this new legal text will soon be amended to transpose the important EU Directive on Restructuring and Insolvency (hereinafter referred to as the DRI),⁵ which all Member States must adopt and publish by 17 July 2021.⁶ Though, as the preamble of the Consolidated Insolvency Law states, the new text may help to undertake the difficult transposition of the DRI in a neater, clearer, and systematic manner.

2. Personal insolvency proceedings in Spain

In Spain, there is no special insolvency proceeding for natural persons but some specific provisions, most of which apply at the end of the proceeding in the case of liquidation, and consist of the possibility of granting the debtor a “second chance” through the so-called “benefit of discharge of unsettled liabilities” after liquidating the assets.⁷

The second chance regime, regulated in former Article 178 *bis* of Law 22/2003 of 9 July on Insolvency (hereinafter referred to as the Former Insolvency Law)⁸ and now established in Articles 486 to 502 of CIL, is a milestone in Spanish insolvency regulation, long

⁴ See the full text of the regulation (available in Spanish) at <https://www.boe.es/buscar/act.php?id=BOE-A-2020-10923>. This Law has been subsequently amended by Royal Decree-Law 34/2020 of 17 November on urgent measures to support business solvency and the energy sector, and on tax matters (full text available in Spanish at <https://www.boe.es/buscar/act.php?id=BOE-A-2020-14368>) and Royal Decree-Law 5/2021 of 12 March on extraordinary measures to support business solvency in response to the COVID-19 pandemic (full text available in Spanish at <https://www.boe.es/buscar/act.php?id=BOE-A-2021-3946>).

⁵ Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132, OJ L 172, 26.6.2019, pp 18-55.

⁶ Except for the provisions necessary to comply with art 28 of the Directive on the use of electronic means of communication, which have an extended deadline for its transposition according to art 34, and the exception established in art 34.2 for Member States that encounter particular difficulties in implementing the Directive, which shall be able to benefit from an extension of a maximum of one year.

⁷ See the definition of “full discharge of debt” stated in DRI, art 2.1.

⁸ Introduced by Law 25/2015 of 28 July on the second chance mechanism, reduction of the financial burden and other social measures, which modified the former regulation introduced in the Former Insolvency Law, firstly by Law 14/2013 of 27 September on support for entrepreneurs and their internationalisation, and secondly by Royal Decree-Law 1/2015 of 27 February on the second chance mechanism, reduction of the financial burden and other social measures.

demanded by academics and legal operators. It is essential to provide a “second chance” to honest consumers and entrepreneurs who fail to meet their credit commitments.⁹

The importance of granting a timely “second chance” has been recognised in Law 3/2020. Such law not only provided the preferential conduct of insolvency proceedings for natural persons by court until 31 December 2020, but extended this preference until 31 December 2021 for the processing of the benefit of discharge of unsettled liabilities.¹⁰

The regime is determined based on two premises: (i) that the natural person must be considered as a debtor in good faith (the so-called “subjective premise”, Article 487 of CIL) and (ii) that the debtor must pay a liability threshold corresponding to certain claims during the proceeding (the “objective premise”, Article 488 of CIL) or according to an agreed payment plan (the “special objective premise”, Article 493 of CIL).

2.1 The subjective premise

The debtor must be understood to be in good faith if the insolvency proceeding has not been declared tortious and the debtor has not been condemned in a final judgement for offences related to the insolvency proceeding (that is, offences against property, social economic order, documentary forgery, Public Treasury or Social Security, or the rights of workers) in the 10 years prior to the declaration opening the insolvency proceeding.

2.2 The objective premise (i): The general regime

According to the general regime, to obtain the discharge claims against the estate and preferential claims must have been fully satisfied in the insolvency proceeding and, if eligible to do so, the debtor must have concluded or at least attempted to conclude an out-of-court payment agreement with the creditors. If a debtor who is eligible to do so has not attempted an out-of-court payment agreement in advance, they may obtain the discharge if, in addition to claims against the estate and preferential claims, they have satisfied at least 25 per cent of ordinary claims.¹¹

According to Article 632 of CIL, the debtor who is a natural person can only initiate the proceeding to reach an out-of-court payment agreement with his creditors if the initial estimation of his debts does not exceed the total amount of EUR 5 million. The former

⁹ The benefits of discharge regimes have been repeatedly highlighted by the World Bank (see World Bank, *Report on the Treatment of the Insolvency of Natural Persons* (Washington, DC, 2013) at 117-120), and by the European Commission (see among many other documents: European Commission, *Overcoming the stigma of business failure – for a second chance policy – Implementing the Lisbon Partnership for Growth and Jobs* COM(2007) 584 final; European Commission, *A new European approach to business failure and insolvency* COM(2012) 742 final; European Commission, *Recommendation of 12 March 2014 on a new approach to business failure and insolvency* (2014/135/EU)).

¹⁰ See Law 3/2020, arts 2 and 9.

¹¹ Claims in an insolvency proceeding are regulated in arts 242 (claims against the estate), 270 (preferential claims with special preference), 280 (preferential claims with general preference), 269.3 (ordinary claims) and 281 (subordinated claims) of CIL.

wording of this provision in Article 178 *bis* of the Former Insolvency Law was quite controversial¹² as it had been interpreted in such a way that the debtor who cannot initiate the proceeding to reach an out-of-court payment agreement due to debts of more than EUR 5 million was obliged to pay 25 percent of the ordinary claims to obtain the discharge.¹³ This interpretation was especially detrimental to debtors with little liquidity and very large debts if, for example, they had guaranteed their company's debts with their personal assets. The new wording of the article is much clearer now, so this extra percentage of credits must only be paid by the debtor who is eligible to attempt the agreement, but has not attempted it at all.¹⁴

On the other hand, the interpretation of what can be considered an attempt to conclude an out-of-court payment agreement has also been controversial, especially since the proceeding to do it requires the participation of an insolvency mediator whose appointment is not always easy.¹⁵ For this reason, Article 12 of Law 3/2020 has established that, for the purpose of initiating a consecutive insolvency proceeding until 31 December 2021, it will be considered that the out-of-court payment agreement has been attempted by the debtor without success if it is proven that there have been two failures of acceptance for appointment by the insolvency mediator. This measure, which had already been adopted in practice by some Commercial Courts and Provincial Courts,¹⁶ is intended to speed up the process of declaring the insolvency proceeding opened and, at the same time, to ensure that the debtor is not prejudiced in the discharge of unsatisfied liabilities because he cannot prove the attempt at reaching an out-of-court payment agreement.

¹² See M Cuenca, "La exoneración del pasivo insatisfecho. Aspectos problemáticos y primeras respuestas judiciales", *Revista de derecho concursal y paraconcursal: Anales de doctrina, praxis, jurisprudencia y legislación* (2016) 25 33 at 42; V Bastante, *El «deudor de buena fe» en la Ley de Segunda Oportunidad. Origen, fundamento y significado* (1st ed, Comares, Granada, 2016), at 212; and M M Hernández, "La segunda oportunidad en el Real Decreto-Ley 1/2015", *El Derecho* (2015), available at <https://elderecho.com/la-segunda-oportunidad-en-el-real-decreto-ley-12015>.

¹³ See the agreement reached by some judges on the interpretation of art 178 *bis* of the Spanish Insolvency Law on 15 June 2016, available at <https://es.slideshare.net/procurador-barcelona/8-acuerdos-jueces-de-lo-mercantil-barcelona-de-15-de-junio-de-2016>.

¹⁴ See M Cuenca, "El régimen de segunda oportunidad en el Texto Refundido de la Ley Concursal. La exoneración del pasivo insatisfecho", *Diario La Ley* (2020) 9675.

¹⁵ The main difficulty in appointing a bankruptcy mediator lies in the defective remuneration system of these professionals. As there are no *ex-officio* mediators, nor a fund to guarantee the coverage of their fees, many professionals refuse to accept their appointment in procedures in which they are unlikely to be able to collect their fees. See A Cantero, "Directrices de la DGRN sobre el nombramiento de mediadores concursales en expedientes de acuerdo extrajudicial de pagos de deudores no empresarios", *Actualidad Profesional* (2019) 20, available at <https://dictumabogados.com/actualidad-profesional/directrices-de-la-dgrn-sobre-el-nombramiento-de-mediadores-concursales-en-expedientes-de-acuerdo-extrajudicial-de-pagos-de-deudores-no-empresarios/20661/>; and M Cuenca, "El régimen de segunda oportunidad en tiempos de pandemia. A propósito del desafortunado RDL 16/2020", *Hay Derecho* (2020), available at <https://hayderecho.expansion.com/2020/05/04/el-regimen-de-segunda-oportunidad-en-tiempos-de-pandemia-a-proposito-del-desafortunado-rdl-16-2020/>.

¹⁶ See Order 188/2018 of 27 December 2018 of the Barcelona Provincial Court.

2.3 The special objective premise (ii): The discharge regime for the approval of a payment plan

Alternatively, in cases where the debtor cannot afford the general objective premise, they may still request the discharge of unsettled liabilities if they expressly agree to submit to a payment plan of non-dischargeable debts. The debtor may benefit from this special regime of discharge if they have (i) not rejected, within the four years prior to the declaration of insolvency, an offer of employment appropriate to their capacity; (ii) not breached the obligations to collaborate with the judge and the insolvency administrator during the insolvency proceeding; and (iii) not obtained the benefit of discharge within the last 10 years.

The application for the special discharge regime by a debtor must be accompanied by a proposal for a payment plan of non-dischargeable claims, which payment must be made within five years of the conclusion of the insolvency proceeding. The period after which insolvent entrepreneurs are able to be fully discharged from their debts is one of the main amendments that the Spanish regime will face with the transposition of the DRI, as Article 21 of DRI establishes that this period may be no longer than three years.

It is worth noting that debtors who submit a petition to obtain the discharge through this special regime are not obliged to attempt an out-of-court payment agreement, even if they are eligible to do so. This has been considered a substantial amendment to the wording of Article 178 *bis* of the Former Spanish Insolvency Law,¹⁷ which interpretation was also controversial as some authors considered that the attempt of the out-of-court payment agreement was mandatory for all debtors seeking to obtain the benefit, regardless of whether they paid the non-dischargeable claims directly (general regime) or according to an agreed payment plan (special regime).

2.4 Extension of discharge

According to the Consolidated Insolvency Law, debtors who have requested a discharge through the general regime will be granted a discharge of all ordinary claims (unless the debtor who qualifies to do so has not attempted an out-of-court payment agreement, in which case the discharge extends to 75 per cent of ordinary claims) and subordinated claims, except for public law claims and maintenance claims. On the other hand, if the debtor has requested a discharge according to the special regime, the discharge must be extended to the unpaid parts of the following claims (according to the plan): ordinary and subordinated claims, except for public law claims and maintenance claims, and the amount of claims with special preference that could not be satisfied with the enforcement of a guarantee.

¹⁷ See M Cuenca, "El régimen de segunda oportunidad en el Texto Refundido de la Ley Concursal. La exoneración del pasivo insatisfecho", *Diario La Ley* (2020) 9675.

This extension of the discharge is another novelty of the regulation established in the Consolidated Insolvency Law. According to Article 178 *bis* of the Former Insolvency Law, discharge was extended to all subordinated claims except for public law claims and maintenance claims, but this exception only applied to debtors who could afford a direct payment of non-dischargeable claims (general regime).¹⁸ Therefore, debtors with a lack of liquidity were discriminated against – a defect in the law that has now been remedied. However, even if the new regulation is better than the former, it is worth noting that public claims should not be excluded from the discharge,¹⁹ considering that these credits are often among the largest debts contributing to the debtor's insolvency. Therefore, these debtors will not be able to benefit from a real second chance without the simultaneous discharge of public claims.²⁰

2.5 Revocation and definitive discharge

The granting of the benefit of discharge of unsettled liabilities may be revoked at the request of any creditor if, during the five years following its concession, it is found that the debtor has hidden goods, rights or income (unless they are unseizable according to the law). The provisional granting of a discharge obtained according to the special regime will further be revoked if (i) the debtor fails to comply with the payment plan;²¹ (ii) the debtor's economic situation improves substantially due to an inheritance, legacy, donation, or due to a game of chance; and (iii) the debtor incurs a cause that would have prevented it to be considered debtor in good faith.

In the case of revocation, the creditors will recover the full extent of their actions against the debtor. However, creditors whose claims are extinguished by reason of the definitive discharge may not initiate any type of action against the debtor for the collection thereof. Nevertheless, this does not affect the rights of creditors against those jointly and severally liable with the debtor and against their guarantors or sureties.

¹⁸ The Supreme Court ruled on this different treatment of public credits in its decision of July 2, 2019, declaring (contrary to the wording of art 178 *bis*.5 of the Spanish Insolvency Law) that debtors who agreed to a payment plan could also exempt themselves from public credit. This jurisprudential criterion, which was discussed by the doctrine (see M Cuenca, "Segunda oportunidad y crédito público. (A propósito de la mal entendida sentencia del Tribunal Supremo de 2 de julio de 2019)", *Hay Derecho* (2019), available at: <https://www.hayderecho.com/2019/07/28/segunda-oportunidad-y-credito-publico-a-proposito-de-la-mal-entendida-sentencia-del-tribunal-supremo-de-2-de-julio-de-2019/>), cannot be maintained with the new regulation established in CIL, art 497.

¹⁹ See M Cuenca, "Crédito público y exoneración de deudas. A propósito de la sentencia del TJUE de 16 de marzo de 2017" *Revista de derecho concursal y paraconcursal: Anales de doctrina, praxis, jurisprudencia y legislación*, (2017) 27 237.

²⁰ The World Bank highlighted the benefits of discharging public claims for entrepreneurs. See World Bank, *Report on the Treatment of the Insolvency of Natural Persons* (Washington, DC, 2013) at 122-123.

²¹ According to Royal Decree Law 6/2012 of March 9 on urgent measures for the protection of mortgage debtors without resources, art 3.1 a) and b), even if the debtor had not complied with the payment plan in its entirety, the definitive discharge will be granted considering the circumstances of the case, if the debtor had used to its fulfilment at least half of the non-unseizable income received during the five years since the provisional granting of the benefit, or a quarter of such income when the debtor is in circumstances of special vulnerability.

The definitive discharge refers to the dischargeable debts (not to non-dischargeable ones), even in the event that the debtor has not been able to comply with the payment plan completely. This interpretation was questioned in view of the previous wording of Article 178 *bis* 8 of the Former Insolvency Law, and the new wording of Article 499 of the CIL seems to make it clearer.²²

3. The promotion of agreements between debtors and creditors as a key measure in the COVID-19 crisis

As the preamble of the RDL 16/2020 expresses, the measures taken by the Government were aimed at ensuring economic continuity, enhancing financing and avoiding an increase of insolvency litigation. To reach this goal, Law 3/2020 has established certain provisions to facilitate new agreements between debtors and creditors, and the amendment of ones that were in the fulfilment period in order to avoid widespread claims for the opening of personal insolvency proceedings against natural persons who found themselves in financial difficulty because of the COVID-19 crisis. As the extension of discharge is partly conditioned upon the attempt of an out-of-court payment agreement, the provisions stated in Law 3/2020 indirectly affect the second chance regime applicable to natural persons.

Article 3 of Law 3/2020 has provided flexibility of the rules on non-compliance of out-of-court payment agreements, with the clear goal of promoting its maintenance or amendment. It has, therefore, mitigated the rush to the courts by thousands of claimants that would have overburden the courts. Therefore, until 31 December 2021, a debtor may submit a proposal to amend the out-of-court payment agreement that is in the period of compliance. Furthermore, until 30 September 2021, the processing by courts of requests of declaration of non-compliance presented by creditors have been withheld until three months after that date.²³ During these three months, the debtor may submit a proposal to amend the agreement, which will be processed in priority to the application for a declaration of non-compliance.

4. The moratorium for the debtor to submit a petition for a declaration opening the insolvency proceeding

The mandatory shutdown due to the nationwide State of Alarm placed thousands of companies and entrepreneurs in a situation of current or imminent insolvency. Given the consequences that strict application of the time limits laid down in the insolvency legislation would have had, Law 3/2020 has provided the debtor with a moratorium on

²² See M Cuenca, "El régimen de segunda oportunidad en el Texto Refundido de la Ley Concursal. La exoneración del pasivo insatisfecho", *Diario La Ley* (2020) 9675.

²³ According to Royal Decree-Law 5/2021 of 12 March amending art 3 of Law 3/2020 by extending the period initially provided in RDL 16/2020.

the duty to submit a petition for the declaration of opening insolvency proceeding until 31 December 2021,²⁴ according to the latest extension of the moratorium.²⁵

On the other hand, applications for the declaration opening insolvency proceedings submitted by creditors since the declaration of the nationwide State of Alarm will not be accepted until 31 December 2021. Furthermore, applications submitted by debtors before that date will be admitted for processing in preference to those presented by creditors, even if they have a later date.

5. Beneficial treatment of financial aid from persons specially related to the debtor in the context of COVID-19 crisis

In addition to the measures affecting personal insolvency, the treatment of claims arising from loans, credit or other similar financial assistance granted to the debtor since the declaration of the nationwide State of Alarm by related persons²⁶ has been improved. According to Article 7 of Law 3/2020, these claims will be considered ordinary claims in insolvency proceedings declared within two years of the declaration of the nationwide State of Alarm (that is, until 14 March 2022). Therefore, the penalty that has traditionally weighed on the assistance of relatives and administrators and partners of companies through the subordination of their claims is suspended.²⁷ This measure highlights the importance that this type of financing continues to have in Spanish society in crisis situations such as what has happened lately. Likewise, related persons who have subrogated themselves in their position after the declaration of Spain's nationwide State of Alarm to attend to the payment of ordinary or preferential claims made on behalf of the debtor, also qualify as ordinary creditors.

6. Conclusion and observations

The measures adopted to mitigate the effects of the COVID-19 crisis on personal insolvency proceedings that have been briefly described in this paper, involve a relaxation of certain provisions of Spanish insolvency regulation in the special circumstances in which we have found ourselves in. Most of these were appropriate and necessary to provide unemployed natural persons and entrepreneurs with some breathing space and avoid an avalanche of insolvency proceedings.

²⁴ According to the general rule stated in CIL, art 5 a debtor shall submit a petition for declaration opening insolvency proceeding within the two months following the date of having known (or should have known) that he is in current insolvency.

²⁵ According to Royal Decree-Law 5/2021 of 12 March amending art 6 of Law 3/2020 by extending the moratorium formerly extended by Royal Decree-Law 34/2020 of 17 November.

²⁶ The concept of "related persons" for natural persons (ie, spouse, ascendants, descendants and siblings, legal entities controlled by the debtor, etc) is regulated in CIL, art 282 in a similar way as legal entities (ie, shareholders, administrators, companies that form part of the same group, etc) regulated in CIL, art 283.

²⁷ See CIL, art 281.

For instance, the moratorium for the debtor to submit a petition for a declaration opening the insolvency proceeding is a lifeline for businesses in a situation of insolvency resulting from the paralysis caused by COVID-19, providing debtors with a chance for recovery by reopening the business after the shutdown due to the health emergency. The price of this measure, however, is the risk of worsening insolvency to the detriment of creditors, and the foreseen avalanche of applications for declarations opening insolvency proceedings at the beginning of 2022. It is submitted that this will cause the collapse of the courts, with undoubted negative consequences for the processing of the proceedings. Other measures, such as the provision stated in Article 12 of Law 3/2020 on what can be considered an attempt to conclude an out-of-court payment agreement, has only temporarily rectified a failure in the system which will reappear once this extraordinary measure has come to an end.²⁸

On the other hand, other desirable measures will have to wait until the transposition of the DRI, which will be an opportunity for the legislator to take more far-reaching decisions in the adaptation of the Consolidated Insolvency Law.²⁹ Consequently, the transposition of the DRI will affect the period after which insolvent entrepreneurs are able to be fully discharged from their debts and may also affect other provisions, such as the privileged treatment of public credit, or the elimination of the EUR 5 million debt limit for being able to access out-of-court payment agreements.

These are just some examples of the work that remains to be done on personal insolvency proceedings in Spain to truly help mitigate the consequences that crises such as the one due to the COVID-19 pandemic has on natural persons and entrepreneurs.

²⁸ See M Cuenca, "El régimen de segunda oportunidad en tiempos de pandemia. A propósito del desafortunado RDL 16/2020", *Hay Derecho* (2020), available at <https://hayderecho.expansion.com/2020/05/04/el-regimen-de-segunda-oportunidad-en-tiempos-de-pandemia-a-proposito-del-desafortunado-rdl-16-2020/>.

²⁹ See some proposals for adequate transposition in M Cuenca, "La exoneración del pasivo insatisfecho en la directiva (UE) 2019/1023 de 20 de junio de 2019: propuestas de transposición al derecho español", *Revista de derecho concursal y paraconcursal: Anales de doctrina, praxis, jurisprudencia y legislación* (2020) 32 39; and a first commentary on the preliminary draft bill for the transposition of the DRI by amending the CIL on the matters addressed in this article in M Cuenca, "El régimen de segunda oportunidad en el Anteproyecto de ley de reforma concursal. Pros y contras...", *Hay Derecho* (2021), available at <https://www.hayderecho.com/2021/09/01/el-regimen-de-segunda-oportunidad-en-el-anteproyecto-de-ley-de-reforma-a-concursal-pros-y-contras/>.

The impact of the EU Restructuring Directive on the Belgian collective plan: “To class or not to class?”, that is the question for the Belgian legislator

By Jente Dengler, DLA Piper, Belgium*

Abstract

The official deadline for the implementation of the Directive (EU) 2019/1023 on restructuring and insolvency was scheduled for 17 July 2021. Like many other Member States, Belgium availed itself of the possibility foreseen in the Directive to benefit from an extension of the implementation period by a maximum of one year. The Directive introduces the obligation to separate creditors into different classes for the purpose of voting on restructuring plans in order to prevent vulnerable creditors from being treated unfairly in business restructurings. Such class formation for the approval of a restructuring plan is unprecedented in Belgian insolvency law. This paper focuses on the expected changes to the Belgian collective plan procedure and discusses the potential impact of this Directive’s voting model on the Belgian restructuring practice.

1. Introduction

On 20 June 2019, the EU Directive 2019/1023 on preventive restructuring frameworks, discharge of debt and disqualifications was adopted (hereinafter referred to as the Directive).¹ The primary aim of the Directive is to improve the preventive restructuring frameworks of the Member States and enable viable debtors to restructure effectively at an early stage to avoid insolvency. This should help prevent the loss of jobs, know-how and skills to the detriment of the economy as a whole.² Additionally, harmonisation should bring greater transparency, legal certainty and predictability across the European Union (EU); also maximising returns to creditors and investors and encouraging cross-border investment.³

The Directive sets minimum standards for effective restructuring proceedings in the EU, which officially had to be transposed into the national laws of the Member States by 17 July 2021 (with a possible extension of up to a maximum of one year). One of the most discussed novelties⁴ is undoubtedly the requirement to separate creditors in classes for

* Jente Dengler is a lawyer in the restructuring and insolvency department of DLA Piper UK LLP in Brussels and part-time lecturer in insolvency law at the Catholic University of Leuven.

¹ Directive (EU) 2019/1023 of the European Parliament and Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency), *OJ L* 172, 26.6.2019, 18-55.

² Directive, recitals 1 and 2.

³ *Idem*, recital 15.

⁴ The newness of the Directive needs to be nuanced as the EU Commission already formulated a non-binding recommendation in 2014 with a view to gently steer the national insolvency reforms at the time (Commission Recommendation (2014/135/EU) of 12 March 2014 on a new approach to business failure and insolvency, *OJ L* 74, 14.3.2014, 65-70). The recommendation roughly included the same standards as

the purpose of voting on restructurings plans. This entails grouping the parties affected by a plan in such a way as to reflect their rights and the seniority of their claims and interests. Such class formation must ensure that rights which are substantially similar are treated equally and that restructuring plans are adopted without unfairly prejudicing certain creditors' rights.⁵

Several Member States have been taking initiatives in the run-up to the Directive's implementation deadline, such as the Dutch *WHOA (Wet Homologatie Onderhands Akkoord)*⁶, which could, as some proclaim, make the Netherlands the new "restructuring hub" of Europe.⁷ The new Restructuring Plan procedure in the United Kingdom (UK), a variant of the well-known Scheme of Arrangement of Part 26 of the Companies Act 2006⁸ and the German *StaRUG (Unternehmensstabilisierungs- und Restrukturierungsgesetz)*⁹ have also been introduced in the past year.

In Belgium, however, it remained remarkably quiet for a long time. Eventually on 10 June 2020, a first (rather disappointing) proposal amending the chapter on insolvency law of the Economic Law Code was presented.¹⁰ Unfortunately, very little can be inferred from it regarding the legislator's intentions in relation to the implementation of the Directive in Belgium.

Yet, the mention of "classes" in the bill, marking a first in Belgian restructuring law, did shake the Belgian insolvency landscape slightly awake. The notion of voting in separate classes for the adoption of restructuring plans is unheard of in Belgium and could completely upset the bargaining dynamics between stakeholders in Belgian restructurings.

the Directive, but had little impact due to its non-binding nature (Treaty on the Functioning of the European Union, Art 288). In Belgium, too, little consideration was given to this 2014 recommendation when Book XX on insolvency law was introduced into the Economic Law Code in 2017 (Wet van 11 augustus 2017 houdende invoeging van het Boek XX "Insolventie van ondernemingen", in het Wetboek van economisch recht, BS 11 September 2017). See also S Madaus, "The EU Recommendation on Business Rescue - Only Another Statement or a Cause for Legislative Action Across Europe?", *Insolvency Intelligence* (2014) 27(6) 84; and University of Leeds, *Study on a new approach to business failure and insolvency: Comparative legal analysis of the Member States' relevant provisions and practices*, January 2016, 218-280, available at www.ec.europa.eu/info/sites/info/files/insolvency_study_2016_final_en.pdf.

⁵ Directive, recital 44.

⁶ *Faillissementswet*, Arts 369-387 (inserted by the Act of 7 October 2020 on the Confirmation of Out-of-Court Restructuring Plans (*Wet homologatie onderhands akkoord*, Staatsblad 2020, 414). See also *Kamerstukken II 2018/19*, 33 695, no 18, 3.

⁷ Bloomberg, "Netherlands Bids to Topple London as Europe's Restructuring Hub" (November 13, 2019) available at <https://www.bloomberg.com/news/articles/2019-11-13/netherlands-bids-to-topple-london-as-europe-s-restructuring-hub>.

⁸ UK Companies Act 2006, part 26A (inserted by Corporate Insolvency and Governance Act 2020 on 26 June 2020).

⁹ *Unternehmensstabilisierungs- und -restrukturierungsgesetz vom 22. Dezember 2020* (BGBl. I S. 3256).

¹⁰ *Parl.St. Kamer 2019-20*, nr. 55-1337/001, 1-13.

This paper focuses on the expected changes to the Belgian collective plan procedure and aims to explain what the introduction of classes would actually mean for Belgian debtors and their stakeholders. Before delving into the detail, the author considers a brief outline of the judicial framework to familiarise the reader with the procedure and possibilities of the Belgian collective plan. Thereafter the voting process under the Belgian collective plan will be compared to the Directive's model, analysing the differences and weighing up the pros and cons of both models in an attempt to conclude how (radically) the Belgian legislator should amend the collective plan procedure in view of the Directive.

2. The collective plan procedure

2.1 The Belgian scheme

Generally speaking, it could be said that the collective plan procedure¹¹ is the Belgian equivalent of the Chapter 11 procedure in the United States (US) or the UK Scheme of Arrangement, on which many continental European insolvency proceedings (for example the recently enacted Dutch *WVOA*),¹² as well as the model of the Directive itself, have been based.

A debtor draws up a plan containing restructuring measures (for example "haircuts", payment deferrals, debt-for-equity swaps, etcetera) in respect of all or most of its debt and submits it to the affected creditors for approval. Once a certain creditor majority agrees to the plan, the plan becomes binding upon all creditors (including dissenting creditors) after it has been confirmed by a court (also known as "cram-down").

The two-fold threshold¹³ to be met is a majority in number, representing at least 50 per cent of the total debt of the voting creditors.¹⁴ The court will subsequently confirm the plan making it binding upon all creditors,¹⁵ unless the procedural requirements have not been complied with (for example, information duties) or if the plan is contrary to public order.¹⁶

¹¹ This is the most frequently used restructuring procedure in Belgium. According to a report of Graydon in 2018, 81% of reorganisation filings in 2017 had a collective plan as their primary objective. This report is available at <https://graydon.be/downloads/report-de-wco-eeen-momentopname-voor-de-lancering-van-boek-xx>.

¹² *Kamerstukken II* 2018/19, 35249, no 3, 4. See also R D Vriesendorp and O Salah, "De WVOA: een nieuw herstructureringsinstrument", *Maandblad voor Vermogensrecht* (2020) 6, 205-216.

¹³ The word "threshold" is specifically chosen instead of "majority" as the Belgian value test does in fact not require a majority but only 50% of the total debt of the creditors voting on the plan. Article 9.6 of the Directive, however, rightly gives preference to a majority in value over a headcount test and specifically provides that a plan shall be adopted if a "majority in the amount of their claims" is achieved. Whilst it is clear that the Belgian legislator will have to amend the statutory approval majority (requiring at least 50%+1 in value), the practical implications will be limited which is why this is only briefly mentioned in this paper for the sake of completeness.

¹⁴ Only creditors whose rights are affected by the proposed restructuring plan are eligible to vote on the plan. Non-voting creditors (those absent, unrepresented or abstaining) will not be taken into account for the calculation of the required majority (Economic Law Code, arts XX.77-78).

¹⁵ *Idem*, art XX.82.

¹⁶ *Idem*, art XX.79.

A debtor whose business continuity is imminently threatened,¹⁷ can submit a collective plan whilst remaining in charge of the business (debtor-in-possession).¹⁸ The debtor determines the content of the restructuring plan in which it is free to include all different types of restructuring measures available, ranging from reductions (“haircuts”), to deferrals, debt rescheduling, interest waivers, debt-for-equity swaps and even a transfer of assets.¹⁹ The plan may also provide for a differentiated treatment of categories of debt, based on, for instance, their amount or nature.²⁰ However, the freedom to differentiate is not absolute as certain creditor claims can only be partly curtailed (for example, public creditors)²¹ or not at all (for example, secured creditors and employees).²² Lastly, the implementation period of a restructuring plan cannot exceed five years.²³

2.2 Differentiation or discrimination?

2.2.1 Secured creditors

Secured creditors or so-called extraordinary creditors (*buitengewone schuldeisers*) cannot have their claims reduced or capitalised, but only have their execution rights suspended for 24 months, extendable to 36 months.²⁴ Some may argue that this almost unassailable position of secured creditors is justified in light of the Directive’s “best-interest-of-creditors test”,²⁵ which prevents a creditor from being treated worse under a restructuring plan than in a liquidation scenario. After all, if a secured claim is fully covered by the value of its underlying collateral, the creditor concerned will in principle – also in bankruptcy – be repaid in full under Belgian insolvency law (for example, with the proceeds of the sale of the collateralised asset).²⁶

¹⁷ If the debtor is a legal person, the continuity of its business shall, in any event, be considered threatened when losses have reduced the net assets to less than half of the share capital (*idem*, art XX.45 §2).

¹⁸ Only in exceptional circumstances (eg, grave misconduct), can creditors request the appointment of a court officer (*idem*, arts XX.31-32).

¹⁹ *Idem*, arts XX.72 and XX.75.

²⁰ *Idem*, art XX.72.

²¹ If the plan provides for a differentiated treatment of creditors, public creditors enjoying a general preferential right must be treated at least as favourably as the best treated ordinary creditors in the plan (*idem*, art XX.73).

²² *Idem*, arts XX.73-74.

²³ *Idem*, art XX.76.

²⁴ This is no deferral of payment as interests will still accrue during this suspension period (*idem*, art XX. 74 §1).

²⁵ Directive, art 2(6) provides that the “best-interest-of-creditors test” means a test that is satisfied if no dissenting creditor would be worse off under a restructuring plan than such a creditor would be if the normal ranking of liquidation priorities under national law were applied, either in the event of liquidation, whether piecemeal or by sale as a going concern; or in the event of the next-best-alternative scenario if the restructuring plan were not confirmed.

²⁶ Secured creditors have a separatist position under Belgian law, which means that they can behave relatively independently from the other creditors in bankruptcy and have an exclusive right to their collateral or the proceeds thereof. Alternatively, being subject to a collective plan, they may no longer be able to exercise these execution rights for up to 36 months. See also F De Leo, “Herstructureringsprocedures in België, Nederland en de richtlijn”, *Tvl* (2020) 40(5) 275 at 286.

This would be a valid argument if a secured creditor would only be regarded as secured or “extraordinary” for the portion of its claim that is actually covered by the real value of the collateral. It is inconsistent and therefore regrettable that for the purpose of a restructuring plan the conventional amount for which a claim is secured is first taken into account. Only in the absence of a specified amount, the *actual* value of the collateral is considered.²⁷ In the end, it is only the *actual* value of the collateral that corresponds with what a secured creditor could effectively receive in the alternative scenario of a bankruptcy.²⁸ It would therefore only be reasonable that the portion of the secured claim that exceeds the actual collateral value qualifies as “unsecured” or “ordinary” and can therefore be equally subject to the broad range of measures that can be imposed on unsecured creditors discussed hereinafter.²⁹

2.2.2 Unsecured creditors

Except for a few statutory exceptions,³⁰ unsecured claims or ordinary creditors (*gewone schuldeisers*) may be subject to the full range of restructuring measures mentioned above (such as “haircuts”, debt-for-equity swaps and payment deferrals). As noted, the debtor has the statutory right to differentiate between categories of debt³¹ and to choose which measures it imposes on which creditors, insofar as this is justified in light of the continuity of the business. Effective business restructuring requires flexibility and as the debtor is by definition faced with illiquidity and unable to pay all of its creditors, the differentiation among creditors is justified where strategic creditors are generally paid a higher proportion of their claims than other, non-strategic creditors.³² However, collective plans treating certain creditors significantly worse than others without any reasonable

²⁷ Economic Law Code, art I.22, 14°.

²⁸ Albeit that the Belgian legislator takes a different view and favours a valuation at going concern value (*Parl.St. Kamer* 2016-17, no. 54-2407/002, 9), the rationale of the European “best-interest-of-creditors test” is to ensure that creditors should at least receive under a plan what they would recover in the alternative scenario of a bankruptcy. Hence, as the alternative usually is a piecemeal liquidation of the collateralised assets, the author is of the opinion that the collateral should be valued at liquidation value. This has already been argued in F De Leo, “Herstructureringsprocedures in België, Nederland en de richtlijn”, *Tvl* (2020) 40(5) 275 at 288.

²⁹ Directive, recital 44. It should be noted, however, that splitting claims into a secured and unsecured portion will undeniably give rise to valuation issues and disputes, considering the different treatment to which each part can be subject under Belgian insolvency law. The limited scope of this paper however does not allow the author to further elaborate on this.

³⁰ Such as employment claims, criminal fines, compensation for physical damages, maintenance obligations (Economic Law Code, art XX.73).

³¹ *Idem*, art XX.72.

³² For example, Brussels 16 December 2010, *DAOR* (2011) 436, at 441. Ghent 21 January 2013, *Kamer 7bis*, 2012/AR/1935, unreported. Also see F Helsen, “Positie RSZ bij gerechtelijke reorganisatie: differentiëren mag, discrimineren niet” *NJW* (2013) 283 454; M Vanmeenen, “In de ban de continuïteit”, *TBH* (2015) 6 487 519; and N Ouchinsky, “Le plan de réorganisation judiciaire: questions choisies” in L Bermond and P Libiez, *Loi sur la continuité des entreprises en pratique: regards croisés, ajustements et bilan* (Larcier, Brussel, 2014) at 56-68.

justification have been rejected in the past for reasons of public order, based on the general principle of equality³³ and the concept of diversion of competence.³⁴

In 2013, the legislator³⁵ clarified, which was later reaffirmed by the Supreme Court,³⁶ that the differentiation should be functional and proportional – targeted at preserving the continuity of the business and not going beyond what is necessary to achieve this.³⁷ In practice, the different treatment of creditors in a plan is usually based on their contribution to the continuity of the business, involvement in the functioning of the company (for example, distinction between shareholder loans and external financing), their private or public nature, or strategic importance for the company.³⁸ For instance, a distinction could be made between a supplier that supplies goods that are no longer needed due to the disposal of a product line, and suppliers delivering vital parts for the business.³⁹ This even allows in some cases for one single creditor to constitute a separate debt category on its own.⁴⁰

Whilst a certain degree of flexibility is desirable and even necessary for a restructuring to succeed, the above practice clearly leaves ample room for interpretation and opportunistic behaviour by Belgian debtors; for instance, by differentiating for the purpose of favouring insiders or solely to achieve the required majority vote⁴¹ (see *infra*

³³ Which principle is laid down in the Belgian Constitution, arts 10-11. On the rejection of collective plans, see Constitutional Court 12 February 2009, *JT* (2012), 125; Constitutional Court 18 January 2012, *NJW* (2012) 263, 379, case note P Hannes; Constitutional Court 2 June 2016, *JLMB* (2016) 32, 1496; Constitutional Court 6 October 2016, *RABG* (2017) 16, 1283; and Ghent 10 September 2012, *RABG* (2013) 4, 203.

³⁴ The right to differentiate in Economic Law Code, art XX.72 is granted for the purpose of business continuity and may not be misused contrary to this legal finality or with a sole view to curtailing creditors' rights. See eg Supreme Court 7 February 2013, *JLMB* (2013), 1510.

³⁵ *Parl.St. Kamer* 2012-13, doc 53-2692/001, 24-25.

³⁶ Supreme Court 13 March 2014, *Arr.Cass.* (2014) 3, 763.

³⁷ See also E Dirix, "De paritasregel en het reorganisatieplan", *RW* (2011-2012) 573; A Van Hoe and I Verougstraete, "Van toegelaten differentiatie tot verboden discriminatie", *TBH* (2011) 924-925; R Fransis, "Gedifferentieerde behandeling van schuldeisers in het reorganisatieplan: een privaatrechtelijke toets aan het verbod van rechtsmisbruik", *TBH* (2014) 702; F De Leo, "Killing Season: weigering homologatie reorganisatieplan", *RABG* (2017) 1315; E Dirix, "Wet Continuïteit Ondernemingen – Procedure gerechtelijke reorganisatie – Reorganisatieplan – Homologatie – Gedifferentieerde behandeling van schuldeisers – Schending van het gelijkheidsbeginsel – Gevolg", *RW* (2011-12) 573-577; and B Pelgrims and E De Noyette, "Afbetalingscapaciteit en de openbare orde: over proportionaliteit, functionaliteit en unanimité bij de homologatie van een reorganisatieplan", *HOR* (2020) 133 90-92.

³⁸ S Loosveld, "De gedifferentieerde behandeling van schuldeisers in een plan", *RABG* (2013) 4 2011 and A Zenner, *Le bon plan, Élaboration, vote et homologation du plan de réorganisation judiciaire, Séminaire La loi sur la continuité des entreprises : premier enseignement* (Verviers, 2010) at 45-52 no 51-59.

³⁹ P Coussement, *Herstelschema's voor ondernemingen in moeilijkheden: een grondslagenonderzoek naar de doelstellingen van insolventieregulering en de verhouding tussen de Wet Gerechtelijk Akkoord en de Failissementswet vanuit een rechtsvergelijkende, rechtseconomische en empirische invalshoek* (UGent, 2007) at 468. Also see Ghent 17 October 2011, *TGR-TWVR* (2012) 1 48 and A Van Hoe and I Verougstraete, "Van toegelaten differentiatie tot verboden discriminatie", *TBH* (2011) 923.

⁴⁰ For example, Ghent 10 September 2012, *RABG* (2013) 4, 203.

⁴¹ For example, the *quasi* full payment of smaller creditors purely to obtain the required majority in number, arguing that the financial management of these creditors would weigh too heavily on the debtor's finance

2.3). Notwithstanding the rejection of blatantly disproportionate and abusive plans in the past,⁴² the Commercial Courts only have marginal powers of appreciation in this respect.⁴³

Besides, a collective plan may provide for “haircuts” of up to 80 per cent and even more in cases of “overriding reasons of business continuity”.⁴⁴ Reductions of up to 90 per cent in relation to non-strategic creditors’ claims do occur in practice and are not rarely considered as a functional and proportional differentiation given the relative insignificance of these creditors for the continuity of the business.⁴⁵ Belgian insolvency law is silent on how the “best-interest-of-creditors-test” fits in here, which is problematic under the Directive as no statutory provision prevents ordinary creditors from being treated worse under a plan than in bankruptcy.

2.2.3 Equity holders

Only in rare cases debt is converted into equity as part of a collective plan, and almost exclusively where the company owes money to insiders such as shareholders, affiliated companies or directors (that is, connected creditors).⁴⁶ The obvious reason for this is that shareholders generally do not want see their shareholding diluted and certainly not to the

department. The risk of such behaviour was also raised in the preparatory works of the bill amending the Act on the Continuity of Enterprises of 12 March 2013 (*Parl.St. Kamer 2012-13, doc 53-2692/001, 25*).

⁴² S Brijs and S Jacmain, “De reorganisatie van een onderneming in het kader van een collectief akkoord” in VBO (ed), *De wet betreffende de continuïteit van de ondernemingen* (Anthemis, Louvain-la-Neuve, 2010) at 108; I Verougstraete, *Manuel de la continuité des entreprises et de la faillite* (Kluwer, Waterloo, 2011) at 200; M Vanmeenen, “De (veron)gelijk(t)e positie van de schuldeiser bij gerechtelijke reorganisatie via collectief akkoord”, *DAOR* (2011) 289 297-298; P Coussement, “Macht en onmacht van de verschillende stakeholders in een gerechtelijke reorganisatie door een collectief akkoord” in K Byttebier, E Dirix, M Tison and M Vanmeenen, *Gerechtelijke reorganisatie. Getest, gewikt en gewogen* (Intersentia, Antwerp, 2010) at 103; Liège 24 March 2011, *JT* (2011), 468 at 470; and Antwerp 30 June 2011, *RW* (2011-12) 12, 573. Also see A Zenner, “P.R.J. et. Q.P.C.” (case note Liège 24 March 2011), *JT* (2011) 470 at 472; S Brijs and R Lindemans, “Draaiboek collectief akkoord en overdracht onder gerechtelijk gezag” in H Braeckmans *et al*, *Curatoren en vereffenaars: actuele ontwikkelingen* (4th ed, Intersentia, Antwerp, 2017) at 20; and M Storme and C Van Den Broeck, “De gevolgen van een reorganisatie- en faillissementsprocedure op de verhaalsmogelijkheden van de betrokken schuldeisers” in J De Rammelaere, *Ondernemingen in moeilijkheden* (Intersentia, Antwerp, 2019) at 261-265.

⁴³ For example, Liège 24 March 2011, *JT* (2011) 468, 47 and Comm. Ghent (div. Dendermonde) 26 September 2016, *RW* (2018-19) 37, 1470. Also see S Brijs a.o., “Kroniek insolventierecht 2019-2020”, *TRV-RPS* (2020) 5 565; A Van Hoe and I Verougstraete, “Van toegelaten differentiatie tot verboden discriminatie”, *RDC-TBH* (2011) 925; W Van Gerven and S Lierman, “Algemeen Deel. Veertig jaar later” in W Van Gerven and R Dillemans, *Beginselen van Belgisch privaatrecht* (Kluwer, Mechelen, 2011) at 408; and I Verougstraete, “Economische opvattingen van het Hof van Cassatie” in *Liber Amicorum Lucien Simont* (Bruylant, Brussels, 2002) at 239 *et seq.*

⁴⁴ Economic Law Code, art XX.73

⁴⁵ For instance, “haircuts” of 87,5% and 85% in Ghent 10 September 2012, *RABG* (2013) 4, 203, and Comm. Ghent (div. Dendermonde) 26 September 2016, *RW* (2018-19) 37, 1470, respectively.

⁴⁶ P Coussement, “Macht en onmacht van de verschillende stakeholders in een gerechtelijke reorganisatie door collectief akkoord” in K Byttebier, E Dirix, M Tison and M Vanmeenen, *Gerechtelijke reorganisatie, getest, gewikt en gewogen* (Intersentia, Antwerp, 2010) at 104; D De Marez and C Stragier, *Boek XX. Een commentaar bij het nieuwe insolventierecht* (Die Keure, Brugge, 2018) at 215.

benefit of external creditors.⁴⁷ As the initiative for drawing up the plan is exclusively reserved for the debtor,⁴⁸ which in fact are the directors appointed by the company's shareholders, (external) creditors' claims are hardly ever swapped for shares: he who pays the piper, clearly calls the tune. Given that creditors do not have the legal possibility of amending the plan either, it is often a "take it or leave it" deal.⁴⁹

This results in one-sided free-rider behaviour, as equity holders who would normally rank at the very end in a liquidation scenario rarely receiving anything at all, in fact suffer no reduction of their rights compared to ordinary creditors that are often confronted with severe "haircuts" (often combined with deferred payment of their significantly reduced claims).⁵⁰ Not only do they not share in the losses, but equity holders also retain the upside potential of the restructured business:⁵¹ in case the plan succeeds and the company returns to profitability, they will be the ones to reap the fruits as legal owners.⁵² Since they have nothing to lose and everything to gain, there is an obvious moral hazard to taking big risks (or, at least, encouraging their appointed directors to do so).⁵³ The creditors, in

⁴⁷ S Landuyt, "De 'voorrang' van de Belgische aandeelhouder bij herstructurering van vennootschappen in moeilijkheden onder druk", *Corporate Finance Lab* 13 January 2020, available at <https://corporatelifinancelab.org/2020/01/13/de-voorrang-van-de-belgische-aandeelhouder-bij-herstructurering-van-vennootschappen-in-moeilijkheden-onder-druk/>.

⁴⁸ The fact that the debtor exclusively takes the lead and has important responsibilities (eg, filing a list of all creditors in the plan with the respective amounts of their claims) has been criticised as it would encourage strategic and even fraudulent behaviour. For instance, in 2015 the Commercial Court of Antwerp refused a restructuring plan because the debtor deliberately inflated the amount of debt owed to an affiliated, and thus approving, creditor to reach the statutory threshold of 50% in value (Comm. Antwerp 31 October 2016, *RABG* (2017) 16, 1299, case note F De Leo). Also see M Vanmeenen, "In de ban van de continuïteit", *TBH* (2015) 6 515.

⁴⁹ S Brijs and S Jacmain, "De reorganisatie van een onderneming in het kader van een collectief akkoord", in VBO (ed), *De wet betreffende de continuïteit van de ondernemingen* (Anthemis, Louvain-la-Neuve, 2010) at 88-90; M Vanmeenen, "De (veron)gelijk(t)e positie van de schuldeiser bij gerechtelijke reorganisatie via collectief akkoord", *DAOR* (2011) 292; and F De Leo, "'Economics trumps politics'. De valkuil van democratische besluitvoering bij vennootschappen en insolventieprocedures", *RW* (2017-18) 32 1251. Also see Y Ren, *A comparative study of the Corporate Bankruptcy Reorganization Law of the US and China* (Eleven International Publishing, Groningen, 2012) at 74-83.

⁵⁰ S Landuyt, "De 'voorrang' van de Belgische aandeelhouder bij herstructurering van vennootschappen in moeilijkheden onder druk", *Corporate Finance Lab* 13 January 2020, available at <https://corporatelifinancelab.org/2020/01/13/de-voorrang-van-de-belgische-aandeelhouder-bij-herstructurering-van-vennootschappen-in-moeilijkheden-onder-druk/>.

⁵¹ R J De Weijs, *Faillissementspauliana, Insolvenzanfechtung & Transaction Avoidance in Insolventies* (Kluwer, Deventer, 2010) at 26; and A Van Hoe, "Over verbonden schuldeisers en de gerechtelijke reorganisatie", *TRV* (2013) 8 800-804.

⁵² D G Baird and T H Jackson, "Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy", *Chicago Law Review* (1984) 97 106-107; R J Schimmelpenninck, "Leningen of schadeclaims van aandeelhouders concurrent?", *Tvl* (2003) 239-246; R J De Weijs, *Wanorde? Hoe het faillissementsrecht zich tegen schuldeisers dreigt te keren* (Boom J.U, Den Haag, 2016) at 27-40; and R J De Weijs, *Nieuwe regels omtrent aandeelhoudersleningen: tussen afdwingbaarheid en onrechtmatigheid in*, *Preadvies NVR II*, 2013, available at www.papers.ssrn.com/sol3/papers.cfm?abstract_id=2381969.

⁵³ P Coussement, "Macht en onmacht van de verschillende stakeholders in een gerechtelijke reorganisatie door collectief akkoord" in K Byttebier, E Dirix, M Tison and M Vanmeenen, *Gerechtelijke reorganisatie*,

turn, who have in fact become the residual economic owners of the company,⁵⁴ will ultimately bear the consequences. This is, of course, directly at odds with the junior position of equity holders and even goes against any priority rule, be it relative⁵⁵ or absolute,⁵⁶ under the Directive.

2.3 No classes, no problem?

2.3.1 Convenient use of minority oppression

After decades of English and US restructuring experience, where voting in classes is the long-standing standard rule,⁵⁷ it is widely accepted that voting in separate categories or classes, each of which are composed of creditors with substantially similar rights and interests, is of crucial importance to avoid minority oppression by large creditors.⁵⁸ An excessive subdivision of creditor classes, on the other hand, is also undesirable given the risk of holdouts and *de facto* veto rights for minority creditors, which could arise if the classes are too narrowly defined with fewer creditors per class.⁵⁹

As mentioned above, a Belgian scheme is approved if an ordinary majority in number, representing at least 50 per cent of the total debt of the voting creditors, vote in favour of the plan. There is no voting in separate classes under Belgian law. Despite the significant difference in restructuring measures to which they can be subjected, secured and unsecured creditors vote together in one single class.

The former risk of minority oppression is therefore undeniably present in the Belgian collective plan procedure and even often taken advantage of by debtors in practice.⁶⁰ Due to the absence of voting in classes, the support of its largest creditor(s) (that is, the bank) combined with the approval of some smaller – even “out of the money”⁶¹ – creditors or affiliated creditors,⁶² often already allows a debtor to reach the aforementioned thresholds

getest, gewikt en gewogen (Intersentia, Antwerp, 2010) at 105. Also see L Bebhuck, “Ex Ante Costs of Violating Absolute Priority in Bankruptcy”, *The Journal of Finance* (2002) 445-460.

⁵⁴ Belgian Mortgage Act, art 8 provides that “[t]he debtor’s assets serve as common security for its creditors”. Also see D G Baird, “The Initiation Problem in Bankruptcy” *ILRE* (1991) 11 223 at 228.

⁵⁵ Where dissenting classes of affected creditors are treated at least as favourably as any other class of the same rank and more favourably than any junior class (Directive, art 11.1).

⁵⁶ Where claims of affected creditors in a dissenting voting class are satisfied in full by the same or equivalent means where a more junior class is to receive any payment or keep any interest under the restructuring plan (*idem*, art 11.2).

⁵⁷ See, eg, J Payne, *Schemes of Arrangement. Theory, Structure and Operation* (Cambridge University Press, 2014) and E Warren, *Chapter 11: Reorganizing American Businesses* (1st ed, Aspen Publishers, New York, 2008).

⁵⁸ Directive, recital 44.

⁵⁹ *Idem*, recital 47.

⁶⁰ M Vanmeenen, “In de ban de continuïteit”, *TBH* (2015) 6 519.

⁶¹ Such as creditors with claims ranking below where value breaks, meaning that they would not receive anything in bankruptcy.

⁶² With the additional risks of debt splitting (see Comm. Dendermonde, 6 July 2010, *RW* (2010-11), 587) and debt inflation (see Comm. Antwerp 31 October 2016, *RABG* (2017) 16, 1299).

in value and number to proceed with its plan.⁶³ This practice is further facilitated by the debtor's right to differentiate among creditors and therefore its ability to strategically choose who will be paid generously under the plan.⁶⁴ As a result, it is possible to "buy" certain creditors' consent and to a certain extent coordinate the voting process.⁶⁵

2.3.2 More conflicting interests

Apart from this rather undemocratic voting process in which both secured and unsecured creditors vote jointly on a plan that treats them differently,⁶⁶ it is even more striking that insiders or connected creditors also vote in the same class – knowing that their interests and priorities clearly lie elsewhere.⁶⁷ These creditors have more to gain than simply having their claims repaid. Given the fact that the claims of these connected creditors are less likely to undergo a "haircut" and will usually be swapped for (additional) equity,⁶⁸ the moral hazard of high-risk investments and the upside potential advantage might be even greater, knowing that the equity value of their converted debt may increase if the company becomes profitable again.⁶⁹

⁶³ P Coussement, "Macht en onmacht van de verschillende stakeholders in een gerechtelijke reorganisatie door collectief akkoord" in K Byttebier, E Dirix, M Tison and M Vanmeenen, *Gerechtelijke reorganisatie, getest, gewikt en gewogen* (Intersentia, Antwerp, 2010) at 98, no 61; and N Tollenaar, *Het pre-insolventieakkoord: grondslagen en raamwerk* (Kluwer, Deventer, 2016) at 249.

⁶⁴ A commonly used strategy is to pay important suppliers as generously as possible under the plan at the expense of other non-strategic creditors. See P Hannes, "Wet Continuïteit Ondernemingen. Vergeet de fiscus niet", *NjW* (2012) 367 and J Peeters, "Het gedwongen huwelijk van de werknemers (of de RSZ) met de WCO. Een eerste overzicht van rechtspraak (2009-2011)", *Sociale Kronieken* (2012) 3 107.

⁶⁵ The vote will normally be well prepared in advance and therefore be a foregone conclusion. At the debtor's proposal, supporting creditors will usually be represented by a proxy holder at the voting hearing in order to make things easier and less costly, as opposed to dissenting creditors for whom the cost of voting against will generally be higher (A Zenner, "Le bon plan, Élaboration, vote et homologation du plan de réorganisation judiciaire", *La loi sur la continuité des entreprises : premier enseignement*, 24 November 2010, Verviers, no 64).

⁶⁶ M Vanmeenen, "In de ban de continuïteit", *TBH* (2015) 6 519.

⁶⁷ Connected creditors sometimes present themselves to take part in the vote and to tip the scales in favour of the debtor. If the other creditors suspect that their claims are false or inflated, they can dispute them in court. However, a creditor will rarely challenge the claim of another creditor. Firstly, an external creditor must know that the creditor concerned is related to the debtor. Secondly, it bears the burden of proof that the amount of the claim is not accurate (see, for instance, Comm. Antwerp, 31 October 2016, *RABG* (2017) 16 1299). See also A Van Hoe and M Vreven, "Knelpunten bij de gerechtelijke reorganisatie door een collectief akkoord", *TBH* (2011) 9 855.

⁶⁸ See S Landuyt, "De 'voorrang' van de Belgische aandeelhouder bij herstructurering van vennootschappen in moeilijkheden onder druk", *Corporate Finance Lab* 13 January 2020, available at <https://corporatefinancelab.org/2020/01/13/de-voorrang-van-de-belgische-aandeelhouder-bij-herstructurering-van-vennootschappen-in-moeilijkheden-onder-druk/> and P Coussement, *Herstelschema's voor ondernemingen in moeilijkheden: een grondslagenonderzoek naar de doelstellingen van insolventieregulering en de verhouding tussen de Wet Gerechtelijk Akkoord en de Failissementswet vanuit een rechtsvergelijkende, rechtseconomische en empirische invalshoek* (UGent, 2007) at 447.

⁶⁹ This is generally accepted as a justified differentiation within the meaning of the Economic Law Code, art XX.72. See, eg, Comm. Antwerp 28 March 2014, *Limb. Rechtsl.* (2014) 3 248; Brussels 1 February 2013, *TRV* (2013) 8 797. Nonetheless, the courts are increasingly vigilant that insiders do not treat themselves more favourably than other ordinary creditors in the plan. Still, these creditors retain the upside potential and their rights are not necessarily permanently reduced (as opposed to external creditors suffering a

3. Balancing the *status quo* against the Directive

Conclusively, whilst the Belgian collective plan offers debtors great flexibility to divide creditors into different categories for the purpose of treating them differently in a restructuring (for example, strategic creditors, non-strategic creditors and suppliers), these categories as such are not taken into account for the approval of the plan. As said, this inconsistency creates a breeding ground for opportunistic behaviour by debtors. In particular, it enables debtors to adopt a strategic position by granting some creditors higher and other creditors lower recovery rates under a plan, and to co-ordinate the voting process to ensure that the required majorities are reached to get a plan approved.⁷⁰

As a result, the decision-making power in fact lies with the largest creditor(s) on the one hand, as an important hurdle for a plan is to meet the value threshold (50 per cent) and, on the other, with the company's shareholders given their indirect but exclusive right to determine the specific measures and creditor categories in a plan. Consequently, the current procedure makes it relatively easy for a debtor and its largest creditor(s) to push through a plan without having to worry too much about other, perhaps unwilling, creditors.

However, the bargaining dynamics of this process might change considerably with the implementation of the Directive in Belgian insolvency law. It is clear that the Belgian collective plan procedure is irreconcilable with the class voting model of the Directive and therefore no longer tenable. Legislative changes are looming that could compensate for the risk of minority oppression and strategic (mis)behaviour by Belgian debtors. Still, there appears to be some leeway for the national legislator to cling to the collective plan in its current form as much as possible.

Even though there seems to be no escaping the Directive's default rule of voting in classes, the Directive does not go as far as to oblige the Member States to implement a voting system with more than two creditor classes (secured versus unsecured).⁷¹ Additionally, the Directive also provides for an exemption for restructuring plans of small or medium-sized enterprises (SMEs).⁷² In essence, this means that the Belgian legislator can choose

"haircut"). See also A Van Hoe, "Over verbonden schuldeisers en de gerechtelijke reorganisatie", *TRV* (2013) 8 800, at 800-804; S Loosveld, "De gedifferentieerde behandeling van schuldeisers in een plan", *RABG* (2013) 4 211; and J F Goffin, "Le plan de réorganisation par accord collectif sous le régime du Livre XX du Code de droit économique" in A Zenner, *Le droit de l'insolvabilité: analyse panoramique de la réforme*, (Anthemis, Limal, 2018) at 330-332.

⁷⁰ See M Vanmeenen, "In de ban de continuïteit", *TBH* (2015) 6 519; N Ouchinsky, "Le plan de réorganisation judiciaire: questions choisies" in L Bermond and P Libiez, *Loi sur la continuité des entreprises en pratique: regards croisés, ajustements et bilan* (Larcier, Brussel, 2014) at 56-68; and S Landuyt, "De 'voorrang' van de Belgische aandeelhouder bij herstructurering van vennootschappen in moeilijkheden onder druk", *Corporate Finance Lab* 13 January 2020, available at: <https://corporatefinancelab.org/2020/01/13/de-voorrang-van-de-belgische-aandeelhouder-bij-herstructurering-van-vennootschappen-in-moeilijkheden-onder-druk/>.

⁷¹ Directive, art 9.4.

⁷² *Ibid.*

between either a thorough, far-reaching transposition of the Directive, including a comprehensive class system similar to its common law counterparts, or a maximum preservation of the *status quo*.

In the first scenario, the voting process will become more democratic and the minority oppression that characterises the current procedure will largely be eliminated. Instead of having only one class including all creditors (secured, unsecured and connected together), equitable and coherent creditor classes will be established to ensure that only creditors with substantially similar rights and interests in the restructuring vote together in the same class. Connected creditors will be separated in a different class avoiding misplaced incentives to prevail in the voting process.⁷³ In order for a plan to be approved, a majority (in value) within each class should in principle vote in favour of it.

The more welcome these amendments are from a creditor protection⁷⁴ and democratic⁷⁵ point of view, the more detrimental they are from a timing and cost-efficiency perspective. Additional costs, delay due to the formation of classes (which risk becoming subject to challenge later in the process) and increased uncertainty for debtors as a result, are the other side of the coin. In addition, more creditor protection and less minority oppression equals an increased risk of hold-out positions and *de facto* veto rights for minority creditors.⁷⁶ The Directive seeks to remedy this issue by introducing a so-called “cross-class cram-down” – a concept originally derived from the US Chapter 11 procedure.⁷⁷ This should allow a restructuring plan to be implemented even though an entire creditor class voted against the plan, provided that this dissenting class is treated at least as favourably as any other class of the same rank and more favourably than any junior class.⁷⁸ However, the US experience demonstrates that in practice debtors want to avoid such a cross class cram down at all costs for reasons of speed, costs and, above all, legal certainty.⁷⁹ Therefore, a potentially dissenting class of creditors will usually be paid off in the plan in exchange for their consent.⁸⁰ This seems to indicate that this cross-class cram-down is not

⁷³ *Idem*, recitals 44 and 46.

⁷⁴ Directive, art 9.4 provides that “Member States shall put in place appropriate measures to ensure that class formation is done with a particular view to protecting vulnerable creditors such as small suppliers”.

⁷⁵ N Tollenaar, *Het pre- insolventieakkoord. Grondslagen en raamwerk* (Kluwer, Deventer, 2016) at 107.

⁷⁶ Directive, recital 47. Also see G O’dea, J Long and A Smyth, *Schemes of arrangement: law and practice* (Oxford University Press, 2012) at 50.

⁷⁷ Where it is better known simply as a cram-down.

⁷⁸ Directive, art 11.1(c) (ie, the relative priority rule). By way of derogation, Member States may provide that the claims of affected creditors in a dissenting voting class have to be satisfied in full by the same or equivalent means where a more junior class is to receive any payment or keep any interest under the restructuring plan (ie, the absolute priority rule) (Directive, art 11.2).

⁷⁹ *American Bankruptcy Institute Commission to study the reform of chapter 11, Final report and recommendations, Alexandria* (American Bankruptcy Institute, 2014) at 182 and 212. Also see D G Baird, “The Uneasy Case for Corporate Reorganizations” *Journal of Legal Studies* (1986) 15 (1)(6) 127 144; and E Warren, *Chapter 11: Reorganizing American Businesses* (1st ed, Aspen Publishers, New York, 2008) at 163.

⁸⁰ For example, *In re MPM Silicones, LLC* [2017] no 15-1771 (2d Cir. 2017). Also see B A Markell, “Fair Equivalents and Market Prices: Bankruptcy Cramdown Interest Rates”, *Emory Bankruptcy Developments Journal* (2016) 33(1) 122.

a perfect solution either, as it fails to effectively tackle the problem of holdouts and nuisance value.

The second scenario, namely if the Belgian legislator were to maintain the *status quo* as much as possible, this would entail a limited class division into secured versus unsecured creditors, further tempered by the implementation of the SME exemption. Given that SMEs account for roughly 99 per cent of all businesses,⁸¹ building this derogation into the national transposition of the Directive actually means that the current procedure will in fact continue to apply to the majority of cases and remain the rule rather than the exception.

Though this conservative stance is not a creditor-friendly nor a democratic one, it does contribute to the speed and efficiency of the process.⁸² It maintains legal certainty for debtors or, at least, does not add an extra layer of uncertainty resulting from class formation issues; avoids opportunistic behaviour by minority creditors (for example, holdouts), and therefore generally accelerates and increases the chances of corporate rescue.⁸³

4. The Belgian legislator is still undecided

So far, the Belgian legislator has only presented a very simplistic proposal on 10 June 2020 to amend Book XX on insolvency law of the Economic Law Code. This bill – which only seeks to adjust the law on a few points and seems more like a “conversation starter” rather than a genuine proposal – merely adds the wording “the voting on the plan shall be per category of creditors” to the relevant procedural provisions, without any further clarification whatsoever.⁸⁴ What is meant by a “category of creditors” is therefore unclear. Neither the Bill nor the current insolvency law provides a definition of “category of creditors”.

The only statutory provision that mentions the term “categories” is Article XX.72 of the Economic Law Code, which provides the legal basis for the differentiated treatment of creditors in a plan (*supra* paragraph 2.2). This raises the question whether this would imply

⁸¹ Directive, recital 17. Albeit that SMEs are to be understood as defined by national law pursuant to Directive, art 2.2, it considers for the purpose of its implementation that an SME is any undertaking with fewer than 250 employees and an annual turnover of less than EUR 50 million, or a balance sheet total of less than EUR 43 million (Directive, recital 18 and art 2(2)(c)).

⁸² According to various comparative insolvency studies conducted in recent years, it appears that Belgium scores well compared to other European countries in terms of duration, recovery rates and success rate of resolving insolvency. See, for instance, University of Leeds, *Study on a new approach to business failure and insolvency: Comparative legal analysis of the Member States’ relevant provisions and practices*, January 2016, 36, available at www.ec.europa.eu/info/sites/info/files/insolvency_study_2016_final_en.pdf and EU Commission, *Impact assessment study on policy options for a new initiative on minimum standards in insolvency and restructuring law*, 2015, 36 available at https://ec.europa.eu/info/sites/info/files/final_report_formatted_jiipib2_for_publication_final_opoce_0.pdf.

⁸³ Directive, recitals 1, 6, 7, 16 and 85.

⁸⁴ *Parl.St. Kamer* 2019-20, doc 55-1337/001, 12-13.

that the legislator proposes to create a separate voting class for each category of creditors that is treated differently under the plan.

This would be an absolute shift from the current process as we know it, in favour of a full-fledged integration of the Directive's voting model. It is clear from the above that this would have far-reaching consequences for Belgian restructurings.⁸⁵ Arguing, based on this one single phrase, that the Belgian legislator would have deliberately chosen this route therefore seems a bit naive. That this ill-considered Bill was pushed through under time pressure (due to the COVID-19 crisis) and insufficient attention was given to its possible implications, is a more plausible assumption. The Belgian Council of State therefore rightly requested the legislator to clarify what is meant by "category of creditors" and to specify how the creditors are to be classified in the light of the Directive. The Bill was subsequently sent back to Belgian Parliament for amendment and is currently still pending.⁸⁶

Ultimately, the only conclusion that can be drawn from this is that the conversation about the Directive's transposition in Belgian insolvency law has commenced, but it remains to be seen in what direction it will evolve. Among scholars,⁸⁷ rumour has it that the Belgian legislator would in fact like to make as few changes as possible to the current procedure.

5. Concluding remarks

Firstly, it appears from the above that even the European legislator itself has in a way remained undecided when it comes to how the process of voting on a restructuring plan should be shaped. On the face of it, the Directive seems to be a fierce advocate of a comprehensive class voting system in order to protect vulnerable creditors in restructurings (for example, suppliers).⁸⁸ A noble goal, but one that, given the complexity of such class formation, the associated legal uncertainty and the risk of delay and additional costs, seems to run directly against the main objective of the Directive: to improve the effectiveness and predictability of preventive frameworks to allow swift restructurings and avoid bankruptcies.⁸⁹

⁸⁵ In fact, if the categories of the Economic Law Code, art XX.72 (differentiation in creditor treatment) were also to serve as the basis for voting, this would entirely erode the collective plan procedure. As mentioned, the debtor has a certain flexibility to divide creditors into differently treated categories which could very well consist of only one creditor. Without a cross-class cram-down mechanism, of which there is no mention in the Bill of 10 June 2020, one single dissenting creditor could thus block the entire plan. It is clear that this is not the aim of the Belgian Legislator, nor the Directive (recital 47).

⁸⁶ *Parl.St. Kamer* 2019-20, doc. 55-1337/002, 15.

⁸⁷ F De Leo, "Herstructureringsprocedures in België, Nederland en de richtlijn", *Tvl* 2020 40(5) 275. In the author's opinion, this would indeed not be surprising, as the Belgian legislator also took a conservative stance following the 2014 Commission Recommendation, which included roughly the same standards and procedures as set out in the Directive, and to which barely any consideration was given when the new insolvency law chapter ("book XX") was introduced in the Economic Law Code in 2017 (*supra* fn 5).

⁸⁸ Directive, art 9.4 and recital 44.

⁸⁹ See, for instance, recitals, 1, 2, 6, 7, 15, 16, 24, 29, 30, 47, 69, 85 and 90 of the Directive.

Apparently aware of this reality, the European legislator, somewhat contradictorily, toned down its position leaving the possibility open for Member States to limit the class formation requirement to just two classes (secured versus unsecured creditors)⁹⁰ and to allow SME restructurings to be exempted,⁹¹ knowing that they represent 99 per cent of all businesses in Europe. This, in fact, allows the Belgian legislator to largely retain the collective plan procedure in its current form, even though it firmly goes against the class voting model, at least *prima facie*, as pursued by the Directive.

Notwithstanding, the current Belgian scheme procedure does appear to meet the Directive's main objectives of effectiveness, legal certainty and swiftness of national restructuring frameworks. This is partly due to the predictability of a voting process for debtors, without the burdensome class formation requirement. Hence, it is clear that certain interests will always be overridden by others, notably the fairness of the voting process by the need for swift, effective and predictable restructuring frameworks or *vice versa*.

Having regard to the difficult reconciliation of these two seemingly conflicting objectives and the derogations foreseen in the Directive, it can be expected that the envisaged harmonisation in this regard will be rather modest. Following the example set by other Belgian scholars, who paraphrased George Orwell with respect to the inequality among creditors in Belgian restructuring plans ("all creditors are equal, but some are more equal than others"),⁹² another of his well-known literary quotes comes to mind when considering this contradiction between the Directive's objectives: "Doublethink means the power of holding two contradictory beliefs in one's mind simultaneously, and accepting both of them."⁹³

Overall, the author is definitely not opposed to the ambiguous compromise reached within the Directive and the necessary adjustments that the Belgian legislator will have to make, such as the implementation of a "best-interest-of-creditors" test and the introduction of a class voting model distinguishing, at least, between secured and unsecured creditors, which is only fair considering the different measures they can be subject to. Whether such or maybe even a more comprehensive class voting model will characterise the new Belgian collective plan procedure, remains to be seen and will largely

⁹⁰ Despite the need of voting in classes to protect vulnerable creditors expressed in the preamble of the Directive (recital 44), no explanation is provided as to why this class voting obligation is in fact limited to only two classes.

⁹¹ The Directive, recital 45, tries to justify the exemption for SMEs by making reference to their relatively simple capital structure. Yet, the *rationale* of the class formation requirement has little to do with the debtor's capital structure, but seeks to prevent creditor minority oppression (Directive, recital 44) - a risk that is no more or less present in restructuring plans of SMEs (as pointed out by F De Leo, "Definiëring (buiten)gewone schuldvorderingen in de opschorting (of hoe het verleden het heden is)", *TBH* (2019) 1226).

⁹² F De Leo, "[Reorganisatieplan] All creditors are equal, but some creditors are more equal than others", *RDC-TBH* (2017) 7, 734-742 with literary reference to G Orwell, *Animal Farm: A Fairy Story* (Martin Secker & Warburg Ltd, London, 1945) at 112.

⁹³ G Orwell, *Nineteen Eighty-Four* (Martin Secker & Warburg Ltd, London, 1949) at part 2, sec 9.

depend on the legislator's use of the SME exemption, which would only reaffirm the *status quo* in practice. "To class or not to class?" thus remains the question.

Tax obstacles to the effectiveness of the Brazilian insolvency legal framework

By Catarina Ferraz, PGMBM, United Kingdom* and Rodrigo Numeriano Dubourcq Dantas, Castro & Numeriano Dantas Advogados, Brazil**

Abstract

Pursuant to Law 14,112, of 24 December 2020 and Law 11,101, of 9 February of 2005, Brazil significantly enhanced its insolvency legal framework with the introduction of two dynamic procedures: the judicial and extrajudicial restructuring proceedings. The country underwent an effort to promote national development by strengthening the participation of creditors, increasing legal certainty for the national financial system, as well as preserving jobs and viable companies. Despite the improvements, the current fiscal policy applicable to illiquid companies present several hurdles that turn into true barriers for the financial readjustment of such companies.

In this context, this paper aims to analyse two current tax requirements that act as obstacles to the success of corporate reorganisation proceedings, and the consequent fiscal reform that is necessary.

1. The insolvency legal framework as a post-COVID-19 Brazilian economic recovery measure: Preliminary considerations

There is no novelty. The Public Calamity status in Brazil has been formally recognised by the Union since 20 March 2020, followed by countless states and municipalities that similarly felt the economic imbalances. In fact, the expansion of COVID-19 in the national territory is an event that could not be anticipated or controlled (as described in the legal definition of the *force majeure* principle in Brazil)¹ and resulted in serious consequences.

This scenario of a national and local crisis was followed by the adoption of social isolation as a “defence weapon” of indisputable relevance against the virus. As the Organisation for Economic Co-operation and Development (OECD) acknowledges, efforts to reduce the scale of the health crisis are of “first-order importance”.² However, one must not lose sight of the fact that the necessary measures to prevent the spread of COVID-19 have a hidden

* Master of Laws, Queen Mary University of London, UK; Associate Lawyer, PGMBM Law Firm, London, UK (cferraz@pgmbm.com).

** Master of Laws, Faculty of Law of Recife (UFPE), Brazil; Doctor of Laws, University of São Paulo (USP), Brazil; Former Legal Consultant of the Brazilian Ministry of Cities; Partner, Castro & Numeriano Dantas Advogados, Brazil (rodrigo@numeriano.com.br).

¹ Consolidation of Labour Laws, Art 501.

² See, eg, <https://www.oecd.org/coronavirus/policy-responses/testing-for-covid-19-a-way-to-lift-confinement-restrictions-89756248/>; <https://www.oecd.org/coronavirus/policy-responses/tax-and-fiscal-policies-after-the-covid-19-crisis-5a8f24c3/>; and <https://www.oecd.org/coronavirus/policy-responses/tax-administration-responses-to-covid-19-administrative-measures-to-facilitate-withholding-tax-relief-claims-373d0051/>.

facet, being the many public and private costs that accompany them. The losses for the national economy will reach billions of reais and are evidenced by an unfeasible recovery in the short term. To illustrate, the less optimistic projections for the Brazilian gross domestic product (GDP) target a retraction of more than 7 per cent this year.³

Excessive liberalisms aside, it is certain that citizens expect an effective response from public authorities, especially from the Federal Government. Its commitments to national development, the reduction of social and regional inequalities, the promotion of jobs and the eradication of poverty (among many other individual and social rights to be protected), all depend on tax expenditures.

The current scenario requires stronger integration between the Financial Constitution and the Tax Constitution. This is as a result of the fact that not only the private sector demands public aid, but also the federated entities themselves. In this sense, economic-induced tax measures must be combined with financial mechanisms that, ultimately, contribute to the maintenance of the Brazilian model of co-operative and balanced federalism and the maintenance of private companies. Furthermore, in addition to all the measures already adopted by the Federal Government (such as the extension of deadlines for payment of taxes and authorisations for discounted tax transactions), it is particularly important to immediately correct the tax distortions related to Brazil's insolvency legal framework. This will affect thousands of Brazilian companies that have experienced a considerable revenue decrease and have had to cease their operations due to the measures of social isolation.

Despite the numerous benefits brought by the insolvency system introduced by Law 11,101/2005, further modified by Law 14,112/2020, the system's flaws must be promptly addressed in a constructive manner. In this paper, two proposals for the enhancement of the current law will be addressed, with the particular aim of overcoming fiscal obstacles in order to make the insolvency legal framework even more efficient. The preservation of companies and jobs demand public solutions in accordance with the promotion of legal certainty for the Brazilian market and market makers. Certainly, the tax component is indispensable for the purpose of recovering Brazilian companies in the post-COVID-19 scenario. After all, tax costs in the country have reached the very high mark of more than 33.26 per cent of the country's GDP.⁴

³ See, eg, <https://g1.globo.com/economia/noticia/2020/06/25/com-coronavirus-banco-central-passa-a-prever-tombo-de-64percent-para-o-pib-em-2020.ghtml>.

⁴ See, eg, <https://receita.economia.gov.br/dados/receitadata/estudos-e-tributarios-e-aduaneiros/estudos-e-estatisticas/carga-tributaria-no-brasil/ctb-2018-publicacao-v5.pdf>.

2. Purpose of the new legal model for protecting insolvency provided by Law 11,101 of 9 February 2005

2.1 Bankruptcy system prior to Law 11,101 of 2005

Law 11,101/05 revoked the previous insolvency system established by Law 7,661/45, introducing profound changes to the regulation of insolvency.⁵ Following such deep changes, on 24 December 2020 Law 14,112/2020 was sanctioned, bringing additional modifications to the system.

The preceding law was strictly punitive, with ineffective reorganisation provisions that, realistically, only served the purpose of postponing bankruptcy. It was outdated for the national economic scenario, neglecting corporate illiquidity by only providing efficient outcomes for insolvent corporations. Moreover, it permitted serious procedural disincentives: the length of insolvency proceedings could be extended into decades and the practice of fraudulent acts were commonly enabled by legal *lacunae*. Such legislation also presented an inharmonious precedent history among the diverse national courts (that diverged on most matters), developing contradictory case law and creating legal uncertainty.

A company's social function and the maintenance of viable businesses were overlooked, with a mere concern to satisfy creditors' interests. The legal reform introduced by Law 11,101/05 became crucial not only from the perspective of complying with business principles, but it also represented an essential foundation towards the economic stability of the country.

2.2 An overview of the current restructuring and bankruptcy legal framework

By the enactment of Law 11,101/2005, the preservation of a company emerged as a purpose sought by the new restructuring and bankruptcy legal framework. Accordingly, the judicial and extrajudicial restructuring proceedings introduced by this law played a fundamental role in consolidating commercial awareness insofar as it allows companies to achieve financial adjustment of their debt obligations during periods of illiquidity and further reposition themselves into the market.

However, the indispensable requirement of economic viability must be met in order for a corporate reorganisation to commence. It is critical to first examine if a company holds enough assets to overcome its financial difficulties and avoid forced liquidation. If a company proves that it has suffered irreparable damage or crisis and is likely to go bankrupt in the long run (despite any restructuring efforts), reorganisation is a waste of time and resources for all stakeholders, including shareholders and the wider economy.⁶

⁵ M Bezerra Filho, *Nova Lei De Recuperação E Falências Comentada* (Revista dos Tribunais, São Paulo, 2005) at 130.

⁶ *Ibid.*

Restructuring proceedings, therefore, seeks to renegotiate debts with the corresponding creditors in order to maintain the company's productive assets.

On 24 December 2020, President Bolsonaro sanctioned Law 14,112/2020, which updates Law 11,101/2005 in several respects. Some modifications that deserve to be mentioned are the possibility of instalment payments of federal tax debts,⁷ the increase of financing possibilities for companies undergoing a restructuring proceeding,⁸ and the exemption of succession of liabilities "for debts of any nature to a third creditor, investor or new administrator due to, respectively, the mere conversion of debt into capital, the contribution of new resources to the debtor or the replacement of the managers of this company".⁹

The current Brazilian Restructuring and Bankruptcy Laws (Law 14,112/2020 and Law 11,101/2005) act as a means of encouraging positive economic behaviour, with the maintenance of viable companies in the market; serving as an instrument for corporations to overcome temporary crises; to preserve jobs; meet creditors' interests and provide economic and financial sustainability. Nonetheless, existing legal flaws can still be recognised and have become even more evident in the light of the COVID-19 pandemic scenario, which will be further illustrated below.

3. Corporate reorganisation proceedings and the collection of public credits: Compatibility required

In Law 11,101/05 the legislator, in a pioneering manner, established that judicial reorganisation proceedings are oriented "to make it possible to overcome the debtor's economic and financial crisis" to preserve the company and its social function and to stimulate economic activity.¹⁰ However, there seems to be an inconsistency in the new Brazilian insolvency legal framework as an important portion on business costs were left out of the model, namely tax costs. The exclusion of tax debts from the judicial proceedings oriented to restructuring the debts of Brazilian companies constitutes a visible privilege in favour of credits held by the Treasury. This exclusion was already contained in the Brazilian Tax Code, according to which "judicial collection of tax credit is not subject to a multiple creditors' contest".¹¹ In the same sense, Law 6,830 of 1980 ratifies such exclusion.¹² Therefore, tax debts are not subjected to judicial recovery proceedings.

It is noted that the Brazilian Tax Code expressly states that the payment of tax debts should be made in preference to any other debt, "whatever their nature or the time of their constitution".¹³ Only debts resulting from labour legislation are an exception to this rule.

⁷ Law 14,112/2020, art 10-A.

⁸ *Idem*, art 69-A.

⁹ *Idem*, art 50 §3

¹⁰ Law 11,101/05, art 47.

¹¹ Brazilian Tax Code, art 187.

¹² Law 6,830 of 1980, art 29.

¹³ Brazilian Tax Code, art 186 (tacitly repealed by Law 11,101/05).

For reasons of hierarchy and specialty, the standards of the Brazilian Tax Code¹⁴ overlap the rule in Law 11,101/05, according to which “all credits existing on the date of the application are subject to judicial reorganization, even if they are not overdue.”¹⁵ With the enactment of Complementary Law 118, also in 2005, of the same hierarchy as the Brazilian Tax Code, several provisions of this last law were changed, so that the national tax system was efficiently aligned with the legal framework oriented to protect companies in economic and financial difficulties.

Today, the Brazilian Tax Code has rules that exclude the possibility of requiring purchasers of certain company assets (where such a company is in the process of restructuring debts), to pay the tax debts of the previous owners of these assets.¹⁶ This measure explicitly serves as a way of stimulating fundraising by these companies in difficulties. It cannot be said, however, that it is sufficient. Currently, tax credits are not subject to the judicial debt restructuring proceedings – their collection continues independently. Thus, pursuant to Law 11,101/05, judicial proceedings for the execution of tax debts are not suspended due to the judiciary’s approval of the company’s debt restructuring proceedings.¹⁷ Companies in difficulty simultaneously start experiencing two parallel realities: on the one hand, there is universal competition from creditors in general; on the other hand, they remain the target of patrimonial capture measures by the Treasury. In some cases, therefore, the Treasury manages to constrain the assets of companies that, once sold, could well provide its solvency in the judicial process of rescuing these companies. As a consequence, taxes are paid to the real detriment of Brazilian economic activities and jobs. A tragic public choice takes place.

It is also difficult to co-ordinate deliberations on the future of the company’s assets as a guarantee to the satisfaction of its general creditors’, on the one hand, conflicts with the effects of the parallel collection of tax credits affecting these same assets, on the other hand. Imagine, for example, that in order to make the recovery plan of the company in difficulty viable, it was necessary to sell one of its production units. It happens that, when this asset is launched on the market, it could be constrained in order to guarantee tax debts. The balance of the equation then becomes very difficult to solve. In this context, the decisions of the Superior Court of Justice that do not tolerate the possibility of constrictions (determined by tax judges, involving assets that could compromise the debt restructuring plans approved by the respective civil judge), are correct and legitimate.¹⁸ However, in this stormy dialogue between the rules for the collection of tax credits and the current legal model of judicial restructuring of Brazilian corporate debts, an important tax obstacle draws attention. It is an obstacle *ex ante* to the success of the legal proceedings in question.

¹⁴ *Idem*, arts 186 and 187.

¹⁵ Law 11,101/05, art 49.

¹⁶ Brazilian Tax Code, art 133, para 1.

¹⁷ Law 11,101/05, art 6, para 7.

¹⁸ See, eg, Brazilian Case Law, Conflict of Competence n. 147.485 / SP, delivered on 12/02/2020.

In Brazil, as a measure to reinforce proper compliance with tax rules by individuals, the practice of several Acts depends on proof of regularity with the Treasury.¹⁹ Pursuant to Law 11,101/05, the judge, when granting the processing of the judicial restructuring of debts, must allow the waiver to present negative certificates for the debtor to exercise his economic activities, except for the purposes of establishing contracts with the Government or to obtain tax or credit incentives.²⁰

However, it is contradictory that Law 11,101/05 requires that after the approval of the rescue plan of the company in difficulty by its creditors, under the supervision of the judiciary, this same company is required to prove its regularity with the Treasury.²¹ This requirement is also provided for in the Brazilian Tax Code, according to which “the granting of judicial recovery depends on presentation of proof of discharge of all taxes”.²² This should not be a condition for the submission of restructuring requests to the Brazilian judiciary, since it compromises the use of this legal measure.

Certainly, the legal requirement of this proof of regularity with the Treasury seems unreasonable, particularly after long months of work and, even more so, after all the costs and efforts incurred by the debtor company to formulate its financial and economic recovery plan and negotiate it with its creditors so that its proposal is accepted in court. If the cash resources have become scarcer during these months of negotiation and the company has not managed to pay all of its taxes or tax instalments, the above efforts would have been useless since the judicial restructuring of debts will not take place.

This tax obstacle *ex ante* compromises both the efficiency and success of judicial recovery procedures in Brazil. For this specific reason, the Superior Court of Justice dispensed with the requirement for the proof of regularity with the Treasury, mentioned above.²³ It was stated that:

“The economic reality of the country reveals that business companies in crisis usually have unpaid tax debts, and it can be said that obligations of this nature are those that in the first-place cease to be fulfilled, especially when considering the high tax burden and the complexity of the current system.”

The Superior Court of Justice thus understood the existence of an apparent contradiction between the two requirements of Law 11,101/05 discussed above.²⁴ The preservation of companies and jobs must never be forgotten.

¹⁹ Brazilian Tax Code, art 205.

²⁰ Law 11,101/05, art 52 II.

²¹ *Idem*, art 57.

²² Brazilian Tax Code, art 191-A.

²³ Appeal 1,187,404 / MT, on 06/19/2013.

²⁴ Law 11,101/05, arts 47 and 57.

Applying the principle of proportionality, the Superior Court of Justice concluded that the requirement of proof of regularity with the Treasury, by preventing the granting of the judicial recovery proceedings in favour of the company in debt, imposed greater difficulty on the interests of the tax authorities themselves, as in this case the company would be bankrupt. Furthermore, the measure was considered unnecessary since the Treasury has its own mechanisms for collecting its tax debts, which are not even suspended, as seen, with the approval of the rescue plan of a company by the judiciary.

The constitutional principle of preservation of a company prevailed. The Superior Court of Justice found that the requirement of proof of regularity with the Treasury would not be compatible with the objectives of the current legal framework for protecting insolvency in the country.

Despite the reasonable position of the Brazilian Superior Court of Justice, the recent decision of the country's Supreme Court on 8 September 2020 was a surprise. In an urgent measure, Minister Luiz Fux²⁵ suspended the effects of a decision issued by the Third Panel of the Superior Court of Justice that had benefited a sugar mill by granting an exemption from presenting the aforementioned proof of tax regularity with the Treasury.

In this case, which involved a debt of more than BRL 40 million, the Minister stated that:

“The requirement of a certificate of tax regularity for the ratification of the judicial reorganization plan is part of a system that imposes on the debtor, in addition to negotiating with private creditors, the regularization of its fiscal situation, through the payment of debts with the tax authorities.”

Thus, he defended the need for companies to adhere to special instalments of tax debts, in the form of Law 11,101/05,²⁶ or of the transaction of these debts with the Treasury, as recently provided in Law 13,988/20.

Considering all the mechanisms that the Treasury has as its disposal to collect its credits, the authors support that maintaining the requirement of the certificate of fiscal regularity, provisionally maintained by the Brazilian Supreme Court, seems like one more indirect way of forcing debtors to regularise themselves before the Treasury. This goes against the *ratio* of other court decisions on the topic, by banning the so-called political sanctions that have no reference within the country's Constitution.²⁷

Fortunately, on 3 December 2020, Justice Dias Toffoli, who is now responsible for Constitutional Complaint no 43169 (as Minister Luiz Fux is the current President of the Court), set aside the decision of his predecessor.

²⁵ In judging Constitutional Complaint no 43169, proposed by the Federal Government.

²⁶ Law 11,101/05, art 68.

²⁷ The Tax Administration cannot use oblique instruments as a coercive way of collecting taxes, as per Summaries 70, 323 and 547 of the Supreme Court of Brazil. On the topic, see R Dantas, *Direito tributário sancionador, culpabilidade e segurança jurídica* (Quartier Latin, São Paulo, 2019) at 285.

Endorsing the same position held in this paper, Justice Dias Toffoli understood that the matter under discussion has an infra-constitutional nature and, thus, had already been correctly decided by the Superior Court of Justice in a sound judgment of consideration between the documentary requirement of Law 11,101/05²⁸ and the company's preservation guideline.²⁹ A final decision is however still pending in this matter.

In addition to this *ex ante* tax obstacle regarding the efficiency of the Brazilian insolvency legal framework, one more situation must be highlighted, namely an *ex post* tax obstacle.

Even after the approval of a judicial reorganisation plan of a company in order to restructure its debts, and after the company managed to present a certificate of regularity with the Treasury, the Union intends to tax the discounts granted by creditors (popularly known as "haircuts"), as an equivalent type of income.

Pursuant to Law 11,101/05, the debt restructuring proceedings discussed in this paper may contemplate discounts on overdue debts with the company's creditors.³⁰ The possibility of the taxation of all types of discounts is currently provided for, among other rules, in Law 9,430/96.³¹

In the context of judicial recovery proceedings, it happens that taking the value of these discounts to taxation not only seems contrary to the constitutional guarantee of preservation of companies³² but, especially, to the constitutional guarantee that imposes respect, by the Treasury, to the economic capacity of each individual.³³ In this case, until a legislative correction takes place, this *ex post* tax obstacle to the efficiency of corporate restructuring proceedings in Brazil can be solved through a systematic interpretation of the country's legal system.

There is no possibility of a broad interpretation of Article 43 of the Brazilian Tax Code, in terms of which the concept of income must always be associated with new revenue, representing an equity increase that, in the court case examined, could only exist by fiction. In this context, valid income taxation depends on a case-by-case basis, and on the identification of "realized income that materializes the respective contributory capacity."³⁴ Therefore, taxation on fictitious gains must be banished.³⁵

²⁸ Law 11,101/05, art 57.

²⁹ *Idem*, art 47.

³⁰ *Idem*, art 50, I.

³¹ Law 9,430/96, art 53.

³² Constitution, art 170.

³³ *Idem*, art 145, § 1.

³⁴ R Mariz de Oliveira, "Regime Tributário da Compra Vantajosa - Questões Fundamentais" in R Mosquera and A Broedel (eds), *Controvérsias Jurídico-Contábeis (Aproximações e Distanciamentos)* (Dialética, São Paulo, 2013) at 257.

³⁵ A Costa, "Imposto de renda: aquisição de disponibilidade econômica ou jurídica como seu fato gerador. Limites de sua incidência" (1987) 40 *Revista de Direito Tributário* 103.

Income, patrimony and temporality must be combined in order to respect the constitutional guarantee of respect for contributory capacity by the Treasury. In this regard, one more warning must be given: the mere approval by the judiciary of the rescue plan required in order to restructure a company's debts, considering the discounts in question, would not be sufficient for the incidence of income tax. For example, if this plan is not fulfilled the company will challenge its own bankruptcy³⁶ and will definitely not reveal any patrimonial increase.³⁷

The demand for legal certainty, oriented to the non-taxation of discounts granted in judicial debt restructuring proceedings, demands an urgent solution as a State measure to promote the preservation of companies in financial and economic difficulty, especially in the current crisis scenario resulting from COVID-19.

4. Two proposals for legal adjustment in order to increase the effectiveness of corporate reorganisation proceedings: conclusions

Similar to the recognition of the advancements that Law 11,101/05 brought to the insolvency legal system, the flaws of this legislation must be acknowledged.

The dynamics of business recommend the maximum reduction of transaction costs, as Coase realised when dealing with the performance of economic actors in the market in an efficient, organised and stable manner.³⁸ Legal normality requires that economic agents operating in the Brazilian market have clear legal parameters for decision-making, based on an objective and calculable examination of the advantages and risks arising from corporate restructuring judicial proceedings, pursuant to Law 11,101/05. Law and economics studies have shown that legal rules are akin to prices and that these rules must be applied from the perspective of efficiency. Thus, if these rules promote inconsistencies, it is up to the judiciary to solve them with neutral decisions that do not generate additional transaction costs, despite what has been demonstrated in the recent Brazilian court case.

Economic structures and processes depend on, and are informed by, legal data. For this reason, the normative force of the law gives stability to the market makers providing predictability to each action that they decide to take. Therefore, aiming to reduce legal doubts and conflicts, the authors suggest a legislative alteration that allows the Treasury to transact debts within the scope of judicial reorganisation proceedings alongside civil creditors. This measure will avoid the present lack of communication between the two legal frameworks now present in Brazil. The authors believe that this first legislative measure could even waive the necessity of the aforementioned presentation of a certificate of regularity with the Treasury, which appears to be only an indirect mechanism

³⁶ Law 11.101/05, art 61.

³⁷ The Brazilian Supreme Court has already stated that the mere potential of economic availability is not sufficient for the purposes of characterising "income" (see *RE 172058* [30/06/1995]).

³⁸ R H Coase, *The Nature of the Firm* (1937) 4 (16) *Economica* 388.

for guaranteeing the satisfaction of some tax debts by companies in financial and economic difficulties.

On the other hand, as seen in the recent legal experience in Brazil,³⁹ there is a clear need for an express rule that avoids the taxation of the discounts granted by creditors in judicial corporate reorganisation proceedings, such as income equivalents. Divergences of interpretation between private companies, Treasury inspectors and judgments relating to this matter generate legal uncertainty that compromises the realisation of the constitutional guarantee of the contributory capacity.⁴⁰ Indeed, it is unreasonable that the effort by a company to self-regulate its liabilities may give rise to disproportionate discussions and legal effects, from a tax law perspective, that compromise its own survival in the post-COVID-19 economic scenario.

The lack of legal certainty, here examined in the form of two tax obstacles to the effectiveness of judicial reorganisation proceedings, violates the freedom of economic initiative, alongside the preservation of companies and jobs; all of which are guidelines of the Brazilian State that must be taken under serious consideration by policymakers.⁴¹

³⁹ See, eg, Law 11,941/09, art 4.

⁴⁰ Constitution, art 145, § 1.

⁴¹ *Idem*, arts 1, 5, XXII and 170.

The Corporate Insolvency and Governance Act 2020: A statute to mitigate the rise in zombie companies in England and Wales?

By Marcus Greet, Jones Day LLP, United Kingdom*

Abstract

There is a strong negative correlation between the market share of companies that may be classified as “zombie companies” (companies that are unprofitable and rely on loans to survive)¹ and the state of a country’s economy.² Where a country’s economy positively correlates with societal well-being,³ it is evident that zombie companies are undesirable, and their presence should be minimised where possible.

Insolvency frameworks can be effective in minimising the market share of zombie companies.⁴ Whilst England and Wales’ framework is considered to be well-equipped to minimise the share of zombie companies and capital sunk within them, some aspects of it may cause the number of zombie companies and the amount of capital sunk within them to increase. This paper critically analyses the English administration procedure and highlights those deficiencies that – more than others – are contributing to the increasing prevalence in zombie companies and amount of capital sunk within them.⁵

This article builds on these findings to investigate whether the Corporate Insolvency and Governance Act 2020 will address the administration’s shortcomings and consequently allow zombie companies to return to profitability or exit the market.

1. Introduction

Over the last few decades, the causal link between the increasing prevalence of zombie companies (typically accepted as firms that are over ten years old and have been unable to pay the totality of the interest accruing on their loans for three consecutive years)⁶ and economic stagnation has been thoroughly explored.⁷ The influence of zombie companies on economies is perhaps best illuminated by an analysis of the causes of Japan’s economic stagnation during the 1990s. The lack of pressure on Japanese companies to restructure

* Future Trainee Solicitor at Jones Day LLP, LLM Candidate (King’s College London), LLB (University of Essex).

¹ F Hayashi and E Prescott, “The 1990s in Japan: A Lost Decade”, *Review of Economic Dynamics* (2002) 5(1) 206.

² *Ibid.*

³ A Lopez-Claros and M Porter, *The Global Competitiveness Report 2007-2008* (Palgrave Macmillan, 2008) at 53.

⁴ M C Carcea, D Ciriaci, C Cuerpo, D Lorenzani and P Pontuch, *The Economic Impact of Rescue and Recovery Frameworks in the EU* (Publications Office of the European Union, Luxembourg, 2015) at 15.

⁵ N Hood, “The Inexorable Rise of Britain’s Army of Walking Corporate Dead”, *Corporate Rescue and Insolvency* (2013) 6 180.

⁶ M A McGowan, D Andrews and V Millot, “Insolvency regimes, zombie firms and capital reallocation” OECD Economics Department Working Papers (2017) 65/2017 7.

⁷ *Idem*, at 6.

or liquidate despite financial difficulty, thereby harbouring “zombies”, is considered to largely account for the country’s lack of economic growth⁸ during its so-called “lost decade”.⁹

The percentage of zombie companies within a country correlates strongly with its economic growth.¹⁰ During the latter stages of Japan’s lost decade, the percentage of companies that constituted zombies was around 30 per cent.¹¹ The steady increase in the percentage of zombie companies in the United Kingdom over the last three decades¹² provides a similar cause for concern. This phenomenon may suggest that a period of economic stagnation, not dissimilar to that seen in Japan, could be imminent if the rise of zombie companies is not curbed. The concern is compounded by the impact on the economy caused by the COVID-19 pandemic, as it has been demonstrated that the percentage of zombie companies in a country increases during economic crises and does not return to the pre-crisis levels after the country recovers from them.¹³

The increase in zombie companies is largely attributed to the lessening of direct pressure on incumbent firms to remain competitive and flourish. Although many factors contribute to the lessening presence and thus the prevalence of zombie companies, this paper will solely evaluate the effect of corporate insolvency frameworks on zombie companies. Recently, the European Commission suggested that countries ought to implement reforms to ensure that their insolvency frameworks have desired qualities to prevent slow and ineffective deleveraging by companies and allow credit under so-called bad loans to be reallocated to viable parts of the economy,¹⁴ substantiating the link between a country’s corporate insolvency framework and its economy.

In an attempt to reform England and Wales’ insolvency framework, the United Kingdom’s legislature recently implemented the Corporate Insolvency and Governance Act 2020 (CIGA).¹⁵ This paper seeks to determine whether the procedures that it has afforded companies, notably a new moratorium and restructuring plan,¹⁶ might successfully remedy the deficiencies of England and Wales’ insolvency framework prior to its implementation.

⁸ A Ahearne and N Shinada, “Zombie Firms and Economic Stagnation in Japan”, *International Economics and Economic Policy* (2005) 2(4) 363-380.

⁹ F Hayashi and E Prescott, “The 1990s in Japan: A Lost Decade”, *Review of Economic Dynamics* (2002) 5(1) 206.

¹⁰ M A McGowan, D Andrews and V Millot, “Walking Dead? Zombie Firms and Productivity Performance in OECD Countries” OECD Economics Department Working Papers (2017) 4/2017 26-30.

¹¹ R Caballero, T Hoshi and A Kashyap, “Zombie Lending and Depressed Restructuring in Japan”, *American Economic Review* (2008) 98(5) 1943-1944-1945.

¹² T Papworth, *The Trading Dead: The zombie firms plaguing Britain’s economy, and what to do about them* (Adam Smith Institute, London, 2013) at 53.

¹³ N Hood, “The Inexorable Rise of Britain’s Army of Walking Corporate Dead”, *Corporate Rescue and Insolvency* (2013) 6 180.

¹⁴ M C Carcea, D Ciriaci, C Cuerpo, D Lorenzani and P Pontuch, *The Economic Impact of Rescue and Recovery Frameworks in the EU* (Publications Office of the European Union, Luxembourg, 2015) at 15.

¹⁵ M Taddia, “Insolvency Law: A new chapter”, *Law Society Gazette* (2020) 16.

¹⁶ CIGA, s 1; CIGA, Sch 9.

This paper is structured as follows. To afford an understanding of the potential detrimental effects of a high percentage of zombie firms on an economy, this paper will briefly analyse the issues associated with zombie companies under heading 2. The qualities that the European Commission found to correlate with the success of a country's insolvency framework in dealing with zombie companies will be evaluated under heading 3. The discussion under heading 3 ought to afford weight to the identified shortcomings of English insolvency law prior to the enactment of the CIGA that potentially prevented a driving-down of zombie companies. These shortcomings will be discussed under heading 4. The discussion under heading 5 will then analyse whether the reforms effected by the CIGA are likely to rectify the shortcomings of England and Wales' insolvency framework prior to its implementation. The conclusion is under heading 6.

The author believes that this paper addresses a novel question, as the author is unaware of the existence of any papers evaluating the potential of the CIGA to either lessen or increase the share of companies that constitute zombie companies. The likely large negative influence of an increase in zombie companies on a country's economic health, which influences the well-being of its population, upholds the question addressed as significant.

2. The issues associated with zombie companies

Building on existing literature on the topic,¹⁷ this section summarises the potential issues associated with zombie companies and the prospective economic detriment that may arise where zombie companies constitute a large proportion of a country's total companies. It does not investigate in detail the extent or the reality of the detriment that is caused where zombie companies represent a significant portion of the market (more than 20 per cent), as many papers have attempted to do so already.¹⁸

2.1 Resource misallocation

The worsening misallocation of resources to zombie companies¹⁹ has been proven to be one of the main factors that hinder economic growth.²⁰ At a basic level, capital consumption by zombie companies causes wage inflation.²¹ Employees of zombie companies do not seek alternative employment opportunities.²² This results in lower unemployment levels and an increased possibility for employees to command higher

¹⁷ R Caballero, T Hoshi and A Kashyap, "Zombie Lending and Depressed Restructuring in Japan", *American Economic Review* (2008) 98(5) 1943, and M A McGowan, D Andrews and V Millot, "Walking Dead? Zombie Firms and Productivity Performance in OECD Countries", OECD Economics Department Working Papers (2017) 4/2017.

¹⁸ S Urionabarrenetxea, J D Garcia-Merino, L San-Jose and J L Retolaza, "Living with Zombie Companies: do we now know where the threat lies?", *European Management Journal* (2018) 36(3) 408.

¹⁹ M A McGowan, D Andrews and V Millot, "Insolvency regimes, zombie firms and capital reallocation", OECD Economics Department Working Papers (2017) 65/2017 10.

²⁰ *Ibid.*

²¹ *Ibid.*

²² *Ibid.*

wages.²³ It also causes a reduction of market prices where companies are placed under less pressure to seek high returns, such is their ability to rely on loans to continue operations. This, in turn, lowers the ability of more innovative companies to enter the market as they would struggle to compete in a saturated market.²⁴ It also lessens the ability of innovative companies to secure capital as it is less available due to its utilisation by zombie companies.²⁵ The repercussions include reduced productivity, largely caused by the necessitation of increased financial expenditure on wages to produce goods and services.²⁶ These consequences are responsible for a hindrance of economic growth, as non-zombie companies tend to be less productive and also invest less than if industry capital was not sunk in zombie companies.²⁷

2.2 Loss of contestability

An increased prevalence of zombie companies is held to have a negative correlation with market contestability.²⁸ Where zombie companies are bred in environments where financial pressure is minimal, they are not incentivised to improve their productivity either through the adoption of new methods of production or technology, or by seeking to innovate themselves to assert market dominance. In effect, they may simply survive without assuming the risk associated with failed operational expansion or failed streamlining of production methods.²⁹ This is also postulated to have reduced start-up rates,³⁰ illuminating a further disincentivising of innovation and advancement. As a result, countries with high percentages of zombie companies become more protectionist (Japan, for example)³¹ or less competitive (Italy, for example)³² than other economies.

In the absence of protectionist policies, this trend weakens the country's industrial structure as consumers will favour foreign goods and services over their domestic counterparts.³³

²³ *Ibid.*

²⁴ *Ibid.*

²⁵ *Ibid.*

²⁶ *Ibid.*

²⁷ M A McGowan, D Andrews and V Millot, "Walking Dead? Zombie Firms and Productivity Performance in OECD Countries", OECD Economics Department Working Papers (2017) 4/2017 20.

²⁸ *Ibid.*

²⁹ E Bartelsman, J Haltiwanger and S Scarpetta, "Microeconomic Evidence of Creative Destruction in Industrial and Developing Countries", Institute for the Study of Labor Discussion Papers (2004) 1374/2004 42-44.

³⁰ M A McGowan, D Andrews and V Millot, "Insolvency regimes, zombie firms and capital reallocation", OECD Economics Department Working Papers (2017) 65/2017 10.

³¹ S Durusoy, E Sica and Z Beyhan, "Economic Crisis and Protectionism Policies: The Case of the EU Countries", *International Journal of Humanities and Social Science* (2015) 5(6) 56 61.

³² *Idem*, at 64.

³³ *Ibid.*

2.3 Summary

This section has only investigated a few key issues associated with the rapid growth of zombie companies. However, through evaluating these key issues, it has been made clear that endeavours should be made to prevent an increase in the prevalence of zombie companies.

3. The influence of insolvency regimes on the prevalence of zombie companies

This section purports to illuminate the characteristics of insolvency legal frameworks that tend to correlate with a lessening of zombie companies and capital sunk into them. Using a doctrinal methodology, this section identifies the characteristics of legal frameworks that tend to promote the growth of zombie companies in the market. Furthermore, it determines which of these characteristics were particularly prevalent in harbouring zombie companies within England and Wales' insolvency framework.

3.1 Characteristics of insolvency frameworks that influence zombie company market share

It is widely accepted that the "inability of insolvency regimes to facilitate the exit or down-sizing of non-viable firms [and] the restructuring of viable firms that encounter financial distress" can increase both the amount of capital invested in and the prevalence of zombie companies.³⁴ Adalet and others³⁵ postulate that the influence of insolvency legal frameworks can be measured by the existence or non-existence of twelve characteristics that predominantly affect the likelihood that non-viable companies exit the market, and that financially struggling, but viable, companies will restructure and do so successfully.³⁶

3.1.1 *The treatment of failed entrepreneurs by insolvency frameworks*

It has been rightly observed that personal insolvency rules can also have a detrimental effect on the promotion of timely rescues and / or the liquidation of failed businesses.³⁷ Attention, in particular, has been paid to the time to discharge (being the time that must elapse before a bankrupt's pre-insolvency indebtedness is forgiven) and the exemptions that exist to protect the insolvent debtor's assets that are not directly linked to the business; these are the first two characteristics evaluated by Adalet *et al.*³⁸ The harsh treatment of entrepreneurs through the imposition of lengthy discharge times and a lack of protection where personal liability is incurred in the event of corporate failure cause huge personal detriment and cost to those running the company in the event of its market exit.³⁹ Such a prospect may disincentivise those running, or wishing to run, a company

³⁴ M A McGowan, D Andrews and V Millot, "Insolvency regimes, zombie firms and capital reallocation", OECD Economics Department Working Papers (2017) 65/2017 6.

³⁵ *Idem.*

³⁶ *Idem*, at 17.

³⁷ *Ibid.*

³⁸ *Ibid.*

³⁹ *Idem*, at 37.

from overseeing its market exit or the potentially risky restructuring efforts of companies if, as a result of doing so, they may accumulate large amounts of corporate debt. In this framework, these players have a perverse incentive to keep failed companies on the market and to thus postpone, at least temporarily, the suffering of personal detriment.⁴⁰

It follows that the harsher the treatment of entrepreneurs in the event of corporate failure, the higher the number of zombie companies. The effect on zombie company prevalence and resources that they prevent from being circulated is seemingly not insignificant. For instance, it has been suggested that the amount of capital sunk into Portuguese zombie companies would decrease by 11 per cent if they adopted provisions that allowed failed entrepreneurs to be treated in the same manner as they are treated in the United Kingdom.⁴¹

3.1.2 Prevention of insolvency and streamlining of procedures

The third, fourth, and fifth characteristics are involved with preventing and streamlining insolvency procedures. It is considered that the implementation of early warning mechanisms, pre-insolvency frameworks, and special insolvency procedures available to small and medium enterprises can minimise zombie company market share and their consumption of capital. Effective deployment of the former is considered particularly important to prevent zombie companies,⁴² as they allow companies to respond quickly and appropriately to the first signs of financial distress. This consideration is afforded additional weight by the European Commission's endorsement of such mechanisms.⁴³ It has been confirmed that a lack of prevention and streamlining tools, particularly early warning mechanisms, are associated with higher proportions of capital being invested in zombie companies.⁴⁴

3.1.3 Restructuring tools

The sixth, seventh, eighth, ninth, and tenth characteristics concern the availability of restructuring tools.⁴⁵ The countries that tend to have fewer zombie companies and less of their capital invested within them have insolvency frameworks that share some key attributes. These attributes concern the ability of insolvency frameworks to afford both creditors and debtors the ability to initiate restructurings, assert a definitive term of stay on assets, and allow new financiers to gain priority over unsecured creditors during a company's financial difficulties. Other features include allowing cram-downs by a majority of creditors to ensure that restructuring plans may be implemented and allowing

⁴⁰ *Ibid.*

⁴¹ *Idem*, at 19.

⁴² *Idem*, at 20.

⁴³ M C Carcea, D Ciriaci, C Cuerpo, D Lorenzani and P Pontuch, *The Economic Impact of Rescue and Recovery Frameworks in the EU* (Publications Office of the European Union, Luxembourg, 2015) at 2.

⁴⁴ M A McGowan, D Andrews and V Millot, "Insolvency regimes, zombie firms and capital reallocation", OECD Economics Department Working Papers (2017) 65/2017 20.

⁴⁵ *Idem*, at 40.

incumbent management to retain management powers during restructuring.⁴⁶ This is the consequence of such characteristics both facilitating the utilisation and enhancing the provision of restructuring plans.⁴⁷ Adalet and others postulate that the countries with the least adherence to these characteristics within their study sample, Italy and Greece, could have seen a reduction in the amount of capital invested in zombie companies of one-half and one-third respectively if they had implemented frameworks mimicking that of the country whose framework considered to bar restructuring the least in their study sample (being the United Kingdom).⁴⁸

3.1.4 Other factors

The final two characteristics are miscellaneous. The eleventh characteristic is the ability of formal insolvency procedures to be utilised without significant court involvement.⁴⁹ Lessened court intervention will likely lessen the length and cost of the proceedings, which may therefore be favourable for more companies to utilise them.⁵⁰ This ought to incentivise more market exits and restructurings.⁵¹ The twelfth characteristic is the distinction between honest and fraudulent insolvencies.⁵² Arguably, this insufficient distinction “raises the costs and the stigma of insolvency proceedings, making it less likely that weak firms exit the market in a timely fashion”.⁵³ Figures do not exist to determine the influence that the existence or non-existence of these factors have on the number of zombie companies that exist and the capital that they assume within countries, though it is accepted that they have less of an influence than the other parameters mentioned.

3.2 Summary

Clearly, a correlation exists between the efficiency of insolvency frameworks in incentivising and allowing the fruitful implementation of *ex ante* and *ex post* responses to financial distress and the amount of capital invested in zombie companies. Although English insolvency law was held by Adalet and others to be the best overall sample when evaluating the law of the countries in the study sample as it existed in 2016,⁵⁴ it seems likely that any reforms that further align the English framework with the aforementioned twelve characteristics have the potential to further diminish the amount of capital sunk into zombie companies. Additionally, despite England and Wales’ insolvency law being labelled the sample best in 2016, issues have been identified with its operation in practice. The next sections look more closely at the English insolvency framework and at the reforms

⁴⁶ *Idem*, at 39-41.

⁴⁷ *Idem*, at 28.

⁴⁸ *Idem*, at 27-28.

⁴⁹ *Idem*, at 15.

⁵⁰ *Ibid.*

⁵¹ *Ibid.*

⁵² *Ibid.*

⁵³ *Ibid.*

⁵⁴ *Idem*, at 20.

recently introduced by the CIGA to identify whether and to what extent these reforms have the potential to reduce the percentage of zombie companies in the market.

4. The shortcomings of the framework under English law prior to the implementation of the Corporate Insolvency and Governance Act 2020

This part evaluates which parts of the English corporate insolvency framework (as existing before the recent changes introduced by the CIGA) had the effect of increasing the amount of capital sunk into zombie companies. To do so, this part analyses the extent to which administration procedures promote the restructuring of viable companies and the exit from the market of zombie companies.

This paper justifies omitting discussion on restructuring tools, other than administration, on two grounds. Firstly, administration is frequently hailed as the procedure that should be used by domestic companies to turn around their business at times of crisis.⁵⁵ Secondly, other restructuring tools are rarely used,⁵⁶ and they are widely considered to be largely ineffective.⁵⁷ Thus, though they may theoretically align England and Wales' insolvency framework with the principles of good practice as discussed in the previous part, they are not doing so in practice.⁵⁸

4.1 Where England and Wales' insolvency framework's weaknesses lie

Given that England and Wales are regarded as having the insolvency framework best equipped to minimise the presence of zombie companies,⁵⁹ it is unsurprising that the extent of this framework's adherence to many of the characteristics removes the need for reform on many fronts. Notably, Sumner suggests that the framework's provision of low personal costs to entrepreneurs for business failure, a result of bankruptcy only lasting for twelve months;⁶⁰ time limits on the stay of assets;⁶¹ and the distinction between fraudulent and honest bankrupts contribute to the reputable framework.⁶²

However, several problems with the current regime have been identified by scholars. Notably, Hood considers that bankers and stakeholders lack incentives to utilise

⁵⁵ S Ellina, "Administration and CVA in corporate insolvency law: pursuing the optimum outcome", *International Company and Commercial Law Review* (2019) 30 180 190.

⁵⁶ C Wong, "Will company voluntary arrangements play a significant role in the UK's corporate rescue culture?", *Company Lawyer* (2017) 38 122.

⁵⁷ *Ibid.*

⁵⁸ M A McGowan, D Andrews and V Millot, "Insolvency regimes, zombie firms and capital reallocation", OECD Economics Department Working Papers (2017) 65/2017 20.

⁵⁹ *Ibid.*

⁶⁰ Insolvency Act 1986, s 279(1).

⁶¹ *Idem*, Sch B1, para 76. Administration procedures have a 12-month time limit (although it can be extended).

⁶² C Sumner, "Rescue, Recovery & Renewal", *Corporate Rescue and Insolvency* (2020) 4 148.

administration (and to utilise restructuring tools more generally).⁶³ Additionally, Finch considers the lack of director incentive to initiate administration and the costs of utilising administration to disincentivise and minimise the chances of successful restructuring or market exit in the appropriate circumstances.⁶⁴ These issues will be explored, and their alignment, or lack thereof, with the characteristics discussed in the previous section scrutinised.

4.2 Barriers to the timely utilisation of administration

Although the administration procedure has the potential to facilitate the restructuring of companies where insolvency practitioners pursue its first objective (that is, to rescue the company as a going concern),⁶⁵ practitioners seldom pursue this objective.⁶⁶ In fact, it is thought that only 10 per cent of administration procedures involve an administrator targeting its first objective.⁶⁷ Even more rarely is this goal achieved.⁶⁸ The suggestion that, in one-quarter of cases, a company would have been rescuable if a company's directors had sought the correct advice earlier,⁶⁹ raises concerns regarding the incentives that exist to persuade the parties empowered to do so to initiate this procedure.⁷⁰

One of the indicators analysed in the previous section stresses the importance of having statutory mechanisms that promote the timely restructuring of distressed entities. It is, therefore, salient to investigate whether the rules on the commencement of administration procedures do actually promote early restructuring and thus curb the risk of increasing the market share of zombie companies.

4.2.1 Ability of creditors to initiate administration

A company's creditors may petition to a court to initiate administration where they can establish that the company is, or is likely to become, unable to pay its debts.⁷¹ Additionally, they need to prove that an administration order is reasonably likely to achieve the purpose of administration.⁷² However, it is considered that these requirements present a "significant" barrier to creditor action where they are unlikely to be able to "muster the evidence and arguments necessary" to pilot a successful petition.⁷³ Notably, it is unlikely

⁶³ N Hood, "The Inexorable Rise of Britain's Army of Walking Corporate Dead", *Corporate Rescue and Insolvency* (2013) 6 180 181.

⁶⁴ V Finch and D Milman, *Corporate Insolvency Law: Perspectives and Principles* (3rd ed, Cambridge University Press, Cambridge, 2017).

⁶⁵ Insolvency Act 1986, Sch B1, para 3(1)(a).

⁶⁶ A Katz and M Mumford, "Study of Administration Cases", *Insolvency Intelligence* (2007) 20 97.

⁶⁷ *Ibid.*

⁶⁸ *Ibid.*

⁶⁹ V Finch and D Milman, *Corporate Insolvency Law: Perspectives and Principles* (3rd ed, Cambridge University Press, Cambridge, 2017) at 155.

⁷⁰ *Ibid.*

⁷¹ Insolvency Act 1986, Sch B1, para 11.

⁷² *Ibid.*

⁷³ R Mokal, "The Floating Charge - An Elegy", *Commercial Law and Commercial Practice* (2003) 479 496.

that creditors would have the proof necessary to establish the company's financial difficulties, and they are unlikely to have the legal knowledge to persuade a court of the advisability of the procedure, thus delaying the permanence on the market of zombie, or at least unprofitable, companies.

4.2.2 Ability of directors to initiate administration

A company's directors may appoint an administrator where a resolution is passed in an annual general meeting⁷⁴ should the company's shareholders establish that the company is insolvent.⁷⁵ However, the practitioner-in-possession nature of administration disincentivises the timely use of this procedure as directors are unwilling to "[give] up [the] reins of office" to an administrator.⁷⁶ Although provisions exist to punish directors who trade despite having knowledge of their company's financial struggles,⁷⁷ these provisions are considered ineffective and largely void of any deterrent value in preventing directors from taking unjustifiable risks in trading.⁷⁸ Thus, directors may continue to consume capital in the form of loans to continue operations in the hope that a miracle befalls them and solvency returns to the company. So far, it is clear that the statutory framework on administration procedures does not effectively address the phenomenon of zombie companies, at least with reference to the provisions analysed in this paper.

4.2.3 The ability of secured creditors to initiate administration

A qualifying floating charge holder (QFCH), which is a floating charge holder whose security extends over all or most of a company's assets,⁷⁹ can initiate administration purely in the event of a default on the terms of their loan agreement with the debtor company.⁸⁰ This may seem a powerful instrument in the hands of sophisticated creditors to curb the permanence of zombie companies on the market. Nevertheless, despite the ease with which a QFCH may force a company's entry into administration,⁸¹ it has been contended that there may be a limited incentive for them to initiate the procedure.⁸² Where a bank's loan may be fragmented (held under both a floating and fixed charge), the bank may have less incentive to monitor the activities of the debtor company.⁸³ The bank is likely to retrieve at least some debt owed by the debtor company in the event of distribution, as fixed charges are paid first. The amount secured under the floating charge is likely to be relatively insignificant, operating only to enable the QFCH control.⁸⁴ Retrieval of the

⁷⁴ Insolvency Act 1986, Sch B1, para 22.

⁷⁵ *Idem*, Sch B1, para 27(2)(a).

⁷⁶ *Ibid.*

⁷⁷ *Idem*, s 214.

⁷⁸ V Finch and D Milman, *Corporate Insolvency Law: Perspectives and Principles* (3rd ed, Cambridge University Press, Cambridge, 2017) at 401.

⁷⁹ Insolvency Act 1986, Sch B1, para 14(3)(a).

⁸⁰ *Idem*, Sch B1, para 16.

⁸¹ V Finch, "Corporate Rescue in a World of Debt", *Journal of Business Law* (2008) 8 756 757.

⁸² *Idem*, at 766.

⁸³ *Ibid.*

⁸⁴ *Ibid.*

amount under it is not imperative.⁸⁵ Furthermore, monitoring is expensive⁸⁶ and there is no need to monitor where the additional returns it may afford to the bank are minimal. Therefore, QFCHs may only need to ensure that they initiate administration proceedings when the company is able to pay the amount secured under their fixed security.⁸⁷ Companies may be extremely insolvent yet still capable of paying amounts under fixed securities in the event of distribution. Therefore, QFCHs seemingly have little reason to initiate proceedings at a time where an effective restructuring could return the company to profitability.

4.2.4 Effect of the lack of incentive for stakeholders to initiate administration

It follows that the lack of incentives for stakeholders to initiate administration may both bar the market exit of zombie companies and allow them to consume more capital, thus minimising productivity. Arguably, particularly problematic is the lack of incentive for directors to initiate administration. This is because they have the most knowledge of the company and would thus be best placed to initiate administration upon realising that the company is struggling, or may soon struggle.⁸⁸

4.3 Cost of administration

Administration procedures are often costly.⁸⁹ Direct costs, which are those that are incurred consequential to practitioner and legal fees,⁹⁰ are often cited as barring corporate rescue.⁹¹ Additionally, indirect costs, which are losses consequential to the duration of any insolvency procedure (such as goodwill), have also been flagged as preventing distressed companies from returning to solvency.⁹²

The previous section dictated that frameworks that tend to cause companies to have frequent court involvement have a higher zombie company market share in comparison to frameworks that relieve companies from significant court action. This is largely owed to the disincentivising effect of the prospect of the cost of court actions. Thus, it is feasible that, where overall costs are reduced, companies will be more likely to utilise restructuring tools, like doing so at a time that would maximise their chances of returning to profitability. This would likely allow more companies to become profitable instead of zombie companies and allow unviable companies to exit the market.

⁸⁵ *Ibid.*

⁸⁶ R Mokal, "The Floating Charge - An Elegy", *Commercial Law and Commercial Practice* (2003) 479 486.

⁸⁷ V Finch, "Corporate Rescue in a World of Debt", *Journal of Business Law* (2008) 8 756 769.

⁸⁸ V Finch and D Milman, *Corporate Insolvency Law: Perspectives and Principles* (3rd ed, Cambridge University Press, Cambridge, 2017) at 399-400.

⁸⁹ J Armour, A Hsu and A Walters, "The Impact of the Enterprise Act 2002 on Realisations and Costs in Corporate Rescue Proceedings: A Report Prepared for the Insolvency Service" (2006).

⁹⁰ *Idem*, at 4.

⁹¹ *Ibid*; R Blazy and N Nigham, "Corporate insolvency procedures in England: the uneasy case for liquidations", *European Journal of Law and Economics* (2019) 47 89 90.

⁹² *Ibid.*

The direct costs of administration procedures are typically high because the costs of insolvency practitioners are largely unchecked.⁹³ Practitioner remuneration tends to be more extortionate where it is to be scrutinised by unsecured creditors as opposed to secured creditors, as unsecured creditors tend to lack the knowledge necessary to challenge practitioners.⁹⁴ Blazy and Nigham make evident the significance of this as an issue. In a dataset of 199 corporations that filed for administration between 1998 and 2005, the direct costs from each procedure were, on average, 176.8 per cent of the worth of the company's assets.⁹⁵ Where parties able to initiate administration are wary of the significance of these costs, and the prospect of them minimising any value that they may reap from the company, they will be hesitant to commence an administration procedure. This hesitance may evidently allow companies to continue to operate long-term as zombie companies should they have the cash flow to do so. Additionally, the significance of administration costs may also harm a zombie company's chances of returning to profitability, where its available capital is significantly diminished.

In addition, the significant duration of administration procedures is causing significant indirect costs incurred by the procedure.⁹⁶ Despite the statutory twelve-month time limit on administration procedures, many companies are utilising provisions to extend their operation. Consequently, Blazy and Nigham's dataset found that administrations last, on average, more than nineteen months.⁹⁷ Although indirect costs are largely unquantifiable, Masnicka and others unveiled significant issues associated therewith where they found that the consequential slowdown of production largely impacted the efficiency of procedures.⁹⁸ Thus, typically, the longer a company's administration procedure lasts, the less likely it is to return profitability, increasing the likelihood that it continues to be, or becomes, a zombie company.

5. The Corporate Insolvency and Governance Act 2020: likely to increase or lessen the amount of capital allocated to zombie companies?

This part will assess the ability of the reforms, notably the new restructuring tools of the moratorium and restructuring plan mechanisms, that the CIGA has imposed to remedy the deficiencies identified in part four.

⁹³ E Kempson, *Review of Insolvency Practitioner fees: report to the Insolvency Service* (The Insolvency Service, London, 2013) at 40.

⁹⁴ *Ibid.*

⁹⁵ R Blazy and N Nigham, "Corporate insolvency procedures in England: the uneasy case for liquidations", *European Journal of Law and Economics* (2019) 47 89 108.

⁹⁶ J Armour, A Hsu and A Walters, "The Impact of the Enterprise Act 2002 on Realisations and Costs in Corporate Rescue Proceedings: A Report Prepared for the Insolvency Service" (2006) at 64.

⁹⁷ R Blazy and N Nigham, "Corporate insolvency procedures in England: the uneasy case for liquidations", *European Journal of Law and Economics* (2019) 47 89 at 108.

⁹⁸ J Kruczalac-Jankowska, M Masnicka and A Machnikowska, "The relation between duration of insolvency proceedings and their efficiency (with a particular emphasis on Polish experiences)", *International Insolvency Review* (2020) 29(3) 379 389.

5.1. Moratorium

The new standalone moratorium is available to companies that are or are likely to become unable to pay their debts as they fall due and which receive an opinion from a monitor stating that they consider it likely that the moratorium would result in a rescue of the petitioning company as a going concern.⁹⁹ Once utilised, the moratorium operates for an initial 20 business days¹⁰⁰ but can be extended for a further 20 days without creditor consent¹⁰¹ and for up to a year with the consent of either creditor or court consent.¹⁰² However, should a monitor consider a company's rescue to no longer be possible, the moratorium must come to an end.¹⁰³ Crucially, directors may retain corporate control whilst the moratorium operates.¹⁰⁴

5.1.1. Cost

In contrast to administration, the standalone moratorium procedure can be utilised by companies without seeking court approval.¹⁰⁵ Given that section 3 above suggests that lessened court involvement minimises the market share of zombie companies, this would seem to be an effective tool in lessening the presence of zombie companies in England and Wales. However, it is not that simple. This is because it is the reduced cost associated with lessened court involvement that negatively correlates with zombie market share, but the standalone moratorium procedure may nevertheless be expensive.

The amount of corporate capital that will be consumed by monitors is uncertain. Alongside their role in evaluating whether a moratorium can, and continue to be able to, allow a company to return to profitability, monitors also provide checks on certain corporate actions.¹⁰⁶ Notably, directors seeking to dispose of property outside of the ordinary course of business must seek the consent of a monitor.¹⁰⁷ How thorough a monitor's evaluation of a company will be and how frequently they will have to make decisions on whether to consent to corporate actions outside of the normal course of business, will likely vary significantly depending on the company utilising the procedure. Additionally, considering that in the previous section it was identified that insolvency practitioners' fees incurred during administration are prone to being overstated (especially where they are largely unchecked), scepticism regarding whether a monitor will overcharge for their services seems justified.

⁹⁹ CIGA, Pt A6, ss 1.

¹⁰⁰ *Idem*, s 1, Pt A9, ss 2.

¹⁰¹ *Idem*, s 1, Pt A10, ss 1.

¹⁰² *Idem*, s 1, Pt A11, ss 3; Pt A12, ss 3.

¹⁰³ *Idem*, s 1, Pt A35, ss 1.

¹⁰⁴ *Ibid*.

¹⁰⁵ *Idem*, s 1, Pt A3, ss 2.

¹⁰⁶ *Idem*, s 1, Pt A29.

¹⁰⁷ *Ibid*.

5.1.2. *Incentivising effect*

There is scope for the standalone moratorium to incentivise directors to react to corporate financial distress at a time where restructuring may allow the company to return to profitability. Notably, in alignment with the characteristics that are associated with a low market share of zombie companies (discussed in section 3), and in contrast to the administration procedure, directors should not hesitate to utilise the procedure in fear of losing managerial control.¹⁰⁸

However, how far the prospect of retaining control will encourage directors to utilise the procedure and act to offset financial distress, may be disputed. Despite the debtor-in-possession nature of Chapter 11 procedures in the United States, directors tend to avoid using the procedure.¹⁰⁹ Additionally, figures produced by Gibson are also concerning. He found that in a dataset of 111 companies between 1979 and 1985,¹¹⁰ 54 per cent of directors left companies before corporate bankruptcy or restructuring ended.¹¹¹ This may undermine the suggestion that directors are worried about losing control and consequently hesitate to initiate corporate restructurings; rather, it may suggest that directors are more worried about dealing with corporate financial distress. Consequently, it may be considered that the benefit derived from offering a debtor-in-possession procedure may be considered minimal. This consideration is afforded further weight by the fact that company voluntary arrangements, another debtor-in-possession restructuring tool available to companies in England and Wales, have “experienced a decline [in uptake] in recent years”.¹¹² Consequently, the Insolvency Service believes that “there is nothing to suggest that directors would suddenly be precipitous [...] in engaging the [moratorium] procedure”.¹¹³

5.1.3. *Will the moratorium procedure’s implementation minimise the defects of the administration procedure?*

Whilst there is certainly scope for the cost of restructuring to be lessened by utilising the standalone moratorium to restructure and reorganise a company, only time will tell how effective it is in doing so and which companies may particularly benefit from restructuring whilst utilising it.

¹⁰⁸ C Norman and S Shukla, “Corporate Insolvency and Governance Act 2020: a Balancing Act”, *Journal of International Banking and Financial Law* (2020) 9 629.

¹⁰⁹ E Altman, “Evaluating the Chapter 11 Bankruptcy-Reorganisation Process” *Columbia Business Law Review* (1993) 1 1 at 19-20.

¹¹⁰ S Gilson, “Bankruptcy, boards, banks, and blockholders: Evidence on changes in corporate ownership and control when firms default”, *Journal of Financial Economics* (199) 27 355.

¹¹¹ *Idem*, at 356.

¹¹² The Insolvency Service, *Summary of Responses: A Review of the Corporate Insolvency Framework* (Open Government Licence, London, 2016) at 326.

¹¹³ *Ibid.*

The debtor-in-possession nature of the procedure could incentivise directors of struggling companies to restructure and reorganise. How much it may incentivise directors, though, is uncertain. However, should the moratorium allow restructuring costs to be reduced, there is potential for directors to be more inclined to seek to rescue a company at a favourable time to do so.

Perhaps it is arguable that the most significant element that prevents the standalone moratorium procedure from offsetting some of the shortcomings of administration, is its limited availability. Notably, it is unavailable to companies that are party to capital market arrangements.¹¹⁴ Therefore, it may predominantly be available to small and medium enterprises as opposed to larger corporations.¹¹⁵ Consequently, the benefits of the procedure will not be available to larger zombie companies which are consuming a disproportionate amount of capital.

It follows that whilst there is some scope for the provision to minimise or slow the increase in the number of zombie companies, the amount of capital allocated to zombie companies is likely to remain largely unchanged. As a result, it may be that the implementation of the standalone moratorium procedure will likely not yield much, if any, benefit to the economy.

5.2. Restructuring plan

Restructuring plans (RPs) may be implemented by companies in circumstances similar to those needed to utilise a standalone moratorium. Notably, RPs can be implemented by companies who have encountered, or are likely to encounter, financial difficulties that threaten their continued operation.¹¹⁶

Whilst RPs are not dissimilar to schemes of arrangement, there are some differences. Similarly to schemes, RPs may be used by a company to propose an arrangement with its creditors and / or shareholders.¹¹⁷ To be implemented, a RP must aim to eliminate, reduce, or mitigate a company's financial difficulties.¹¹⁸ However, contrastingly to schemes, a RP may be binding on each class of creditor or shareholder where 75 per cent of that class agrees to the terms of the RP and the court sanctions the plan.¹¹⁹ Additionally, even where a class or classes vote(s) against a RP, a court can impose it on those dissenting creditors. This is possible if the court is satisfied that all dissenting creditors will benefit from the compromise more than they would "under the relevant alternative"¹²⁰ and at least one of

¹¹⁴ CIGA, Sch 1, s 13(1)(a).

¹¹⁵ P Sidle, "The new Standalone Moratorium procedure under CIGA 2020", *Corporate Rescue and Insolvency Journal* (2020) 4 119 123.

¹¹⁶ CIGA, Sch 9, Pt 26A, s 901A(2).

¹¹⁷ *Idem*, Sch 9, Pt 26A, s 901A(3)(a).

¹¹⁸ *Idem*, Sch 9, Pt 26A, s 901A(3)(b).

¹¹⁹ *Idem*, Sch 9, Pt 26A, s 901F(1).

¹²⁰ *Idem*, Sch 9, Pt 26A, s 901G(3).

the approving classes would receive payment or have a genuine economic interest in the “relevant alternative”.¹²¹ This is the so-called cross-class cram-down provision.¹²²

5.2.1 Cost

RPs may, potentially, be costly. Notably, it is considered that complex disputes may arise regarding, amongst other things, what constitutes the relevant alternative, which courts may judge the utility of a RP, and whether a class of creditors or shareholders hold genuine economic interests in what they consider to be the relevant alternative.¹²³ Additionally, Benson and others believe that courts may also face challenges in determining whether a RP is fair to impose.¹²⁴ Consequently, there is scope for lengthy and costly disputes to ensue before a RP is successfully implemented by a company.

5.2.2. Incentivising effect

As discussed, evidence exists to suggest that the debtor-in-possession nature of a procedure does not automatically incentivise directors to utilise it. Whilst the procedure has benefits not afforded by other restructuring tools, notably its cross-class cramdown feature, which affords directors additional flexibility in returning their company to profitability,¹²⁵ it is unknown whether these benefits will incentivise directors to restructure or reorganise the company to which they are party at a time when the company has a good chance of being rescued.

5.2.3. Will the restructuring plan mechanism’s implementation minimise the defects of the administration procedure?

There is little to no evidence to suggest that the introduction of the RP mechanism will reduce the increase in or the overall number of zombie companies. The procedure’s costs may often be significant, thus disincentivising its use and, by reducing the capital available to that company, jeopardising a company’s chances of returning to profitability. Whether directors’ perceptions of the utility of the procedure will encourage them to use it at a time when a struggling company’s fortunes can be turned around, is yet to be seen.

6. Conclusion

In summary, it seems that the CIGA will not significantly rectify the issues associated with the administration procedure. As the administration procedure is the primary mechanism

¹²¹ *Idem*, Sch 9, Pt 26A, s 901G(5).

¹²² M Benson, N Devaney, M Lawford and A Wilkinson, “A new dynamic: an in-depth look at the restructuring plan introduced by CIGA 2020”, *Corporate Rescue and Insolvency* (2020) 4 115.

¹²³ C Norman and S Shukla, “Corporate Insolvency and Governance Act 2020: a balancing act”, *Journal of International Banking and Financial Law* (2020) 9 629 632.

¹²⁴ M Benson, N Devaney, M Lawford and A Wilkinson, “A new dynamic: an in-depth look at the restructuring plan introduced by CIGA 2020”, *Corporate Rescue and Insolvency* (2020) 4 115 117.

¹²⁵ *Ibid.*

through which corporate restructurings and rescues are attempted, the utility of the CIGA's provisions may be negligible if its issues are not rectified.

Whilst the CIGA has not furthered adherence to many of the insolvency framework characteristics that correlate with lessened zombie company market share and zombie company consumption of capital within England and Wales' legislation, commentators do praise some of its provisions.¹²⁶ Notably, the implementation of provisions preventing the validity of *ipso facto* clauses,¹²⁷ thus allowing companies to continue to operate as normal despite their financial difficulties, has been well received.¹²⁸ It did not fall within the scope of this paper to explore many of the benefits that the CIGA may bring.

¹²⁶ L Hotton and J Norris, "UK Corporate Insolvency and Governance Act: effects of ipso facto clauses", *Journal of International Banking and Financial Law* 8 550 552.

¹²⁷ CIGA, Sch 12, Pt 1.

¹²⁸ L Hotton and J Norris, "UK Corporate Insolvency and Governance Act: effects of ipso facto clauses", *Journal of International Banking and Financial Law* 8 550 552.

A “Model Law” for cross-border insolvency and resolution of financial institutions

By Shuai Guo, China University of Political Science and Law, People’s Republic of China*

Abstract

The global financial crisis of 2007 / 2008 demonstrated the necessity for an orderly resolution regime for financial institutions. The current downturn caused by COVID-19 is putting more pressure on the financial sector. However, no substantive cross-border rules are in place for resolving failing financial institutions. Traditional international insolvency law instruments, such as Chapter 15 of the US Bankruptcy Code, adopting the UNCITRAL Model Law, do not apply to certain financial institutions. Special rules for financial institutions are in place in the EU, such as the Directive on Reorganisation and Winding-up of Credit Institutions, the Bank and Recovery and Resolution Directive and the Single Resolution Mechanism Regulation. However, the EU regime rests on special intra-EU economic and legal arrangements and cannot be easily applied to other parts of the world. This paper proposes that a new model law should be established for cross-border insolvency and resolution of financial institutions at a global level.

1. Introduction

The global financial crisis of 2007 / 2008 demonstrated the lack of a global framework for the orderly resolution of financial institutions.¹ During the global financial crisis, many banks were placed under normal bankruptcy / insolvency proceedings (such as Lehman Brothers), which led to chaotic and contagious consequences as normal bankruptcy / insolvency proceedings do not have the function of adequately protecting the stability of financial systems.² Some other financial institutions were saved by governments using taxpayers’ money, such as the American International Group (AIG). This may lead to moral hazard issues, as financial institutions have the presumption that they can rely on government funding when they get into trouble.³

Against this background, a new administrative mechanism was created, namely, “resolution”. The resolution regime empowers administrative resolution authorities to directly intervene in the operations of a financial institution that is failing or likely to fail, and resolution authorities can thus act swiftly based on their financial knowledge and

* Dr Shuai Guo, Assistant Professor / Lecturer at China University of Political Science and Law; PhD (Leiden). ORCID iD: 0000000345296389. This paper is based on the author’s PhD thesis, *Recognition of Foreign Bank Resolution Actions* (Edward Elgar, Cheltenham, 2022).

¹ M Čihak and E Nier, *The Need for Special Resolution Regimes for Financial Institutions: The Case of the European Union* (International Monetary Fund, Washington DC, 2009).

² D Skeel, *The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences* (John Wiley & Sons, Hoboken, 2010); O McDonald, *Lehman Brothers: A Crisis of Value* (Manchester University Press, Manchester, 2016); and D Faber and N Vermunt (eds), *Bank Failure: Lessons from Lehman Brothers* (Oxford University Press, Oxford, 2017).

³ W Sjoström, “The AIG Bailout”, *Washington and Lee Law Review* (2009) 66(3) 943; and William Sjoström, “Afterword to the AIG Bailout”, *Washington and Lee Law Review* (2015) 72(2) 795.

experience in order to maintain financial stability. This process also does not involve courts.⁴ A distinct feature of resolution is that shareholders and senior creditors are required to absorb the losses first so as to minimise the usage of taxpayers' money (a so-called bail-in), by writing down the claims or converting creditors' claims into equity. There is no need to obtain consent from shareholders or creditors.⁵

In the past decade, international organisations such as the Basel Committee on Banking Supervision (BCBS)⁶ and the International Monetary Fund (IMF),⁷ have been advocating for establishing a resolution regime for financial institutions and one of the leading documents in this regard is the "Key Attributes of Effective Resolution Regimes for Financial Institutions" (Key Attributes, or KAs) issued by the Financial Stability Board (FSB).⁸ Much progress has been made with regard to reforming domestic resolution laws.⁹ In the United States (US), the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) designated a new Orderly Resolution Authority and empowered this agency to resolve large financial holding companies that are failing or likely to fail.¹⁰ In the European Union (EU), the Bank Recovery and Resolution Directive (BRRD) harmonised the resolution laws across EU Member States, and the Single Resolution Mechanism Regulation (SRMR) established a new Single Resolution Board (SRB) as the supranational agency for the resolution of large financial institutions and cross-border institutions in the Euro Area.¹¹

⁴ See, eg, PS Kenadjian (ed), *The Bank Recovery and Resolution Directive Europe's Solution for "Too Big To Fail"?* (De Gruyter, Berlin, 2013); M Haentjens and B Wessels (eds), *Bank Recovery and Resolution A Conference Book* (Eleven International Publishing, The Hague, 2014); S Schelo, *Bank Recovery and Resolution* (Kluwer Law International, Deventer, 2015); J-H Binder and D Singh (eds), *Bank Resolution: The European Regime* (Oxford University Press, Oxford, 2016); M Schillig, *Resolution and Insolvency of Banks and Financial Institutions* (Oxford University Press, Oxford, 2016); and S Gleeson and RD Guynn, *Bank Resolution and Crisis Management: Law and Practice* (Oxford University Press, Oxford, 2016).

⁵ See, eg, C Bates and S Gleeson, "Legal Aspects of Bank Bail-ins", *Law and Financial Markets Review* (2011) 5(4) 264; V de Serière, "Bail-in: Some Fundamental Questions" in M Haentjens and B Wessels (eds), *Bank Recovery and Resolution: A Conference Book* (Eleven International Publishing, The Hague, 2014); J H Sommer, "Why Bail-in? And How?", *Federal Reserve Bank of New York Economic Policy Review* (2014) 207; E Avgouleas and C Goodhart, "Critical Reflections on Bank Bail-ins", *Journal of Financial Regulation* (2015) 1(1) 3; B Joosen, "Regulatory Capital Requirements and Bail in Mechanisms" in M Haentjens and B Wessels (eds), *Research Handbook on Crisis Management in the Banking Sector* (Edward Elgar, Cheltenham, 2015); and K-P Wojcik, "Bail-in in the Banking Union", *Common Market Law Review* (2016) 53(1) 91.

⁶ BCBS, "Report and Recommendations of the Cross-Border Bank Resolution Group" (2010), available at <https://www.bis.org/publ/bcbs169.pdf>.

⁷ IMF, "IMF, 'Resolution of Cross-Border Banks - A Proposed Framework for Enhanced Coordination'" (2010), available at <https://www.imf.org/external/np/pp/eng/2010/061110.pdf>.

⁸ FSB, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (2011), available at https://www.fsb.org/wp-content/uploads/r_111104cc.pdf; and FSB, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (2014), available at https://www.fsb.org/wp-content/uploads/r_141015.pdf.

⁹ FSB, "2020 Resolution Report 'Be Prepared'" (2020), available at <https://www.fsb.org/wp-content/uploads/P181120.pdf>.

¹⁰ Title II of the Dodd-Frank Act (Orderly Resolution Authority).

¹¹ In fact, the SRB is responsible for financial institutions within the Banking Union, which, by definition, refers to Euro Area States and any other states that would like to participate. For the moment, the Banking Union only consists of Euro Area States. See, eg, G S Zavvos and S Kaltsouni, "The Single Resolution Mechanism

Given the international expansion of large financial institutions, orderly resolution of these financial institutions has significant implications on the global financial market. In the present time of COVID-19, the world economy is also facing increasing pressure, which in turn puts the financial sector at risk.¹² For financial institutions there is a strong need for an orderly cross-border insolvency and resolution regime that can minimise the impact of an economic or financial crisis.¹³ Yet, the current legal reforms with regard to bank resolution have not adequately addressed cross-border issues.¹⁴ This paper proposes a solution to the problem by advocating a model law that applies to cross-border insolvency and resolution of financial institutions.

2. Problems of *status quo* rules

2.1 Lack of binding international treaties of co-operation

The existing rules are not adequate to address cross-border insolvency and resolution of financial institutions. First of all, at the moment there is no binding international treaty to address cross-border issues. The aforementioned international organisations' recommendations, such as the Key Attributes, are not hard law and do not have a binding effect on sovereign states.¹⁵ Some authorities in different jurisdictions have entered into co-operation agreements, such as a memorandum of understanding,¹⁶ or other co-operation agreements.¹⁷ These agreements are however not binding and can thus not

in the European Banking Union: Legal Foundations, Governance Structure and Financing" in M Haentjens and B Wessels (eds), *Research Handbook on Crisis Management in the Banking Sector* (Edward Elgar, Cheltenham, 2015) at 117-149.

¹² See, eg, FSB, "COVID-19 Pandemic: Financial Stability Implications and Policy Measures Taken" (2020); J Letzing, "The Economic Toll of the Coronavirus - From iPhones to Solar Panels to Tourism", *World Economic Forum*, 21 February 2020, available at <https://www.weforum.org/agenda/2020/02/economic-toll-coronavirus-manufacturing-tourism-china-asia/>; and T Adrian and F Natalucci, "COVID-19 Crisis Poses Threat to Financial Stability" *IMF Blog*, 4 April 2020, available at <https://blogs.imf.org/2020/04/14/covid-19-crisis-poses-threat-to-financial-stability/>.

¹³ See a general overview, eg, J M Edwards, "A Model Law Framework for the Resolution of G-SIFIs", *Capital Markets Law Journal* (2012) 7(2) 122; I Mevorach, "Beyond the Search for Certainty: Addressing the Cross-Border Resolution Gap", *Brooklyn Journal of Corporate, Financial and Commercial Law* (2015) 10(1) 183; V Chen, A Godwin and I Ramsay, "Cross-Border Cooperation in Bank Resolution: A Framework for Asia", *Singapore Journal of Legal Studies* (2016) 1; S Guo, "Cross-Border Resolution of Financial Institutions: Perspectives from International Insolvency Law", *Norton Journal of Bankruptcy Law and Practice* (2018) 27(5) 481; and M Haentjens and B Wessels (eds), *Research Handbook on Cross-Border Bank Resolution* (Edward Elgar, Cheltenham, 2019).

¹⁴ FSB, "FSB 2019 Resolution Report Eighth Report on the Implementation of Resolution Reforms 'Mind the Gap'" (2019), available at <https://www.fsb.org/wp-content/uploads/P141119-3.pdf>.

¹⁵ See, eg, C S Crespo, "Explaining the Financial Stability Board: Path Dependency and Zealous Regulatory Apprehension", *Penn State Journal of Law & International Affairs* (2017) 5(2) 302-311.

¹⁶ For example, Memorandum of Understanding Concerning Consultation, Cooperation and the Exchange of Information Related to the Resolution of Insured Depository Institutions with Cross-border Operations in the United States and the United Kingdom, signed on 10 January 2010 (FDIC-BOE Resolution MOU).

¹⁷ For example, Cooperation Arrangement Concerning the Resolution of Insured Depository Institutions and Certain other Financial Companies with Cross-border Operations in the United States and the European Banking Union, signed in September 2017 (FDIC-SRB Resolution CA).

guarantee the effectiveness of cross-border actions.¹⁸ Within the EU, the BRRD provides that resolution colleges consisting of authorities of different jurisdictions should be established where entities within a banking group are located.¹⁹ This is similar to crisis management groups (CMGs) proposed by the FSB.²⁰ The function of such resolution colleges / CMGs is to “provide a forum for the exchange of information and coordination of resolution actions” and “with a view to agreeing a group resolution”.²¹ However, even in a binding legal regime such as the BRRD, a dissenting authority within a resolution college can still depart from the joint decisions of the resolution college.²² As a result this mechanism cannot ensure an ultimate effect on cross-border co-operation.

2.2 Concerns about applying international insolvency law instruments

In many jurisdictions, international insolvency laws are embedded in national codes that resolve cross-border insolvency cases. However, banks are normally excluded from the scope of (cross-border) insolvency law instruments.²³ A representative example is Chapter 15 of the US Bankruptcy Code, which adopted the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-border Insolvency (MLCBI). Accordingly, section 1501 explicitly excludes “a foreign bank, savings bank, cooperative bank, savings and loan association, building and loan association, or credit union, that has a branch or agency ... in the United States”.²⁴ In other words, foreign banks with branches or agencies in the US are not subject to Chapter 15 and thus foreign insolvency proceedings concerning these entities cannot be recognised in the US pursuant to Chapter 15.²⁵ In fact, US branches and agencies of foreign banks are solely subject to the resolution regime of the US authorities, including the Federal Deposit Insurance Corporation,²⁶ the Office of the Comptroller of the Currency,²⁷ or state resolution authorities.²⁸

However, in contrast to foreign banks with branches or agencies in the US, other types of financial institutions are still subject to Chapter 15. For instance, in the *In re Irish Bank*

¹⁸ FDIC-BOE Resolution MOU, Art 2(5) and FDIC-SRB Resolution CA, s 2(6). See also S Guo, “Cross-Border Resolution of Financial Institutions: Perspectives from International Insolvency Law” *Norton Journal of Bankruptcy Law and Practice* (2018) 27(5) 481 500-501.

¹⁹ BRRD, art 88.

²⁰ FSB KA 8.

²¹ BRRD, Recital 96. Also see EBA Final draft Regulatory Technical Standards on resolution colleges under Article 88(7) of Directive 2014/59/EU, EBA/RTS/2015/03, 3 July 2015.

²² BRRD, arts 91(8) and 92(4).

²³ See, eg, E H G Hüpkens, *The Legal Aspects of Bank Insolvency: A Comparative Analysis of Western Europe, the United States, and Canada* (Kluwer Law International, Deventer, 2000).

²⁴ 11 US Code, §§109(b)(3)(B) and 1501(c)(1).

²⁵ See, eg, S L Schwarcz, “The Confused US Framework for Foreign-Bank Insolvency: An Open Research Agenda”, *Review of Law & Economics* (2005) 1(1) 81 and P L Lee, “Cross-Border Resolution of Banking Groups: International Initiatives and US Perspectives-Part III”, *Pratt’s Journal of Bankruptcy Law* (2014) 10(4) 291.

²⁶ 12 USC, § 3104(d).

²⁷ *Idem*, § 3102(i) and (j).

²⁸ See, eg, New York Banking Law, s 606(4)(a).

Resolution Corporation case, the Irish bank had closed all branches or agencies in the US ten months before its Chapter 15 application and was still an eligible debtor.²⁹

It should be noted that the MLCBI-based cross-border bank insolvency laws are primarily designed to address insolvency, but not administrative resolution proceedings. However, in the aforementioned *In re Irish Bank Resolution Corporation* case, the judge confirmed that an Irish proceeding taken by the Special Liquidators and Minister of Finance was of an administrative nature and could be recognised as a foreign proceeding, as under the definition of Chapter 15, insolvency proceedings included those taken by administrative authorities.³⁰ Nevertheless, for jurisdictions that have not adopted the MLCBI, it is still not clear whether traditional cross-border insolvency laws can directly apply to cross-border resolution scenarios.

Another issue is the protection of creditors. Although a recognition process may not involve creditors, their interests are an important factor to consider when a court discretionarily grants reliefs after recognition. For instance, Chapter 15 prescribes that “[t]he court may grant relief under section 1519 or 1521, or may modify or terminate relief ... only if the interests of the creditors ... are sufficiently protected”.³¹ However, as mentioned earlier, the resolution regime puts (some) creditors in a subordinated position and the creditors’ interests may be infringed because their claims would be bailed-in by either write-down or conversion into equity.³² It is not clear whether a bail-in mechanism would suffice the condition of protection of creditors under Chapter 15 - without meeting this standard, a foreign resolution action may be refused relief and thus cross-border resolution effects may be impeded. This example also adds the concern of whether the traditional international insolvency law is suitable to address cross-border resolution cases.

2.3 Inadequacy of special cross-border resolution rules

Many jurisdictions have not adopted special rules for cross-border resolution of financial institutions. Yet, the EU is an advanced jurisdiction where the BRRD established a special administrative recognition regime and empowered resolution authorities to recognise and enforce third country resolution actions outside the EU.³³ However, these rules

²⁹ *In re Irish Bank Resolution Corporation*, 538 BR 629 (D Del 2015).

³⁰ *Ibid* at 697. See also *In re Tradex Swiss AG*, 384 BR 34, 42 (Bankr D Mass 2008); and *In re ENNIA Caribe Holding NV*, 594 BR 631, 639 (Bankr SDNY 2018).

³¹ 11 USC, § 1522(a).

³² See, eg, C Bates and S Gleeson, “Legal Aspects of Bank Bail-ins”, *Law and Financial Markets Review* (2011) 5(4) 264; V de Serière, “Bail-in: Some Fundamental Questions” in M Haentjens and B Wessels (eds), *Bank Recovery and Resolution: A Conference Book* (Eleven International Publishing, The Hague, 2014); J H Sommer, “Why Bail-in? And How?”, *Federal Reserve Bank of New York Economic Policy Review* (2014) 207; E Avgouleas and C Goodhart, “Critical Reflections on Bank Bail-ins”, *Journal of Financial Regulation* (2015) 1(1) 3; B Joosen, “Regulatory Capital Requirements and Bail in Mechanisms” in M Haentjens and B Wessels (eds), *Research Handbook on Crisis Management in the Banking Sector* (Edward Elgar, Cheltenham, 2015); and K-P Wojcik, “Bail-in in the Banking Union”, *Common Market Law Review* (2016) 53(1) 91.

³³ BRRD, arts 94-96.

prescribed in the BRRD are overly simple and cannot provide sufficient guidance for relevant role-players. For instance, there is no jurisdiction rule that prescribes which (foreign) jurisdiction is a competent one to open resolution proceedings. And the provisions do not address procedural issues such as time, or required documents to file a petition for recognition. The effects of recognition are further not clearly specified, with only a general description that EU resolution authorities may take actions with regard to third country institutions' subsidiaries, branches, and assets located in the EU or subject to EU-law governed financial contracts.³⁴

However one well-drafted provision enumerates five public policy exceptions that can be invoked to refuse recognition of foreign resolution actions, namely, financial stability; resolution objectives; equal treatment of creditors; material fiscal implications and national laws.³⁵ This list contains more specific circumstances than Chapter 15 of the US Bankruptcy Code which simply mentions a public policy exception as a general rule to refuse recognition.³⁶

2.4 Difficulty of establishing a supranational resolution or an automatic recognition regime at a global level

With the adoption of the SRMR and the BRRD, the EU established special arrangements for the cross-border resolution of financial institutions within the EU, in particular, a supranational resolution authority – the SRB in the Euro Area, and an automatic recognition regime across EU Member States. However, as explained below, these arrangements rely on the special EU systems and are difficult to extrapolate to a global level.

Firstly, the SRB acts as a supranational authority and can directly make resolution decisions for cross-border financial institutions within the Euro Area.³⁷ It greatly reduces the challenges faced in normal insolvency proceedings where national authorities act in their own interest.³⁸ However, such a supranational approach largely depends on the system of the EU, which acknowledges that “[e]nsuring effective resolution decisions for failing banks within the Union ... is essential for the completion of the internal market in financial services”.³⁹ This corresponds to the Treaty on the Functioning of the European Union (TFEU) as the legal basis for the approximation of laws in the EU.⁴⁰ Nevertheless, such an

³⁴ *Idem*, art 94.

³⁵ *Idem*, art 95. See comments in M Haentjens, S Guo and B Wessels, *New Bank Insolvency Law for China and Europe* (Eleven International Publishing, 2021) at 152-157.

³⁶ 11 USC, § 1506.

³⁷ SRMR, art 7(2).

³⁸ See, eg, the financial nationalism doctrine: Federico Lupo-Pasini, *The Logic of Financial Nationalism: The Challenges of Cooperation and the Role of International Law* (Cambridge University Press, Cambridge, 2017).

³⁹ SRMR, recital (12).

⁴⁰ TFEU, art 114. See also G S Zavvos and S Kaltsouni, “The Single Resolution Mechanism in the European Banking Union: Legal Foundations, Governance Structure and Financing” in M Haentjens and B Wessels (eds), *Research Handbook on Crisis Management in the Banking Sector* (Edward Elgar, Cheltenham, 2015) at 117-149.

internal market or a unified legal basis is absent at a global level and the supranational model is difficult to apply elsewhere.⁴¹

Secondly, the BRRD amends the Directive on Reorganisation and Winding-up of Credit Institutions (CIWUD) and makes resolution actions effective across EU Member States.⁴² The well-known European Insolvency Regulation (EIR) explicitly excludes “insurance undertakings”, “credit institutions”, “investment firms and other firms, institutions and undertakings” and “collective investment undertakings”.⁴³ The CIWUD thus acts as a supplementary instrument and applies to the insolvency of credit institutions in the EU.⁴⁴ Accordingly, reorganisation and winding up proceedings of a bank in a home Member State are automatically recognised in a host Member State where a branch of that bank is located.⁴⁵ The BRRD redefines “reorganisation” and to include resolution proceedings. Therefore, resolution actions are also automatically recognised in a host Member State.⁴⁶ This mechanism builds on the special EU banking authorisation and supervision model, being “a credit institution and its branches form a single entity subject to the supervision of the competent authorities of the State where authorisation valid throughout the Community was granted”,⁴⁷ and it would be “particularly undesirable to relinquish such unity”.⁴⁸ In the EU, there exists a “passport” mechanism that allows a bank licensed in one Member State to operate and provide services in other Member States without the need to obtain additional authorisation.⁴⁹ Accordingly, the supervisory authority in the Member State where the bank is authorised needs to supervise all of the bank’s activities across the EU, which is so-called “home-country control” supervision.⁵⁰ However, such an automatic recognition regime is difficult to apply to other parts of the world without a similar underlying mechanism.

3. The need for a Model Law on Cross-Border Insolvency and Resolution of Financial Institutions

As mentioned in the previous section, the existing rules are not adequate to address cross-border insolvency and resolution of financial institutions. This paper proposes that a Model Law for Cross-border Insolvency and Resolution of Financial Institutions (MLFI) should be formulated as a guiding document for national legislators. Compared to other instruments, the MLFI would have several advantages.

⁴¹ S Guo, “Cross-Border Resolution of Financial Institutions: Perspectives from International Insolvency Law”, *Norton Journal of Bankruptcy Law and Practice* (2018) 27(5) 481.

⁴² BRRD, art 117.

⁴³ EIR 2015 recast, art 1(2).

⁴⁴ CIWUD, art 1(1). See, eg, G Moss, B Wessels and M Haentjens, *EU Banking and Insurance Insolvency* (Oxford University Press, Oxford, 2017).

⁴⁵ CIWUD, arts 3(1) and (2), and 9(1) and (2).

⁴⁶ BRRD, art 117.

⁴⁷ CIWUD, recital (3).

⁴⁸ *Idem*, recital (4).

⁴⁹ M Haentjens and P De Gioia-Carabellese, *European Banking and Financial Law* (Routledge, Abingdon, 2015) 8-10.

⁵⁰ *Ibid.*

3.1 A global reach

Firstly, the proposed MLFI would have a global reach. The aforementioned supranational model and automatic recognition regime are restricted to the territory of the EU. By contrast, the MLFI would aim at providing solutions at a global level. As will be further illustrated below, the MLFI would build on the core issue of recognition of foreign resolution actions. This parallels the MLCBI and the new UNCITRAL Model Law on Recognition and Enforcement of Insolvency-Related Judgments (MLJ).⁵¹ The purpose of the MLCBI is to “assist States to equip their insolvency laws with a modern harmonized and fair framework to address more effectively instances of cross-border proceedings concerning debtors experiencing severe financial distress or insolvency”.⁵² Similarly, the MLJ aims to “assist States to equip their laws with a framework of provisions for recognizing and enforcing insolvency-related judgments that will facilitate the conduct of cross-border insolvency proceedings and complement ... the MLCBI”.⁵³ Likewise, the MLFI would be able to assist participating states in providing a recognition framework in addition to their existing laws and, therefore, make resolution actions effective across borders. The MLCBI has contributed to international co-operation in cross-border insolvency cases,⁵⁴ and it is proposed that a MLFI will function in a similar way.

3.2 Low negotiation cost

The MLFI would be used as a soft law instrument, which is easier to accept than a hard law international treaty. Hard law is characterised by precision and certainty and imposes legally binding international obligations, but it usually needs a lengthy negotiation period and may be difficult to achieve so as to balance the different interests of sovereign states.⁵⁵ This is probably why there is no hard law international treaty at the moment for cross-border insolvency and resolution of financial institutions. By contrast, soft law, although with less certainty and fewer stringent obligations, is preferred by national authorities, as

⁵¹ See comments in, eg, L Metreveli, “Toward Standardized Enforcement of Cross-Border Insolvency Decisions: Encouraging the United States to Adopt UNCITRAL’s Recent Amendment to Its Model Law on Cross-Border Insolvency”, *Columbia Journal of Law and Social Problems* (2017) 51(2) 315; R Mason, “Cross-border Insolvency: Recognition of Insolvency-Related Judgments and Choice of Law Characterization”, *Norton Journal of Bankruptcy Law and Practice* (2018) 27(5) 639; and F Bruder, “Recognition and Enforcement of Insolvency-Related Judgments”, *Eurofenix* (2018) 32.

⁵² MLCBI Guide, para 1.

⁵³ MLJ Guide, para 1.

⁵⁴ See, eg, J Clift, “The UNCITRAL Model Law on Cross-Border Insolvency – A Legislative Framework to Facilitate Coordination and Cooperation in Cross-Border Insolvency”, *Tulane Journal of International and Comparative Law* (2004) 12 307; B Wessels, “Will UNCITRAL Bring Changes To Insolvency Proceedings Outside the USA and Great Britain? It Certainly Will”, *International Corporate Rescue* (2006) 3(4) 200; I Mevorach, “On the Road to Universalism: A Comparative and Empirical Study of the UNCITRAL Model Law on Cross-Border Insolvency”, *European Business Organization Law Review* (2011) 12(4) 517; and J L Westbrook, “An Empirical Study of the Implementation in the United States of the Model Law on Cross Border Insolvency”, *American Bankruptcy Law Journal* (2013) 87(2) 247.

⁵⁵ K W Abbott and D Snidal, “Hard and Soft Law in International Governance”, *International Organization* (2000) 54(3) 421.

it interferes less on sovereignty and facilitates compromises among negotiation parties.⁵⁶ This is particularly the case in global financial governance.⁵⁷ The MLFI would only serve as a model text to be included in national legal systems and would not impose binding obligations; its adoption would therefore be easier, with a lower negotiation cost than any attempt to agree an international treaty.

3.3 Flexibility

The proposed MLFI would also have the advantage of flexibility. Each participating state would be able to modify or leave out some of the provisions, or tailor it to its own national interests. It is proposed that wording similar to the MLCBI be inserted to a new proposed MLFI, that is, “States make as few changes as possible in incorporating the Model Law into their legal systems” in order to “achieve a satisfactory degree of harmonization and certainty”.⁵⁸ For example, South Africa adopted the MLCBI but with a reciprocity requirement, which is not prescribed in the MLCBI.⁵⁹ Also, explanatory notes can be added to a proposed MLFI after years of practice to help interpret the provisions in a more coherent manner. For example, UNCITRAL issued the Guide to Enactment and Interpretation of the MLCBI in 2013,⁶⁰ which provides useful insight to executive branches, legislators, judges or other users.⁶¹ Authorities may refer to such an explanatory note for a globally accepted interpretation.

4. The content of a Model Law for Cross-border Insolvency and Resolution of Financial Institutions (MLFI)

4.1 A recognition regime

This paper proposes that the core issue that the MLFI should prescribe is the recognition of foreign resolution actions. This follows the MLCBI and MLJ and aims to give effects to foreign resolution actions.⁶² The MLFI would need to be incorporated into national law, which would be part of the domestic legal system and serve as the legal basis for recognition. The advantage of such a recognition regime is that it can be decided

⁵⁶ *Ibid.*

⁵⁷ See, eg, C Brummer, “Why Soft Law Dominates International Finance - And Not Trade”, *Journal of International Economic Law* (2010) 13(3) 623; and C Brummer, *Soft Law and the Global Financial System: Rule Making in the 21st Century* (Cambridge University Press, Cambridge, 2015).

⁵⁸ MLCBI Guide, para 20.

⁵⁹ K D Yamauchi, “Should Reciprocity be a Part of the UNCITRAL Model Cross-Border Insolvency Law?”, *International Insolvency Review* (2007) 16(3) 145; and S C Mohan, “Cross-border Insolvency Problems: Is the UNCITRAL Model Law the Answer?”, *International Insolvency Review* (2012) 21(2) 199-208-210.

⁶⁰ MLCBI Guide, para 18.

⁶¹ *Idem*, para 17.

⁶² For a comprehensive overview, see S Guo, *Recognition of Foreign Bank Resolution Actions* (Edward Elgar, Cheltenham, 2022).

unilaterally by national authorities, without the need to reach bilateral or multilateral international agreements.⁶³

One problem, though, is the administrative nature of resolution actions. The word “recognition” is usually associated with judgments made by courts. Yet, resolution actions are decided and implemented by administrative resolution authorities. In the EU, the BRRD established an administrative recognition regime, which empowers administrative resolution authorities to recognise foreign resolution actions. In many other jurisdictions where no special administrative recognition regime exists, recognition still relies on traditional legal instruments. For instance, as mentioned earlier, the US interpreted resolution under the umbrella of bankruptcy, subject to Chapter 15 of the US Bankruptcy Code.⁶⁴ In jurisdictions where the MLCBI has not been adopted, recognising a foreign administrative action may still be problematic. This paper thus proposes that a new model law should designate a competent authority, either a judicial or administrative one, to recognise foreign resolution actions. National legislators may choose their own preference in this regard.⁶⁵

4.2 Jurisdiction

In the current prevailing international insolvency law, the jurisdiction rule is based on the identification of centre of main interests (COMI) *vis-à-vis* establishment, reflecting the modified universalism principle.⁶⁶ However, for a cross-border bank insolvency / resolution, this paper advocates a paradigm shift to a home / host distinction.⁶⁷ This paradigm shift is closely related to the special supervisory model for financial institutions. As explained earlier, the CIWUD in the EU applies a home / host jurisdiction rule, as a result of the supervision model of cross-border banking, namely, home-country control.⁶⁸ Simply put, home resolution authorities are equipped with more information about the

⁶³ See, eg, M Haentjens, B Wessels and S Guo, “Conclusions” in M Haentjens and B Wessels (eds), *Research Handbook on Cross-border Bank Resolution* (Edward Elgar, Cheltenham, 2019) at 398-408.

⁶⁴ *In re Irish Bank Resolution Corporation*, 538 BR 697 (D Del 2015). See also *In re Tradex Swiss AG*, 384 BR 34, 42 (Bankr D Mass 2008); and *In re ENNIA Caribe Holding NV*, 594 BR 631, 639 (Bankr SDNY 2018).

⁶⁵ FSB, “Principles for Cross-border Effectiveness of Resolution Actions” (2015) at 11, available at <https://www.fsb.org/wp-content/uploads/Principles-for-Cross-border-Effectiveness-of-Resolution-Actions.pdf>.

⁶⁶ See, eg, J L Westbrook, “A Global Solution to Multinational Default”, *Michigan Law Review* (2000) 98(7) 2276; B Wessels, *International Insolvency Law Part I: Global Perspectives on Cross-Border Insolvency Law* (Kluwer, Deventer, 2015); R Bork, *Principles of Cross-Border Insolvency* (Intersentia, Cambridge, 2017) 26-28; and I Mevorach, *The Future of Cross-Border Insolvency: Overcoming Biases and Closing Gaps* (Oxford University Press, Oxford, 2018).

⁶⁷ See, eg, J M Edwards, “A Model Law Framework for the Resolution of G-SIFIs”, *Capital Markets Law Journal* (2012) 7(2) 122 141-143; J L Westbrook, “SIFIs and States”, *Texas International Law Journal* (2014) 49(2) 329 349-352; I Mevorach, “Beyond the Search for Certainty: Addressing the Cross-Border Resolution Gap”, *Brooklyn Journal of Corporate, Financial and Commercial Law* (2015) 10(1) 183 252; and S Guo, “Cross-Border Resolution of Financial Institutions: Perspectives from International Insolvency Law”, *Norton Journal of Bankruptcy Law and Practice* (2018) 27(5) 481 489-492.

⁶⁸ M Haentjens and P De Gioia-Carabellese, *European Banking and Financial Law* (Routledge, Abingdon, 2015) 8-10.

operation of the parent institution and the whole group and are thus in a better position to manage the group resolution.

At an international level, thanks to the efforts of the BCBS, large international banking groups also follow the home-country control supervision model, where home supervisors conduct consolidated supervision for all entities within one banking group, including foreign subsidiaries and foreign branches.⁶⁹ This rule is clearly set out in the latest BCBS *Core Principles for Effective Banking Supervision*.⁷⁰ As Edwards summarises, “G-SIFIs [global systemically important financial institutions] are significantly regulated by one country on a consolidated basis, making it easier to design a rule that predictably identifies the home country of the corporate group”.⁷¹ Therefore, at an international level, a home / host distinction can also be applied.

4.3 Public policy exception

This paper also maintains that a public policy exception should be in place in a MLFI. This is different from the aforementioned CIWUD, which adopts an automatic recognition regime and does not prescribe public policy exceptions. Unlike special intra-EU relations, outside the EU, when extending the recognition regime to other parts of the world, it is necessary to allow public policy exceptions that prescribe circumstances where host jurisdictions may refuse to recognise foreign resolution actions. A home resolution authority is a special agency of a government, which is only accountable to its domestic constituencies (including domestic financial institutions and financial consumers, like investors and depositors).⁷² Thus, home resolution authorities usually have no legal obligations to fully consider the interests of host jurisdictions. It is of the utmost importance that host jurisdictions have counter-measures to block the adverse effect of home resolution actions within the host territories.

The case of the insolvency of several Icelandic banks against the background of the global financial crisis, demonstrates the concern that home authorities only consider home creditors’ interests. During the crisis, the Icelandic authority only transferred Icelandic depositors’ deposits to a new bank covered by the Icelandic deposit guarantee scheme

⁶⁹ See Basel Concordat, BCBS, “Report to the Governors on the Supervision of Bank’s Foreign Establishments BS/75/44e” (1975), available at <https://www.bis.org/publ/bcbs00a.pdf>; BCBS, “Principles for the Supervision of Banks” (1983), available at <https://www.bis.org/publ/bcbsc312.pdf>; and BCBS, “Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments” (1992), available at <https://www.bis.org/publ/bcbsc314.pdf>.

⁷⁰ BCBS, “Core Principles of Effective Banking Supervision” (2019), available at https://www.bis.org/basel_framework/standard/BCP.htm. Specifically see principles 12 (consolidated supervision) and 13 (home-host relationships) respectively.

⁷¹ J M Edwards, “A Model Law Framework for the Resolution of G-SIFIs”, *Capital Markets Law Journal* (2012) 7(2) 122 141-143.

⁷² See, eg, E H G Hüpkes, M Quintyn and M W Taylor, “The Accountability of Financial Sector Supervisors: Principles and Practice”, *IMF Working Paper* (2005) WP/05/51; and J Black and S Jacobzone, “Tools for Regulatory Quality and Financial Sector Regulation: A Cross-Country Perspective”, *OECD Working Papers on Public Governance* (2009) No 16.

(DGS), but English and Dutch creditors were left behind and were later rescued by English and Dutch DGSs, respectively.⁷³ This case showed how foreign creditors can be discriminated against in a resolution proceeding and how foreign jurisdictions might be burdened with additional fiscal expenditures.⁷⁴ As such, public policy exceptions are needed to protect host interests.

However, it should be noted that public policies should be interpreted narrowly in cross-border insolvency and in the resolution of financial institutions. This method follows the international acceptance of the restrictive way of interpreting public policies.⁷⁵ One particular issue is whether the administrative intervention of resolution authorities violates public policies. In the aforementioned case *In re Irish Bank Resolution Corporation*, the court raised such a concern and finally found that the Irish proceedings paralleled administrative measures implemented after the global financial crisis in the US, and did not therefore violate public policies.⁷⁶

4.4 Effects of recognition

A MLFI should also prescribe the effects of recognition, in particular the direct enforcement of foreign resolution actions or taking domestic measures to support foreign resolution proceedings. The FSB distinguishes recognition and (domestic) supportive measures.⁷⁷ Recognition means acknowledging the effects of foreign resolution measures within domestic territories. Upon recognition, foreign resolution actions could be enforced.⁷⁸ Supportive measures mean that host authorities support home authorities by taking domestic actions, on condition of "commencement of domestic resolution

⁷³ BCBS, "Report and Recommendations of the Cross-Border Bank Resolution Group" (2010) at 12-14; S Claessens *et al*, *A Safer World Financial System: Improving the Resolution of Systemic Institutions* (International Center for Monetary and Banking Studies, Geneva, 2010) at 51-53; and IMF, "Cross-Border Bank Resolution: Recent Developments" (2014) at 30-31, available at <https://www.imf.org/external/np/pp/eng/2014/060214.pdf>.

⁷⁴ Cf Judgment of EFTA Court, *EFTA Surveillance Authority v Iceland*, E-16/11, 28 January 2013. This paper argues that the court, in this case, was wrong in ruling that there was no legal obligation for Iceland to ensure payment to foreign depositors, and the court failed to consider the principles of equal treatment of domestic and foreign depositors. See V Babis, "Abandoning Foreign Depositors in a Bank Failure? The EFTA Court Judgment in *EFTA Surveillance Authority v. Iceland*", *Global Markets Law Journal* (2013) 2(Fall) 1.

⁷⁵ MLCBI Guide, paras 101-104; Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Report of the Committee on the Judiciary House of Representatives to accompany S. 256 together with Dissenting, Additional Dissenting, and Additional Minority Views, HR Rep No 109-31 (2005), 109. See, eg, S C Mund, "11 USC 1506: US Courts Keep a Tight Rein on the Public Policy Exception, but the Potential to Undermine Internationals Cooperation in Insolvency Proceedings Remains", *Wisconsin International Law Journal* (2010) 28(2) 325; E Buckel, "Curbing Comity: the Increasingly Expansive Public Policy Exception of Chapter 15", *Georgetown Journal of International Law* (2013) 44(3) 1281; and M A Garza, "When Is Cross-Border Insolvency Recognition Manifestly Contrary to Public Policy", *Fordham International Law Journal* (2015) 38(5) 1587.

⁷⁶ *In re Irish Bank Resolution Corporation*, 538 BR 629, 698 (D Del 2015).

⁷⁷ FSB KA 7.5; FSB, "Principles for Cross-border Effectiveness of Resolution Actions" (2015) at 5-6.

⁷⁸ FSB, "Principles for Cross-border Effectiveness of Resolution Actions" (2015) at 6.

proceedings” and restricted to “measures that are available under the domestic regime”.⁷⁹ A MLFI should therefore make a clear distinction between the two proceedings. In addition, effects of recognition should also extend to recognising the authority of a foreign representative,⁸⁰ and in the bank resolution context, foreign resolution authorities or their designated persons; or granting a moratorium and putting a (temporary) stay on host proceedings.⁸¹ These effects should also be specified in a MLFI text.

5. Concluding remarks

This paper proposes that a model law should be established to address cross-border insolvency and resolution of financial institutions. The latest financial crisis a decade ago, together with the current pressure faced by the global economy, call for an orderly resolution regime for financial institutions, especially large international ones. However, traditional international insolvency law is not adequate to address the characteristics of financial institutions. Firstly, banks are usually excluded from international insolvency laws. Secondly, previous legal instruments did not take into account the new development of resolution. Therefore, in order to ensure the effectiveness of cross-border resolution actions, a new legal basis is needed.

Compared to international treaties, a model law does not impose binding international obligations and is thus more easily accepted by participating states. A new MLFI, as proposed in this paper, would centre around the issue of recognition of foreign resolution actions, namely, giving effects to foreign resolution actions. The idea of a model law for cross-border insolvency and resolution of financial institutions has received a large amount of attention by academics, yet the concept still needs to be further discussed by participating national authorities and drafted by international organisations such as UNCITRAL. This paper’s intention was to provide some insight on how to design such a model law. It is further clarified that a model law is not the only approach to address cross-border insolvency and resolution of financial institutions. It should be developed in parallel with other instruments, such as international treaties and global crisis management groups.⁸² International co-operation is essential to ensure a global resolution outcome.

⁷⁹ *Ibid.*

⁸⁰ MLCBI Guide, at 29.

⁸¹ *Ibid.*, at 30.

⁸² M Haentjens, B Wessels and S Guo, “Conclusions” in M Haentjens and B Wessels (eds), *Research Handbook on Cross-border Bank Resolution* (Edward Elgar, Cheltenham, 2019) at 398-408.

Take the money and fly! A critical analysis of insolvency practitioner remuneration in South African corporate rescue (the case of South African Airways)

By Lézelle Jacobs, University of Wolverhampton, United Kingdom*

Abstract

In an attempt to save the suffering state-owned enterprise from liquidation, South African Airways was placed in business rescue (a corporate rescue procedure) in terms of the Companies Act 71 of 2008, in 2019. The circumstances surrounding this case are complex and laden with various contentious issues. One of these issues relates to the costs associated with the rescue proceedings in light of raging poverty in South Africa. The remuneration and disbursements claimed by the business rescue practitioners are therefore under scrutiny. This paper examines the remuneration and disbursements claimed by the business rescue practitioners in this case against the backdrop of the legislative framework on practitioner remuneration and the consequences of the business rescue practitioners' approach to remuneration in the corporate rescue regime and profession in South Africa.

1. Introduction

The commencement of voluntary business rescue proceedings in the case of South Africa's national carrier, South African Airways (SAA), was welcomed with mixed feelings by interested parties. The lead up to this historic event¹ is well-documented and fraught with tales of financial struggles, incompetence and corruption. Moreover, the amount of government funding spent on keeping the beleaguered state enterprise afloat is a fact that draws ire from most members of the South African public.

The daunting task of attempting to rescue SAA from almost certain liquidation fell on two business rescue practitioners (BRPs). As can be expected, the BRPs were subjected to much criticism, the least of which related to the remuneration and expenses they claimed as part of the process.

This paper provides a critical analysis and reflection on the known initial remuneration and disbursements claimed by the BRPs appointed in the case of SAA.² The facts of the case will be measured against the legislative framework for remuneration of BRPs in South

* Dr Lézelle Jacobs (l.jacobs@wlv.ac.uk) is a senior lecturer at Wolverhampton School of Law, University of Wolverhampton, United Kingdom and Extraordinary Lecturer at the Department of Mercantile Law, Faculty of Law, University of Pretoria, South Africa. ORCID ID: 0000-0001-8217-8467.

¹ SAA is the first state-owned company to enter the rescue procedure provided for under Ch 6 of the Companies Act 71 of 2008.

² Information regarding the procedure and the remuneration and disbursements claimed by the BRPs are available online and have been widely reported on. To this end, this paper relies on information published by the BRPs to the Parliamentary Standing Committee on Public Accounts, the websites of their respective firms, media reporting and court documents.

Africa and against international best practice guidance. The analysis will focus on the initial disclosures made by the BRPs regarding their remuneration. It is worth noting that the cost of SAA's entire business rescue procedure amounted to ZAR 16.8 billion and the inference can be drawn that a large proportion of this was in relation to fees.³

Although there are quite a number of issues in relation to the application of the law in relation to the business rescue procedure in general, it is not the aim of this paper to consider these in much detail. Relevant issues that contribute to the topic of this paper (being remuneration) will, however, be commented on.

2. Flight information - business rescue and business rescue practitioners in South Africa

In order to discuss the remuneration of the BRPs in the case of SAA, a brief introduction of the business rescue procedure as well as the remuneration framework applicable to the BRPs is needed to provide sufficient context.

South Africa's corporate rescue regime, business rescue, was introduced by Chapter 6 of the Companies Act 71 of 2008 (the Companies Act). The procedure was largely hailed as a new era for financially distressed companies that would pave the way for sustaining more viable companies, which would in turn strengthen the country's economy in a new and exciting way.⁴

The procedure was introduced to provide a mechanism for financially distressed companies to avoid liquidation. The formulation of the concept of "financial distress" in the Companies Act also refers to commercial and factual insolvency at a future date, implying that business rescue should ideally not be utilised by companies that are already insolvent.⁵ The formulation of the term also pursues early intervention.

³ R Mahlaka, "Flying solo: SAA will have to stand on its own after Treasury ushers in a new era of no bailouts to SOEs", Business Maverick, 1 September 2021 (article available at <https://www.dailymaverick.co.za/article/2021-09-01-flying-solo-saa-will-have-to-stand-on-its-own-after-treasury-ushers-in-a-new-era-of-no-bailouts-to-soes/>).

⁴ Although many academics and scholars alike voiced concerns with regard to the introduction of new ideas and foreign terminology at the time.

⁵ Companies Act, s 128(1)(f)(i). A company will be deemed to be financially distressed if it appears to be reasonably unlikely that the company will be able to pay all of its debts as they become due and payable within the immediately ensuing six months, or if it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months. South African courts have on numerous occasions denied applications for the initiation of business rescue where the companies are insolvent and not in financial distress. See *Gormley v West City Precinct Properties (Pty) Ltd* (unreported case) where it was held that "[I]t must either be unlikely that the debts can be repaid within 6 months or that the company will go insolvent within the ensuing 6 months. In this case the company is presently insolvent and cannot pay its debts unless a moratorium of 3-5 years is granted. The facts of this matter does not bring West City's financial situation within the definition of 'financially distressed'". See also *Wellman v Marcelle Props* 193 2012 JDR 0408 GSJ: 12 where the court held that "[I]n my view, Business Rescue proceedings are not for the terminally ill close corporation." Also see *Southern Palace Investments 265 (Pty) Ltd v Midnight Storm Investments 386 Ltd* 2012 2 SA 423 (WCC). In *African Banking Corporation of Botswana v Kariba Furniture Manufacturers* (228/2014) [2015] ZASCA 69 the court held that "[S]uffice it to say that the company was

There are two statutory aims of the business rescue procedure set out in the Companies Act. They provide for a procedure that through temporary supervision and a temporary moratorium allows for the development and implementation of a plan to rescue the company by restructuring the affairs, business, property, debt and other liabilities, and equity in a manner that: a) maximises the likelihood of the company continuing in existence on a solvent basis; or if not possible to so continue in existence b) provide for a better return for the company's creditors or shareholders than would result from an immediate liquidation of the company.⁶

The business rescue procedure can be initiated voluntarily by way of a company resolution or by way of petition to the High Court by an affected person.⁷

2.1 The pilot - business rescue practitioner: A new profession

A new feature in terms of the business rescue procedure is the creation of the profession of the BRP.⁸ This new position created by the Companies Act opened the world of insolvency practice to professionals who were previously not engaged in this type of work. According to the Companies Act, a person may be appointed as a BRP of a company if he is a member in good standing of a legal, accounting or business management profession.⁹ The new procedure thus invited members of the accounting and business management spheres who previously did not take up appointments as judicial managers in terms of the rescue procedure under the previous Companies Act 61 of 1973.¹⁰ The Companies Act further contains requirements regarding the qualifications of the practitioner, including references to licensing and requirements relating to maintaining independence and objectivity.¹¹

clearly hopelessly insolvent and effectively dormant in that it had not traded for years and had no business contacts in place." However, in *Oakdene Square Properties (Pty) Ltd and Others v Farm Bothasfontein (Kyalami) Pty Ltd and Others* [2013] 3 All SA 303 (SCA) it was remarked that as existing commercial or factual insolvency might not fall within the statutory definition of "financial distress", this should not constitute a bar to business rescue where the court believes it to be just and equitable for financial reasons to grant an application.

⁶ Companies Act, s 128(1)(b)(iii).

⁷ *Idem*, s 128(1)(a). An affected person is defined in the Companies Act as a shareholder or creditor of the company, any registered trade union representing employees of the company and any employees of the company not represented by a trade union.

⁸ South Africa utilises the mixed management approach. This means that neither the debtor-in-possession nor the management substitution approach is followed. The business rescue proceedings described in Ch 6 of the Companies Act retain the board of directors as part of management, but place them under the authority of the BRP, who in essence has full management control of the company.

⁹ Companies Act, s 138(1)(a). See s 138 on the further requirements regarding the qualifications of BRPs.

¹⁰ Judicial management was the preceding rescue mechanism contained in the Companies Act 61 of 1973.

¹¹ Companies Act, s 138(1)(a).

A BRP is regarded as a fiduciary *sui generis*, owing fiduciary duties to all affected persons in accordance to a hierarchy of interests based on their relative position to influence the outcome of business rescue proceedings.¹²

2.2 Paying the pilot - remuneration framework for business rescue practitioners

The Companies Act provides that the practitioner is entitled to charge remuneration in accordance with the regulations issued by the Minister in terms of the Companies Act.¹³

The regulations stipulate that the company itself or the court should determine the BRP's basic remuneration at the time of appointment, which remuneration is limited to certain amounts depending on the size of the company.¹⁴ For a small company, the BRP's fee may not exceed ZAR 1,250 per hour, up to a maximum of ZAR 15,625 per day,¹⁵ while a medium-sized company may be charged up to ZAR 1,500 per hour, with a maximum of ZAR 18,750 per day.¹⁶ For a large or state-owned company, the practitioner's remuneration may not exceed ZAR 2,000 per hour, up to a maximum of ZAR 25,000 per day.¹⁷ These amounts are also supposed to be inclusive of value added tax. The appointment to the company in question further depends on the experience and seniority of the BRPs, for example only allowing senior BRPs to be appointed as practitioners for large and state-owned companies.¹⁸

A BRP may propose an agreement with the debtor company that provides for the payment of further remuneration (other than the normal remuneration during such an appointment), to be calculated on the basis of a contingency related to: a) the adoption of a business rescue plan at all, or within a particular time, or the inclusion of a particular

¹² L Jacobs "The fiduciary duties of Business Rescue Practitioners: A legal comparative study" (LLD thesis, University of the Free State, 2015) 260.

¹³ Companies Act, s 143(1) and (6). Issues in relation to the priority of the BRP's remuneration are relevant but fall outside of the scope of this paper. See in this regard L Jacobs and D Burdette, "Queue Politely! South African Business Rescue Practitioners and their fees in Liquidation. *Diener NO v Minister of Justice and Correctional Services and Others* [2017] ZASCA 180; [2018] 1 All SA 317 (SCA); 2018 (2) SA 399 (SCA)", (2019) 2 WLJ 1, 61.

¹⁴ Regulations to the Companies Act, reg 128(1). The size of the company is determined in relation to the company's most recent "public interest score" as calculated in terms of reg 26(2) and requires an evaluation of the company's affairs as it relates to: the number of employees, third party liability, turnover and the number of shareholders.

¹⁵ *Idem*, reg 128(1)(a).

¹⁶ *Idem*, reg 128(1)(b).

¹⁷ *Idem*, reg 128(1)(c).

¹⁸ *Idem*, reg 127(4). In terms of reg 127 a junior practitioner (less than five years' experience) may only be appointed in the case of a small company, whereas an experienced practitioner (at least five years' experienced) may be appointed for small and medium companies and assist a senior practitioner (at least ten years' experience) for a large or state-owned company, A senior practitioner may be appointed as the practitioner for any company.

matter in the plan;¹⁹ or b) the attainment of any particular result or combination of results in relation to the proceedings.²⁰

In addition to the prescribed rates regarding the remuneration of BRPs, the regulations to the Companies Act provide that a BRP is entitled to be reimbursed for the actual cost of any disbursements made by such BRP, or expenses incurred by such BRP to the extent reasonably necessary to carry out the BRP's functions and facilitate the conduct of the company's business rescue proceedings.²¹

The inference can be drawn from the wording of the regulations to the Companies Act that, should a BRP be remunerated or claim disbursements outside of the framework provided for by the Companies Act and regulations thereto, such remuneration and disbursements would be unlawfully drawn and claimed.

2.3 Disparity between business rescue practitioner remuneration issues and issues relating to liquidators' fees

There is an inconsistent approach to reviewing remuneration in South Africa due to the categorisation of the profession and a lack of harmonisation in the jurisdiction. The remuneration sought by the liquidator of an insolvent company will be subject to taxation (review) by the Master of the High Court in South Africa.²² This is a task that the Master takes very seriously and diligently applies the rules in relation to remuneration to all liquidations in South Africa on a fairly consistent basis. Should a party feel aggrieved by the outcome of the taxation, it is possible to take it on review to court. However, the fees of BRPs in South Africa are not subject to any form of formal taxation and, should a stakeholder feel aggrieved by the remuneration claimed by a BRP, his only recourse would be to the court.²³

¹⁹ Companies Act, s 143(2)(a).

²⁰ *Idem*, s 143(2)(b).

²¹ Regulations to the Companies Act, reg 128(3).

²² Companies Act 61 of 1973, s 384(1). The Companies Act 61 of 1973 still applies to the liquidation of insolvent companies whilst the Companies Act 2018 applies only to solvent companies. The Master plays a pivotal role in every stage of the administration of the insolvent estate. In *Ex parte The Master of the High Court South Africa (North Gauteng)* [2011] 5 SA 311 (GNP) at 322, Bertelsmann J held that: "[E]very stage of the administration of the insolvent estates and companies and close corporations under winding up, from the launching of the original sequestration or liquidation application to the rehabilitation of the insolvent or the deregistration of the corporate entity, is controlled by the Master's office. Its duties include many specialised functions and administrative tasks that can only be carried out efficiently by a dedicated organisation that exists specifically for that purpose".

²³ *Murgatroyd v Van Den Heever NO* (20456/2014) [2014] ZAGPJHC 142; [2014] 4 All SA 89 (GJ); 2015 (2) SA 514 (GJ), where it was held that "[N]o provision is made in the Companies Act for the taxation of a business rescue practitioner's remuneration, disbursements and expenses".

3. **Mayday! South African Airways: History, background and the commencement of the proceedings**

In order to understand the controversy surrounding the SAA rescue procedure, it is necessary to provide some background information regarding the company, its financial difficulties, as well as the main reasons behind its struggles in the lead up to the commencement of the formal rescue proceedings.

SAA is a state-owned company in terms of the Companies Act and the Public Finance Management Act 1 of 1999 (the Public Finance Management Act),²⁴ a fact that places the company and its affairs in the media spotlight as well as in the general public's concern.²⁵

As a state-owned company the Public Finance Management Act applies to the governance of the company. According to the preamble of the Public Finance Management Act, its aim is: "[T]o regulate financial management in the national government and provincial governments; to ensure that all revenue, expenditure, assets and liabilities of those governments are managed efficiently and effectively; to provide for the responsibilities of persons entrusted with financial management in those governments; and to provide for matters connected therewith."²⁶ The clear intent, therefore, is to ensure some measure of proper financial oversight where public entities are involved, in order to safeguard the wealth and prosperity of these entities for the benefit of the state and economy and consequently the South African taxpayer.

Despite the extensive level of oversight envisioned by the Public Finance Management Act,²⁷ the struggles of SAA are well-documented and relate to the company's financial decline over several years.²⁸ The company has a history of receiving substantial bailouts and it is estimated that the cumulative government cash bailouts received by SAA amounts to ZAR 57 billion prior to the commencement of business rescue proceedings.²⁹ Even

²⁴ Companies Act, s 1. The Act defines a state-owned company as an enterprise registered in terms of the act and also listed as a public entity in Sch 2 or 3 of the Public Finance Management Act. SAA is in fact listed in Sch 2 of the Public Finance Management Act as a public entity, and is described as the national carrier to engage in passenger airline and cargo transport services, and other related services.

²⁵ S Mantshantsha, "Since 1994 the government has given SAA more than R57, 000, 000, 000 in bailouts. Now is the time to stop the madness", Business Maverick, 18 November 2019. Article available at <https://www.dailymaverick.co.za/article/2019-11-18-since-1994-the-government-has-given-saa-more-than-r57000000000-in-bailouts-now-is-the-time-to-stop-this-madness/>. This article quite adequately describes the public's perception of the entity: "SAA is an overstuffed, inefficient and ancient dinosaur that, except for a steady stream of taxpayer funds, has been bankrupt for the past 25 years."

²⁶ Public Finance Management Act, preamble.

²⁷ *Ibid.*

²⁸ G Nell, "South African Airways: Brace for Impact or Fly off into the Sunset?", INSOL World 3rd Quarter 2020, 6, [8] where it is stated that "SAA was in dire financial distress long before the business rescue process commenced. The BR Plan made mention of amongst others that: SAA suffered significant losses in each financial year since 2012..."

²⁹ S Mantshantsha, "Since 1994 the government has given SAA more than R57, 000, 000, 000 in bailouts. Now is the time to stop the madness", Business Maverick, 18 November 2019. Article available at <https://www.dailymaverick.co.za/article/2019-11-18-since-1994-the-government-has-given-saa-more->

more alarming than this exorbitant bailout figure in a poverty stricken jurisdiction such as South Africa, are the main reasons behind the financial distress and decline. The dire financial straits of SAA can be directly attributed to years of mismanagement and corruption.³⁰ In May of 2020 the former chairperson of the board of directors of SAA, Dudu Myeni, was declared a delinquent director for the remainder of her lifetime in terms of the Companies Act due to her "...dishonesty, breach of fiduciary duty, recklessness and gross negligence..." as chairperson of the SAA board.³¹

Regardless of the reasons for the financial difficulties of the company, it was evident that steps would have to be taken to deal with its challenges. In South Africa, commercial airlines are treated the same as any other company suffering financial difficulty. The same options regarding insolvency procedures are, therefore, available to airlines; that is a) liquidation as terminal procedure in terms of the Companies Act 61 of 1973, or b) business rescue or a compromise in terms of Chapter 6 of the Companies Act.

Past experience illustrates that the South African government is exceptionally keen to keep its national carrier and to keep the enterprise under its control.³² As such, it comes as no surprise that the government played a significant role in the initiation of SAA's voluntary business rescue proceedings, despite the company being hopelessly insolvent. On 4 December 2019, the Minister of Public Enterprises issued a statement that confirmed that the company's board, with the support of government, resolved to initiate business rescue proceedings after a letter by the president, Cyril Ramaphosa, to the cabinet was leaked stating that SAA must enter the rescue process. There are, therefore, a number of anomalies with regard to how the law has been applied in this case with a clear inference

than-r57000000000-in-bailouts-now-is-the-time-to-stop-this-madness/. The article states that "[I]nstead, the audited annual reports of SAA and national treasury documents show that more than R57 billion has been wasted bailing out a perennially loss-making entity, thus giving its management and workforce no incentive to run as a successful commercial entity". See also *Organisation Undoing Tax Abuse and Another v Myeni and Others* (15996/2017) [2020] ZAGPPHC 169 [276] where it was held that "[I]t is a matter of public knowledge that SAA received billions in government guarantees, leaving government liable should SAA default on any of its liabilities".

³⁰ *Idem*, "Compounding its status as an uncompetitive and lethargic operator, SAA has been a victim of a sustained campaign of looting, both by the government officials who play the role of shareholder, and the executives charged with advancing the operator's best interests. The past ten years, under the board chairmanship of Dudu Myeni, have seen the worst rampant theft of public resources at SAA." See also *Organisation Undoing Tax Abuse and Another v Myeni and Others* (15996/2017) [2020] ZAGPPHC 169 [276] where it was held that "[I]t will not be inappropriate for this Court to take judicial notice of the immense harm that was done to the country and its people in the last years due to the mismanagement, not only of SAA, but also other SOE's and the suffering that it brought and continues to bring to millions of South Africans".

³¹ Companies Act, s 162(5); and *Organisation Undoing Tax Abuse and Another v Myeni and Others* (15996/2017) [2020] ZAGPPHC 169 [278], [285]. Ms Myeni also received a cost order against her and the court referred the matter to the National Prosecuting Authority for further investigation.

³² The possibility of privatisation and private investment have been contentious discussion topics in the ongoing debate about the future of SAA. See P Ash, "Opposition parties slam 'immoral' SAA bailout in Tito Mboweni's mini-budget", Times Live, 28 October 2020 article available at <https://www.timeslive.co.za/news/south-africa/2020-10-28-opposition-parties-slam-immoral-saa-bailout-in-tito-mbowenis-mini-budget/>.

being drawn that state-owned companies operate in accordance with a separate set of rules.

Loubser recently commented that it is her belief that business rescue is not an appropriate (pre-)insolvency procedure for state-owned companies.³³ Moreover, she is of the firm opinion that it would have been in the interest of all stakeholders had the company rather been wound-up. In light of the discussion regarding the cost of proceedings to follow, this is an important comment.

The purpose of this paper is not to reflect on how the law relating to the procedure has been implemented or what the BRPs' plans for restructuring SAA entail. However, it must be noted that the procedure was not without turbulence. Due to a lack of funding offers and issues in relation to the employees of SAA, the business rescue plan was only adopted approximately eight months after the commencement of the proceedings, a task which should have been completed within 25 business days.³⁴ Moreover, the global COVID-19 pandemic had a devastating effect on the aviation industry in general and SAA was not left unscathed by this unforeseen occurrence, which had a significant influence on any plans for rescue.

Ultimately, the South African government stepped into the breach, once again committing to another ZAR 10,5 billion on top of the ZAR 6,5 billion granted in February 2020 to fund the rescue of the company.³⁵ The statement was met with disdain from the general public who saw yet more money diverted from the poor and being given to bail out an insolvent SAA.³⁶

SAA exited the business rescue proceedings in May 2021 after extensive Government intervention and with a strategic equity partnership in the works.³⁷

³³ Emeritus Professor Anneli Loubser (University of South Africa), commenting during the INSOL International ERA Coffee break held on 16 September 2020, during a discussion on commercial airlines and COVID-19. Comments referenced with permission.

³⁴ The business rescue plan was adopted on 14 July 2020. Approximately 86 per cent of the creditors entitled to vote passed the resolution to adopt the plan in accordance with s 152(2)(a) of the Companies Act, which requires the vote to be passed with a 75 per cent approval threshold.

³⁵ G Nell, "South African Airways: Brace for Impact or Fly off into the Sunset?", INSOL World 3rd Quarter 2020, 6, [8]; and P Ash, "Opposition parties slam 'immoral' SAA bailout in Tito Mboweni's mini-budget", Times Live, 28 October 2020. Article available at <https://www.timeslive.co.za/news/south-africa/2020-10-28-opposition-parties-slam-immoral-saa-bailout-in-tito-mbowenis-mini-budget/>.

³⁶ P Ash, "Opposition parties slam 'immoral' SAA bailout in Tito Mboweni's mini-budget", Times Live, 28 October 2020. Article available at <https://www.timeslive.co.za/news/south-africa/2020-10-28-opposition-parties-slam-immoral-saa-bailout-in-tito-mbowenis-mini-budget/>. See also R Mahlaka, "The poor will pay for SAA", Business Maverick, 27 September 2020. Article available at https://www.dailymaverick.co.za/article/2020-09-27-the-poor-will-pay-for-saa/?utm_campaign=snd-autopilot&fbclid=IwAR2eBUyjFD-XSNERLW1N8OhIRouLB-B4IHx-DZpT3XI-7 P2CoE6NKtpYA where the resultant budget cuts are discussed.

³⁷ "SAA exits business rescue". News article available at <https://www.news24.com/fin24/companies/industrial/just-in-saa-exits-business-rescue-20210430>.

3.1 The business rescue practitioners of South African Airways and their initial fees and expenses

It is against the preceding backdrop of a mismanaged, struggling and money-guzzling state enterprise that the initial fees and expenses claimed by the appointed BRPs should be assessed.

As SAA is a state-owned company the BRPs (and by virtue of being senior BRPs) are entitled to the highest bracket of fees as set out in the regulations to the Companies Act.

The BRPs were obliged to disclose their fee arrangements in Part A of the business rescue plan.³⁸ The practitioners stated in the SAA business rescue plan that they would not be claiming any additional funding in terms of the Companies Act,³⁹ meaning they were not planning on entering into a contingency fee arrangement with the company. Based on this, one would expect to have seen fees that are commensurate with the amounts stated in the regulations, which are, for a state-owned company, remuneration that does not exceed ZAR 2,000 per hour, up to a maximum of ZAR 25,000 per day.⁴⁰

The two appointed BRPs released details on the fees and expenses they were paid over a period of roughly two months.⁴¹ The focus of this paper will be on the initial disclosure relating to fees.⁴²

The two-month period started on 5 December 2019 and ended on 31 January 2020. Evidently, this included the 2019 festive period usually celebrated between the 25th of December and the 1st of January. Disregarding the festive period and including all weekends, the total number of days for this period amounts to 57 days. Although it is extremely unlikely that both of the BRPs provided their services for the full 57 days (for the entirety of every day), the assumption will be made for purposes of this argument that this is the case. A very basic calculation can then be made – if the BRPs claimed fees for 57 days against the prescribed rate of ZAR 25,000 per day, it would amount to ZAR 1,425,000

³⁸ Companies Act, s 150(2)(a)(v).

³⁹ *Idem*, s 143(2). The business rescue plan published on 16 June 2020 on p 74 at para 21.2, states that: “[T]he BRPs, however, will not be proposing an agreement providing for further remuneration, additional to the prescribed tariff, in terms of section 143 or the Companies Act”.

⁴⁰ Regulations to the Companies Act, reg 128(1)(c).

⁴¹ The remuneration and disbursements claimed in this period were widely publicised with several media outlets reporting on the exact fees. The BRPs were also asked to comment on their fees and expenditure by these outlets as well as to the Parliamentary Standing Committee on Public Accounts. The amounts used in this paper were not disputed by the practitioners. See “SAA business rescue practitioners were paid R36m”, IOL, 9 June 2020. Article available at <https://www.iol.co.za/news/politics/saa-business-rescue-practitioners-were-paid-r36m-49150503>; and R Mahlaka, “Flying high: SAA rescue practitioners defend their R30m fees”, Business Maverick, 27 May 2020. Article available at <https://www.dailymaverick.co.za/article/2020-05-27-flying-high-saa-rescue-practitioners-defend-their-r30m-fees/>.

⁴² More information regarding the case and the cost of the proceedings have come to light and, where relevant, mention has been made of this information in this section.

each for the period in question. However, one BRP claimed ZAR 1,996,749.88 for this period whilst the other claimed ZAR 11,469,323.14 for the same period.

At first glance it would appear that the BRPs are claiming remuneration outside of the legislative remuneration framework. Of course, it is not envisaged that the BRPs should only be paid fees, but that their reasonable disbursements and expenses should also be paid. As both BRPs indicated that they were not entering into a contingency fee arrangement, it is reasonable to assume that the balance of their invoiced remuneration should be attributed to disbursements and expenses. This translates to ZAR 571,741.88 for the one BRP and ZAR 10,044,323.14 for the other. Insolvency practitioners will invariably come across the need to incur certain expenses which, at times, could be expensive as it might relate to the use of other professionals.⁴³ However, it is unclear what the disbursements and expenses in relation to these amounts refer to or include, as the summary of the BRPs' remuneration already sets out the amounts owing to (a) legal advisers to the BRPs (ZAR 12,154,325.72);⁴⁴ (b) international aviation restructuring advisers to the BRPs (ZAR 30,010,576.15);⁴⁵ and (c) an accounting firm to assist with the liquidation calculation (ZAR 25,069,361.44).⁴⁶

The question that immediately comes to mind regarding these disbursements and expenses is this: if the fees for legal and consulting services are listed separately and evidently amount to quite an exorbitant expenditure for 57 days' work, what does the considerable balance of the BRPs' fees relate to for the same period?

A number of issues arise from the disclosed remuneration package and the expenses for the two-month period. These issues will now be considered in light of the nature of the BRP's office, as well as accepted international best-practice guidance on the particular issues and the practical consequences.

⁴³ L Jacobs, "Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy?", *INSOL International Special Report* (August 2020) 58-61. See also R Mahlaka, "Flying high: SAA rescue practitioners defend their R30m fees", *Business Maverick*, 27 May 2020. Article available at <https://www.dailymaverick.co.za/article/2020-05-27-flying-high-saa-rescue-practitioners-defend-their-r30m-fees/> where it is reported that "Dongwana and Matuson have defended their use of consultancy firms, saying 'it is not outside the norm' as the duo requires a 'supporting team of highly skilled professionals, especially in a company of the size and complexity' of SAA..."

⁴⁴ R Mahlaka, "Flying high: SAA rescue practitioners defend their R30m fees", *Business Maverick*, 27 May 2020. Article available at <https://www.dailymaverick.co.za/article/2020-05-27-flying-high-saa-rescue-practitioners-defend-their-r30m-fees/>. The practitioners are reported as saying "given the complex legal issues that emanate from a business rescue process involving many different aspects of the law".

⁴⁵ *Idem*, "A&M was hired to develop scenarios on how to restructure SAA such as cutting unprofitable flight routes (regional and international) and using SAA's subsidiary, Mango Airlines, as the main mechanism through which the airline will only operate domestic flight routes".

⁴⁶ *Idem*, "This undertaking [by PwC] is crucial in enabling the BRPs to assess whether a business rescue would yield a better return to creditors and for creditors to then make an assessment as to whether to support the BR process or support an immediate liquidation of the company".

4. Course correction: best practice guidance and ethical considerations

Unfortunately, there is not a great deal of jurisprudence on the matter of BRPs' fees or even a great number of cases dealing with nuanced elements of the topic. As such it would be informative and sensible to investigate the matter by looking for best practice guidance elsewhere.

To this end the *UNCITRAL Legislative Guide on Insolvency Law*,⁴⁷ the recent *INSOL International Ethical Principles for Insolvency Professionals*⁴⁸ and even foreign judgments pertaining to the topic can offer some assistance in an attempt to critically reflect on the facts relating to the remuneration and expenses of the BRPs in the SAA case.

From the preceding discussion the following issues have been identified for discussion.

4.1 Public perception

The large media outcry and discussions at the meetings of the Parliamentary Standing Committee on Public Accounts relating to the fees and disbursements claimed by the BRPs, are clearly indicative of the public's perception that the BRPs have claimed vast amounts of money in relation to the performance of their duties, but yet did not have much to show by way of any results.⁴⁹

The consequences of this are that the public will invariably start to mistrust rescue professionals. Not only will the ethics of their conduct be called into question but also their competency. A lack of trust and confidence in the profession erodes its efficacy in bringing about successful rescues and / or ensuring that returns to creditors for failed companies can be maximised.⁵⁰ If the public forms the opinion that these professionals are unethical and incompetent, it would result in fewer directors taking steps to initiate rescue and fewer creditors would vote in favour of restructuring plans, etcetera.

These anticipated consequences could have been minimised had the BRPs been more transparent and frank in the disclosure of their remuneration and expenditure.

⁴⁷ *UNCITRAL Legislative Guide on Insolvency Law*, 2004, available online at http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf.

⁴⁸ *INSOL International Ethical Principles for Insolvency Professionals* (INSOL International, London, 2019).

⁴⁹ Meeting of the Parliamentary Standing Committee on Public Accounts held on 15 May 2020. Chairperson: Mr M Hlengwa. Meeting summary available at <https://pmg.org.za/committee-meeting/30235/> and provides that "[T]he Department made it clear that they were not happy with these endless extensions and the fact that there was no business rescue plan after five months of work and the amount of money and fees that have been earned"; and "[T]he Minister asked how can the business practitioners justify taking R5.5 billion and spreading it over 162 days and not having a credible business plan for a viable business to emerge?"

⁵⁰ L Jacobs, "Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy?", *INSOL International Special Report* (August 2020) 1.

4.2 Disbursements and expenses

The main issue in relation to the actual amounts disclosed by the BRPs for the two-month period are their “excess baggage claims” – the exorbitant amounts paid as disbursements and expenses.

On 4 November 2020, at another meeting of the Standing Committee on Public Accounts, the BRPs acknowledged the issue with regard to their costs raised by various members of the committee. The BRP said: “The BRPs had teams that did various things. In addition to the team there were various levels of advisors that were involved in order to assist. SAA had been subjected to litigation from various quarters and had to negotiate with creditors for them to continue providing services to SAA to keep the airline operating. SAA did not have the funding to pay them. All of those matters required expert advice to augment what was in the BRP teams.”⁵¹

The first set of expenses relate to what is commonly known as disbursements and can be defined as sums paid to the BRP or his firm to third parties of costs incurred by the BRP, which are charged to the estate.⁵² These types of disbursements refer to monies paid to the BRPs for expenses incurred by them or their firms in the discharge of their duties. This serves to reimburse the BRPs.⁵³ The balance due to the SAA BRPs in terms of their disclosed fees would in all probability relate to this type of expenditure. The BRPs and the Minister mention the teams working with the BRPs in the performance of their duties.

The second set of expenses relate to what is commonly known as third-party costs and can be defined as sums paid directly from the estate to third-party suppliers.⁵⁴ Third-party costs would be paid to parties who rendered services which were not paid by the BRP but by the estate.⁵⁵ The legal and other professional services used by the BRPs could fall within this category.

It should be noted that there might be some overlap between these two forms of expenditure.

⁵¹ Meeting of the Parliamentary Standing Committee on Public Accounts held on 4 November 2020. Chairperson: Mr M Hlengwa. Meeting summary available at <https://pmg.org.za/committee-meeting/31392/>. At an earlier meeting of the Standing Committee on Public Accounts on 15 May 2020, one of the BRPs stated the following when questioned about their fee arrangement: “The fees of the BRPs were regulated by the CIPC. The fees of the rest of the team can be provided to the Committee.” The Minister of Public Enterprises, Pravin Gordhan, in commenting on the BRP’s statement said: “On the issue of fees, a total of R30 million was shared between the two business rescue practitioners over four months. The hourly rate that is in the legislation was not a reflection of the amount of money the team was receiving. Each practitioner came with different teams.” Meeting summary available at <https://pmg.org.za/committee-meeting/30235/>.

⁵² *INSOL International Ethical Principles for Insolvency Professionals* (INSOL International, London, 2019) p 9.

⁵³ L Jacobs, “Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy?”, *INSOL International Special Report* (August 2020) 58.

⁵⁴ *INSOL International Ethical Principles for Insolvency Professionals* (INSOL International, London, 2019) p 9.

⁵⁵ L Jacobs, “Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy?”, *INSOL International Special Report* (August 2020) 58.

As fiduciaries, BRPs have a duty to minimise the extent of the impact of these types of administrative costs on the wealth of the estate.⁵⁶ Moreover, the incurring of these expenses is dependent upon their commercial judgement, reasonably exercised.

In relation to the disbursements for the teams of workers that provided assistance to the BRPs, one feels compelled to observe that this would most definitely fall outside the scope of what was intended by the relevant legislation. It brings about a situation where the fees of the key players are prescribed and regulated, but as for the fees of the people who they employ to work with them, it may be charged at any amount they like. One might argue that due to the size of SAA and the complexity of the case, assistance from a large team of people might be warranted. The counter argument, however, would be that given the very short time frame to which the disclosed amounts apply, these disbursements seem exorbitant in proportion to the time to which it relates. It might also seem as though the BRPs found a loophole to charge more remuneration and fees than what is allowed for within the governing legislation.

Unfortunately the BRPs were not very transparent regarding the expenses of their teams, allowing for too many negative inferences to be drawn as to their conduct and behaviour. There should be a full and frank disclosure of why they incurred the expenses – proving that it was reasonably incurred in the discharge of their stewardship.⁵⁷ Moreover, no determination could be made as to the necessity or reasonableness of the expenses claimed for their teams.⁵⁸ The BRPs seem to operate under the incorrect impression that they have an automatic right to be reimbursed for every expense incurred by them.

The BRPs' approach to the remuneration of their own support teams and other direct expenses in such a high-profile case will most assuredly have an impact on the behaviour of rescue professionals in South Africa. More BRPs might attempt to augment their own fees by claiming disbursements for work done by their support teams.

The other disbursements and third-party costs relating to the professional services the BRPs of SAA required, should also be examined. As a starting point, it should be noted that the need and use of professional services are commonplace in insolvency practice. However, multiple sets of professionals⁵⁹ translate to multiple sets of professional fees and disbursements. These expenses are not subject to any outside scrutiny and it is solely the responsibility of the BRPs to ensure that the invoices presented are scrutinised. As part of their fiduciary duties towards the affected parties, the BRPs should take care to ensure that no unnecessary tasks are performed and that work is not duplicated.⁶⁰

⁵⁶ *Ibid.*

⁵⁷ *Kao Chai-Chau Linda v Fong Wai Lyn Carolyn* [2015] SGHC 260, [2016] 1 SLR 21, 35 [32] [Singapore].

⁵⁸ Regulations to the Companies Act, reg 128(1)(3).

⁵⁹ The BRPs, the accountants, the lawyers and the aviation experts.

⁶⁰ L Jacobs, "Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy?", *INSOL International Special Report* (August 2020) 59, 68 where it states that "[I]n this regard CIPs as fiduciaries have a duty to negotiate the best possible rates and should subject every bill received to intense scrutiny".

Although the BRPs of SAA provided valid explanations as to why they were in need of the professional services, the amounts claimed for these expenses can only be deemed reasonable if it is also proportionate to the size of the estate and its assets; proportionate to the benefit obtained from the work; and proportionate to the difficulty and importance of the task and the time that has elapsed.⁶¹ Moreover, it is a reasonable inference to draw that, as fiduciaries, the BRPs acting in good faith and in the best interest of their beneficiaries ought not to claim fees that are exorbitant when weighed against the factors set out above. To this end, it is difficult to see how the BRPs would be able to justify an expenditure of ZAR 67,234,263.31⁶² as being proportionate when weighed against all of the factors mentioned. As mentioned earlier, one of the main criticisms levelled against the BRPs was their lack of visible progress. It also cannot be said that reasonable expenses were claimed if the work done was complex and for a large corporation with various stakeholders, but the remuneration and expenses claimed depleted a large proportion of the funds available for the continued operation of the airline or for distribution to creditors.⁶³

4.3 Transparency

Most of the issues already discussed could have been mitigated by a more transparent approach by the BRPs.

“...the core principle which undergirds the remuneration process is transparency, which behoves disclosure, and the central objective of disclosure is to allow an informed decision to be made.”⁶⁴

The summaries of the meetings of the Parliamentary Standing Committee on Public Accounts, the media reporting on the business rescue procedure and the conduct and decisions of the BRPs, make it apparent that there is a large information gap or information asymmetry⁶⁵ present in this case. Several members of the Standing Committee on Public Accounts had trouble coming to grips with some of the practical aspects of the rescue procedure and the role and powers of the BRPs in the procedure. The lack of information

⁶¹ *Conlan v Adams* [2008] WASCA 61 [47] [Australia]; *Sanderson as Liquidator of Sakr Nominees Pty Ltd (in liquidation) v Sakr* [2017] NSWCA 38, [55] [Australia] where it was held that “...the question of proportionality is a well recognised factor in considering the question of reasonableness...”

⁶² The sum of the amounts owing to (i) legal advisers to the Business Rescue Practitioners (ZAR 12,154,325.72); (ii) International Aviation restructuring advisers to the Business Rescue Practitioners (ZAR 30,010,576.15); and (iii) an accounting firm to assist with the liquidation calculation (ZAR 25,069 361.44).

⁶³ L Jacobs, “Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy?”, *INSOL International Special Report* (August 2020) 43; M Murray and J Harris, *Keay’s Insolvency Personal and Corporate Law and Practice* (10th ed, Thomson Reuters, 2018) at 433; and *Re On Q Group Ltd (in liquidation)* [2014] NSWSC 1428.

⁶⁴ *Kao Chai-Chau Linda v Fong Wai Lyn Carolyn* [2015] SGHC 260, [2016] 1 SLR 21, 59 [A 14] [Singapore]. See also *Re Korda; in the matter of Stockford Ltd* (2004) 140 FCR 424 at para 35 [Australia].

⁶⁵ J Dickfos, “The Costs and Benefits of Regulating the Market for Corporate Insolvency Practitioner Remuneration”, *Int Insolv Rev* (2016) 25 56.

and practical knowledge played a significant role in how the procedure and the officeholders were perceived by the key role players and the public.

Transparency and fiduciary duties are inextricably linked.⁶⁶ It is important that an insolvency practitioner be transparent regarding his fees and the cost of proceedings from the outset. The level of detail required should be proportionate to the complexity of the appointment. Understanding the steps to be taken in a case with a complex set of facts or legal issues, would necessarily require a more detailed explanation in order to place parties in the best position to appreciate what steps are required.

In a case such as SAA, where scrutiny will be at its highest due to the already contentious history and circumstances, one would expect the BRPs to offer an abundance of detailed information to help the affected parties and taxpayers better understand the complexity of the task they faced and to educate, rather than to be unclear and secretive in their dealings and conduct.⁶⁷

A sensible approach for the BRPs would have been to provide clarity on the following: (a) the identity and seniority and years of experience of the person who performed the work (the people on their teams); (b) the circumstances of the appointment, including any unusual features of the tasks to be undertaken or details regarding circumstances giving rise to urgency or special attention (various unique issues in relation to the SAA case explained in practical terms); (c) the need for and the role of various team members (each person had a unique task); and (d) time spent on performing the various tasks.⁶⁸ These details clearly relate to the creation of a narrative that would enable stakeholders to understand the practicality of the work performed by the BRPs and, consequently, the remuneration and expenses sought.⁶⁹

This approach would also have assisted in managing the unrealistic expectations of the stakeholders and the public. Often these parties have unrealistic views as to what the insolvency practitioner will do and what the outcomes of the procedure will be.⁷⁰

⁶⁶ L Jacobs, "Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy?", *INSOL International Special Report* (August 2020) 51. In relation to the duty of fiduciaries to account, see *Kao Chai-Chau Linda v Fong Wai Lyn Carolyn* [2015] SGHC 260, [2016] 1 SLR 21, 31 [24] [Singapore]; and *Mirror Group Newspapers plc v Maxwell (No 2)* [1998] 1 BCLC 638, 648 [England].

⁶⁷ L Jacobs, "Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy?", *INSOL International Special Report* (August 2020) 65 states that "[I]gnorance of insolvency practice often contributes to and exacerbates remuneration disputes. Remuneration frameworks should assist in educating stakeholders by requiring that CIPs be as forthright and transparent as possible regarding their remuneration and expenses throughout their appointment".

⁶⁸ *Re Econ Corp Ltd (No 2)* [2004] SGHC 49, 264, 288 [61] [Singapore].

⁶⁹ L Jacobs, "Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy?", *INSOL International Special Report* (August 2020) 54.

⁷⁰ J Dickfos, "The Costs and Benefits of Regulating the Market for Corporate Insolvency Practitioner Remuneration", *Int Insolv Rev* (2016) 25 56 [61].

4.4 Market-related fees critique

There is another issue in relation to the issues discussed above. It is possible that BRPs are inflating their disbursements in order to fill the gap left by non-market related fees.

BRPs have not seen an increase in their fee structure since the inception of the procedure in 2011. Many practitioners are of the opinion that the current remuneration framework is no longer market-related when considering the specialist knowledge, skills and experience they bring to the table.⁷¹

The prescribed fees contained in the regulations to the Companies Act can be viewed as a time-based fixed fee⁷² method of calculation or determination of quantum. The biggest ethical stumbling blocks in cases such as these are that it is often not representative of the value of the work done and can be disproportionate as well as leading to delays and inefficiency.⁷³ BRPs might feel that they have invested more time and resources to complete the work than is reflected by the fee they receive.⁷⁴ A fixed fee cannot be said to represent a fair method of calculating remuneration, unless the remuneration framework allows for the adjustment of the fee in cases where it proves necessary.⁷⁵ This does not, however, excuse ethically dubious practices by insolvency professionals.

A rogue approach to the inflation of fees in this manner will lead to increased scrutiny and critique of the profession as it would encourage dishonest behaviour by BRPs.

It is recommended that practitioners should advocate for reform in this area and for the prescribed remuneration to be reconsidered from time to time, or perhaps for a proposal to include a provision that the amount fixed by legislation might be amended when it has been demonstrated that more work has been done on the tasks than appears from the fees.

4.5 Lack of an adequate review mechanism

As stated earlier, the fees of BRPs in South Africa are not subject to any form of formal taxation and should a stakeholder feel aggrieved by the remuneration claimed by a BRP, his only recourse would be to the court.⁷⁶ The lack of an adequate review mechanism constitutes a major shortcoming in the provisions relating to the remuneration framework

⁷¹ A Crotty, "Conflicts of interest, backtracking and moving the chessboard pieces", Moneyweb, 27 July 2020. Article available at <https://www.moneyweb.co.za/news/companies-and-deals/conflicts-of-interest-backtracking-and-moving-the-chessboard-pieces/>.

⁷² L Jacobs, "Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy?", INSOL International *Special Report* (August 2020) 22.

⁷³ *Idem*, p 27.

⁷⁴ *Ibid*.

⁷⁵ *Idem*, p 28.

⁷⁶ *Murgatroyd v Van Den Heever N.O.* (20456/2014) [2014] ZAGPJHC 142; [2014] 4 All SA 89 (GJ); 2015 (2) SA 514 (GJ) where it was held that "[N]o provision is made in the Companies Act for the taxation of a business rescue practitioner's remuneration, disbursements and expenses".

of these professionals in South Africa. This is especially the case given the fact that the remuneration of liquidators in the same jurisdiction are heavily regulated and subject to stringent taxation.

This disparity between the two branches of the insolvency profession in South Africa creates an inconsistent attitude and approach to remuneration by the insolvency practitioners. It is argued that the lack of a proper review mechanism encourages BRPs to “fly first class” when they should be in “economy class”. Stated differently, the lack of a proper review mechanism can encourage over-charging and the incurring of expenses and disbursements that are not in line with the framework provided for by the Companies Act.⁷⁷

5. The final approach - closing remarks

Loubser recently commented that: “The SAA case has caused a lot of reputational damage to the Business Rescue Procedure”.⁷⁸

As a result of the SAA case, the public’s perception of the South African rescue procedure is that it is a long and protracted procedure; that there is a vast amount of interference and demands made by the shareholders; and that BRPs charge an arm and a leg without having much to show for it.⁷⁹ As the South African rescue regime relies heavily on the co-operation of the affected parties, this perception will not have a positive influence on the rescue procedure going forward.

The reputational damage to the procedure and the insolvency profession has been exacerbated by the BRPs’ approach to dealing with their fees and disbursements. One would have hoped that given the exceptionally contentious lead-up to their appointment and the public’s ire with SAA’s management in general, the BRPs would have taken a more sensible, transparent and even careful approach in exercising their duties.⁸⁰ Their approach reflects an attitude that is out of touch and tone-deaf given the financial burdens on South Africa and all its citizens brought about by the COVID-19 pandemic.

⁷⁷ L Jacobs, “Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy?”, *INSOL International Special Report* (August 2020) 50-51.

⁷⁸ Emeritus Professor Anneli Loubser (University of South Africa). *INSOL International ERA Coffee Break*, 16 September 2020, discussion on commercial airlines and COVID-19. Comments referenced with permission.

⁷⁹ Meeting of the Parliamentary Standing Committee on Public Accounts held on 15 May 2020. Chairperson: Mr M Hlengwa. Meeting summary available at <https://pmg.org.za/committee-meeting/30235/>. In reflecting on the BRPs’ fees, the chairperson of a meeting of the Standing Committee on Public Accounts stated the following: “This operation was not a money making scheme. The tax payer cannot continue to pay for something that has no end in sight. The Committee wants a timeline and date for when the matter would be concluded. All South Africans cannot afford an airline that will bleed South Africa further.”

⁸⁰ L Jacobs, “Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy?”, *INSOL International Special Report* (August 2020) 65 states that “CIPs should approach this task sensibly and provide the type and volume of information that would place stakeholders and especially creditors in an informed yet unconfused position”.

By seemingly allowing the BRPs in such a high-profile case to clearly flout the rules when it comes to reasonable remuneration and expenses, it will only encourage unethical behaviour in an industry that is already showing signs of a major crisis of confidence. Due to the BRPs approach in this case, the Minister of Public Enterprises, Pravin Gordhan, has called for a policy change with regard to the powers of BRPs and noted to the Public Enterprises Committee that BRPs cannot be free agents and should be held accountable “for what monies they take, for how they spend that money and for how they account for that money as well.”⁸¹

The BRP of a company has a professional duty to engender trust and confidence in the rescue procedure and the professions’ ability to deal with insolvency matters in an ethical and efficient manner. In the case of SAA, the BRPs fall short of engendering the trust and confidence the office requires, the consequences of which will only result in the need for an “air crash investigation” and urgent policy reforms to remedy the lack of trust in the industry set in motion by their approach.

⁸¹ B Ndenze, “SAA BRPS cannot be law unto themselves, says Gordhan”, news article reporting on the SAA matter available at <https://ewn.co.za/2021/02/03/saa-brps-cannot-be-law-unto-themselves-says-gordhan>.

A divided Kingdom? Insolvency law in Scotland

By Alisdair D J MacPherson, University of Aberdeen, United Kingdom*

Abstract

Insolvency law in Scotland is a complicated puzzle. Legislative competence for corporate insolvency and corporate insolvency is divided between the Scottish and the United Kingdom Parliaments and while some aspects of insolvency law are shared with the rest of the United Kingdom, others are distinctively Scottish. In this paper the background to these divisions is explained and their parameters are outlined, with particular reference made to legislative competence. This paper then reflects upon advantages of the present system, especially those that arise as a result of the large degree of alignment with the rest of the United Kingdom in corporate insolvency matters. It also considers problems with the current position and how these may be addressed (or could have been circumvented). Finally, attention is paid to what the future of insolvency law in Scotland might hold in the age of Brexit, COVID-19 and possible Scottish independence. This article recognises continuing advantages of a high degree of alignment with the rest of the United Kingdom, particularly in the corporate insolvency sphere. This would need to be carefully weighed against the consequences of any approach that involves further divergence from the rest of the United Kingdom.

1. Introduction

Insolvency law is a notoriously difficult area of law and in Scotland it is less straightforward than in many other jurisdictions. There are various reasons for this: modern legislation combined with common law stretching back centuries; the fact that legislative competence for most of personal insolvency law¹ is devolved to the Scottish Parliament while the United Kingdom (UK) Parliament has sole competence for much of corporate insolvency law; and the fact that particular aspects of insolvency law are the same as in the rest of the UK while others are distinctively Scottish.

Despite its complexity, insolvency law holds a special place in Scots law. It has a rich heritage, with a number of significant works devoted to the subject. Most notably, the Scottish institutional writer² George Joseph Bell (1770-1843) examined the whole system

* Lecturer in Commercial Law, University of Aberdeen, <https://www.abdn.ac.uk/people/alisdair.macpherson>. I am grateful to Emeritus Professor Donna McKenzie Skene (University of Aberdeen) and Dr Eugenio Vaccari (Royal Holloway, University of London) for their helpful comments on an earlier version of this paper.

¹ In Scotland, personal insolvency is known as bankruptcy and applies to certain legal entities as well as to individuals, and is discussed further below. However, due to ease of reference and for simpler comparisons with other systems, the term personal insolvency will be used in this paper.

² The institutional writers were individuals who, from the seventeenth century to the nineteenth century, produced treatises that systematised Scots law. Even in the present day, the institutional writings can be regarded as primary sources of law. For further details of the institutional writers, see eg A Rahmatian, "The Role of Institutional Writers in Scots Law", *Juridical Review* 2018 42.

of Scots law through the lens of bankruptcy,³ while a number of the most important texts from the late nineteenth century deal with insolvency and related subjects, demonstrating its ongoing importance.⁴ Even in the present day, insolvency law exerts more of a presence than in many jurisdictions. For example, insolvency law is a necessary subject of study to become a practising lawyer in Scotland. As a result, Scottish universities devote undergraduate courses to the study of the discipline.⁵

A grasp of insolvency law is not only vital for those intending to practise law in Scotland but is very helpful for those in other jurisdictions who wish to know more about the broader system of Scots law.

This paper provides insight into the Scottish system of insolvency law. It discusses legislative competence for insolvency law in Scotland and difficulties arising from the division of competence between the UK and Scottish Parliaments. It notes the infeasibility of full alignment with the rest of the UK but discusses and acknowledges advantages of the current system, including as a result of the high level of economic integration across the UK. The article proceeds to consider some of the challenges arising from the present situation and the problems that have been caused, where, for example, particular aspects of Scots law have been overlooked when UK legislation was produced or cases were decided. Suggestions are given as to how such issues could have been avoided, or might be overcome in future.

The paper then briefly assesses how the relationship between Scotland and the rest of the UK, regarding insolvency law, may be affected in the wake of Brexit, COVID-19 and the growing possibility of Scottish independence. It is asserted that there will remain advantages of alignment with the rest of the UK, particularly in relation to company law and corporate insolvency. These would need to be considered as a major factor in any weighing of policy options if divergence from the rest of the UK was being considered in future.

³ His *Commentaries on the Law of Scotland*, an institutional work, started out as *A Treatise on the Law of Bankruptcy in Scotland*, with the title changing to *Commentaries on the Municipal and Mercantile Law of Scotland Considered in Relation to the Subject of Bankruptcy* by the time the second volume of the first edition was published (Manners & Miller, Edinburgh, 1800-1804).

⁴ See H Goudy, *A Treatise on the Law of Bankruptcy in Scotland* (T & T Clark, Edinburgh, 1886, with further editions following in 1895, 1903 and 1914); W M Gloag and J M Irvine, *Law of Rights in Security, Heritable and Moveable including Cautionary Obligations* (W Green, Edinburgh, 1897); and J G Stewart, *A Treatise on the Law of Diligence* (W Green, Edinburgh, 1898).

⁵ At the University of Edinburgh, eg, it is a significant component of the compulsory second year LLB course Commercial Law; while at the University of Aberdeen, it is part of the mandatory second year LLB course Commercial Organisations and Insolvency.

2. Legislative competence

2.1 Background

Prior to devolution in the UK in the late 1990s, legislative competence for all of insolvency law in Scotland was held by the UK Parliament. Yet much insolvency legislation applicable to Scotland, especially in the personal insolvency sphere, was Scotland-only legislation rather than being UK-wide. Some of the relevant legislation pre-dated the existence of the UK Parliament, such as the Bankruptcy Act 1621 and Bankruptcy Act 1696 of the old Scottish Parliament that was dissolved in 1707. And, in spite of the Union with England, Scottish-specific legislation was produced over the centuries by the UK Parliament, including the principal governing statutes for personal insolvency law, such as the Bankruptcy (Scotland) Act 1839, Bankruptcy (Scotland) Act 1856, Bankruptcy (Scotland) Act 1913, and Bankruptcy (Scotland) Act 1985.⁶ It is unquestionable that a distinctive Scottish law of personal insolvency persisted, even with increasing political, economic and social integration across the UK following the Union.

By contrast, corporate insolvency law has principally been a UK-wide legislative endeavour. This can largely be explained by modern company law's origins in the nineteenth century, by which point Scotland was already part of the UK and because of the economic advantages of having as uniform a system as possible applying to companies operating across the UK. The Joint Stock Companies Act 1856, Companies Act 1862, Companies (Consolidation) Act 1908, Companies Act 1948, and Companies Act 1985 were among the major pieces of company law legislation to contain provisions dealing with corporate insolvency that applied to Scotland and elsewhere in the UK. The current principal legislation for corporate insolvency in the UK,⁷ the Insolvency Act 1986, covers Scotland.⁸ Nevertheless, even in the field of company law and corporate insolvency there are still some notable differences between Scots law and English law, which will be discussed further below.

⁶ For details of the history of Scots law in this area, including earlier legislation, see D McKenzie Skene, "Plus Ça Change, Plus C'est La Même Chose? The Reform of Bankruptcy Law in Scotland", *Nottingham Insolvency and Business Law e-Journal* (2015) 3 15 285, 286-290; and D W McKenzie Skene, *Bankruptcy* (W Green, Edinburgh, 2018), Ch 2. As McKenzie Skene notes, the sequestration process (the formal personal insolvency process in Scotland) was limited to traders prior to the Bankruptcy (Scotland) Act 1856.

⁷ However, only a limited number of the provisions in the legislation apply to Northern Ireland - see Insolvency Act 1986, s 441. The position with respect to insolvency law in Northern Ireland is rather complicated and cannot be dealt with here. However, see the Insolvency (Northern Ireland) Order 1989, SI 1989/2405 (NI 19), for many of the main insolvency provisions applying to Northern Ireland.

⁸ Unlike under previous legislation, corporate insolvency law is dealt with in separate legislation from the main part of company law (see the Companies Act 2006 in this regard). The Insolvency Act 1986 also contains the statutory regime for personal insolvency in English law but not Scots law. The fact that English law deals with personal and corporate insolvency law in the same statute, and that one legislature has sole competence over the relevant laws, which contrasts with Scotland on both counts, seems to suggest that the division between corporate insolvency law and personal insolvency law is narrower in England than in Scotland. Of course, however, the separation of insolvency law into personal and corporate branches in both England and Scotland means that the division is wider than in other jurisdictions like the United States of America.

2.2. Current law

Under the Scotland Act 1998, “[a]n Act of the Scottish Parliament is not law so far as any provision of the Act is outside the legislative competence of the Parliament”.⁹ If a provision relates to a “reserved matter”, it is outside the Scottish Parliament’s legislative competence.¹⁰ The question of whether a provision of an act of the Scottish Parliament relates to a reserved matter is to be determined “by reference to the purpose of the provision, having regard (among other things) to its effect in all the circumstances”.¹¹ The reserved matters are specified in Schedule 5 of the Scotland Act 1998. Some of the reserved matters expressly involve insolvency, such as the following in relation to business associations:¹²

- (a) the modes of, the grounds for and the general legal effect of winding up and the persons who may initiate winding up;
- (b) liability to contribute to assets on winding up;
- (c) powers of courts in relation to proceedings for winding up, other than the power to sist proceedings;
- (d) arrangements with creditors;¹³ and
- (e) procedures giving protection from creditors.¹⁴

As the *Explanatory Notes* to the Scotland Act 1998 state, these reservations mean that all matters leading to the commencement of winding up of business associations and matters relating to the commencement of winding up, are reserved to the UK Parliament.¹⁵ It is noted that “[t]his ensures that, so far as possible, the law relating to the winding up of business associations will be similar in England and Wales and Scotland”.¹⁶

There are, however, some exceptions to these reserved matters (being matters involving the insolvency of business associations that are not reserved). These exceptions are: the

⁹ Scotland Act 1998, s 29(1).

¹⁰ *Idem*, s 29(2)(b). The other grounds that will cause provisions to be outside the Parliament’s competence are also outlined in s 29(2). Further also see s 126.

¹¹ *Idem*, s 29(3).

¹² *Idem*, Sch 5, section C2.

¹³ Including company voluntary arrangements. See *Explanatory Notes* to the Scotland Act 1998, section C2.

¹⁴ *Explanatory Notes* to the Scotland Act 1998, section C2.

¹⁵ *Ibid.* As the *Explanatory Notes* make clear, this means that the following are reserved: the circumstances in which a business association may be wound up voluntarily or by the courts; the grounds on which a petition for winding up may be presented; the persons who may initiate a winding up; the powers of the courts on hearing a petition for winding up; the definition of the commencement of the winding up; and the liability of persons (such as shareholders) to contribute to the assets on a winding up.

¹⁶ *Ibid.*

process of winding up,¹⁷ including the person having responsibility for the conduct of a winding up or any part of it and their conduct of it or of that part; the avoidance and adjustment of prior transactions on winding up; and the effect of winding up on diligence.¹⁸ Diligence is a term in Scots law describing the processes by which court judgments for debts are enforced against a debtor's assets.¹⁹ The term is also used for the property rights arising from such processes. Ordinarily, diligences (as a form of security) give a creditor priority over other creditors but those executed within a certain period prior to the commencement of sequestration or winding up are equalised with the unsecured creditors.²⁰

It should be noted that "business association" under the insolvency-related reservations of the Scotland Act 1998 does not extend to a partnership²¹ or a trust. That is because these are subject to sequestration under the bankruptcy legislation, rather than corporate insolvency processes such as liquidation.²² Consequently, the law relating to the insolvency of partnerships and trusts is generally not reserved. For commercial purposes, it would seem preferable if business vehicles such as partnerships were subject to a regime more akin to the corporate insolvency system, which would better enable the rescue and restructuring of failing partnerships. Such an approach would be especially viable in Scots law as partnerships have separate legal personality from the partners (unlike in England).²³

A number of other aspects of insolvency law in addition to those outlined above are also reserved: preferred or preferential debts for both personal and corporate insolvency legislation; the preference of such debts against other debts and the extent of their preference over other types of debt; the regulation of insolvency practitioners; and the co-operation of insolvency courts.²⁴ However, floating charges and receivers are expressly not reserved, except in relation to preferential debts, regulation of insolvency practitioners and co-operation of insolvency courts.²⁵

More broadly, the model of Scottish devolution, whereby the Scottish Parliament can legislate in areas that are not specifically reserved, means that the absence of general

¹⁷ In other words, aspects of the process after the winding up commences - see *Explanatory Notes* to the Scotland Act 1998, section C2.

¹⁸ There are additional exceptions where the business associations are "social landlords".

¹⁹ See *Explanatory Notes* to the Scotland Act 1998, section C2. For details of the law of diligence, see L J Macgregor, D J Garrity, J Hardman, A D J MacPherson and L Richardson, *Commercial Law in Scotland* (6th edn, W Green, Edinburgh, 2020), Ch 9.

²⁰ See Bankruptcy (Scotland) Act 2016, s 24, as applied to liquidation by the Insolvency Act 1986, s 185(1)(a).

²¹ Including limited partnerships, but limited liability partnerships (LLPs) are not included in the term here.

²² Scotland Act 1998, Sch 5, section C2; Bankruptcy (Scotland) Act 2016, s 6(1) (and see s 6(2) for details of the entities whose estates cannot be sequestrated, most notably companies registered under the companies legislation and LLPs).

²³ For the law of partnerships in Scotland, see eg L J Macgregor, D J Garrity, J Hardman, A D J MacPherson and L Richardson, *Commercial Law in Scotland* (6th edn, W Green, Edinburgh, 2020), Ch 5.

²⁴ Scotland Act 1998, Sch 5, section C2.

²⁵ *Ibid.*

references to personal insolvency (bankruptcy) cause it to be within the legislative competence of the Scottish Parliament, except with respect to the reserved matters already outlined. Since the commencement of devolution, the Scottish Parliament has been active in the field of insolvency law, especially regarding personal insolvency but also extending to matters such as diligence, which affects corporate insolvency law too. Legislation has included the Debt Arrangement and Attachment (Scotland) Act 2002, the Bankruptcy and Diligence etc (Scotland) Act 2007, the Home Owner and Debtor Protection (Scotland) Act 2010 and the Bankruptcy (Scotland) Act 2016.²⁶

The combined effect of this collection of rules and overlapping competencies produces a complicated web. As a result, in some circumstances it may be difficult to discern whether an insolvency matter is reserved or not.²⁷ What can also happen is that because of the interrelated nature of various aspects of insolvency law, reforms need to deal with both reserved and devolved aspects. This also feeds through to subordinate legislation. For example, the new rules for corporate insolvency consist of the Insolvency (Scotland) (Receivership and Winding up) Rules 2018, which is a Scottish statutory instrument made by Scottish Ministers, and the Insolvency (Scotland) (Company Voluntary Arrangements and Administration) Rules 2018, which is a UK statutory instrument, albeit made with the consent of the Scottish Ministers.²⁸ More recently, responses to the COVID-19 crisis have involved the Scottish Parliament making amendments to personal insolvency, via the Coronavirus (Scotland) Act 2020 and Coronavirus (Scotland) (No 2) Act 2020,²⁹ and the UK Parliament has reformed the corporate insolvency regime through the Corporate Insolvency and Governance Act 2020.³⁰

Of course, in considering the law that is relevant to insolvency, it would be inappropriate to limit the analysis to “pure” insolvency law alone. Other areas such as company law, the law of obligations, property law, rights in security and the law of actions must also be considered. The law involving the “creation, operation, regulation and dissolution of types of business association”, including companies, is reserved,³¹ while the other private law areas mentioned are devolved. However, if a provision would otherwise not relate to

²⁶ For an in-depth discussion of insolvency legislation passed by the Scottish Parliament, see D McKenzie Skene, “Credit where Credit is Due: The Effect of Devolution on Insolvency Law in Scotland”, *Nottingham Insolvency and Business Law e-Journal* (2013) 1 5 51.

²⁷ For an example of discussion as to whether a suggested reform would relate to wholly devolved matters, see D Cabrelli, “The Case against the Floating Charge in Scotland”, *Edinburgh Law Review* (2005) 8 407, 433-436.

²⁸ This reflects the fact that administration and company voluntary arrangements are reserved, while receivership and the process of liquidation after commencement are not.

²⁹ See Coronavirus (Scotland) Act 2020, s 3 and Sch 2; and Coronavirus (Scotland) (No 2) Act 2020, s 2 and Sch 1, paras 8-14. These changes are of a temporary nature.

³⁰ Some of the changes are a temporary response to the crisis, such as restrictions on winding up petitions and orders and the suspension of liability for wrongful trading - see Corporate Insolvency and Governance Act 2020, ss 10-13 and Schs 10-11. The legislation was also used as a means to accelerate other intended changes, such as the new moratorium and arrangements and reconstructions for companies in financial difficulty - see ss 1-7 and Schs 1-9. The UK Parliament has also passed the Coronavirus Act 2020 but this does not contain substantive amendments to the insolvency law regime(s).

³¹ Scotland Act 1998, Sch 5, section C1.

reserved matters but “makes modifications of Scots private law... as it applies to reserved matters” it is to be treated as relating to such matters “unless the purpose of the provision is to make the law in question apply consistently to reserved matters and otherwise”.³² Consequently, in insolvency law, any attempt to change private law in relation to reserved matters alone will involve a reserved matter and will be solely within the competence of the UK Parliament.

A further point is that the UK is not a federal system. Despite having devolved competence, the Scottish Parliament is subordinate to the UK Parliament and the latter still has the ability to legislate in devolved matters, which can enable the clear resolution of disputes regarding legislative competence.³³ Yet if the UK Parliament is to legislate in relation to devolved matters, it will not normally do so without the Scottish Parliament’s consent.³⁴

2.3. Problems and solutions?

It is clear that the constitutional position for insolvency law in Scotland is not easy to navigate and aspects of insolvency cannot always be separated neatly on the basis of legislative competence. Instead, proposed reforms can straddle the reserved / devolved divide, with the need for involvement of both the Scottish and UK Parliaments (or Scottish and UK Governments). Reserved and devolved matters are also often interconnected and changes to the law relating to a reserved matter (for example, on a UK-wide basis) can have an impact on devolved matters, without the full effects of those changes on devolved matters being taken into account.³⁵ In addition, there can be policy divergences and inconsistencies where different legislative or executive bodies are involved and these issues transmit through to enacted laws.

An extreme solution would be for full alignment of insolvency laws with the rest of the UK. However, given the range of differences between Scots law and English law within insolvency law and in areas interacting with insolvency law, anything approaching a full alignment of laws, even in corporate insolvency, would not be feasible or desirable. And, from a political perspective, the challenge would almost certainly be insurmountable. The political direction of travel may suggest that greater divergence from the laws in the rest of the UK is likely and could also provide at least a partial solution if Scotland were to become independent or further areas of insolvency law were devolved. However, the next section will show that there are positive aspects arising both from the UK Parliament having

³² *Idem*, s 29(4).

³³ *Idem*, s 28(1). This section provides that, subject to s 29, the Scottish Parliament may make laws, to be known as acts of the Scottish Parliament, but s 28(7) stipulates that the section “does not affect the power of the Parliament of the United Kingdom to make laws for Scotland”. Whether it would be politically expedient for the UK Parliament to legislate in a devolved matter is another matter.

³⁴ *Idem*, s 28(8). This provision was added by the Scotland Act 2016, ss 2 and 72(7). It reflects a pre-existing convention known as the “Sewel Convention” – see H L Deb, 21 July 1998, vol 592, col 791 per Lord Sewel during the passage of the Bill that became the Scotland Act 1998. For further discussion of the provision and the convention, see *R (on the application of Miller) v Secretary of State for Exiting the European Union* [2017] UKSC 5; [2018] AC 61.

³⁵ For further details, see the section on “Challenges” below.

competence in certain areas and from a significant amount of alignment of Scots law with English law, as is the case at present.

3. Advantages of the current system

Despite the difficulties identified already, the current system has a number of advantages. Given the high level of economic integration between Scotland and the rest of the UK, there is desirability in having a relatively uniform regime of company law and corporate insolvency law.³⁶ The further apart that Scots law is from English law (in particular) in these areas, the more costly it can be to establish, operate and rescue, restructure or wind up a company in Scotland. This is especially true where companies are engaging in business throughout the UK. In addition, if Scots law diverges substantially from English law in the corporate sphere, there is a danger that companies will be established outside Scotland and that the Scottish economy will lose out on investment accordingly. A motivating factor for the introduction of floating charges to Scotland was that its restrictive law of security rights caused difficulties for Scottish companies in the raising of finance and, because of such restrictions, companies were being set up elsewhere in the UK instead, as the ability to grant floating charges and the ease of creating other types of security outside Scotland assisted with obtaining finance.³⁷

English corporate insolvency law and company law are well known and highly respected internationally. The greater the extent to which those laws are replicated in Scotland, the more likely it may be that Scotland can derive advantage from parties seeking to set up businesses in accordance with law akin to that applicable in England, or utilise insolvency proceedings on the English model. If the relevant laws are viewed through a competitive lens, Scots law could be considered to have the advantage of alignment with English law in most areas but could endeavour to make itself more attractive to outside investors.³⁸ Yet this may not be entirely feasible given that UK company law and much of corporate insolvency law is reserved³⁹ and the UK parliament may be unlikely to want to encourage competition among the jurisdictions of the UK. Nevertheless, there are devolved areas of law in Scotland that interact with corporate insolvency and which could be improved to “compete” with English law, such as the law of security rights.⁴⁰

³⁶ For discussion of the desirability of Scotland having its own distinct commercial law generally, see P S Hodge, “Does Scotland Need its Own Commercial Law?”, *Edinburgh Law Review* (2015) 19 299; and J Hardman, “Some Legal Determinants of External Finance in Scotland: A Response to Lord Hodge” *Edinburgh Law Review* (2017) 21 30.

³⁷ Law Reform Committee for Scotland, *Eighth Report of the Law Reform Committee for Scotland: The Constitution of Security over Moveable Property; and Floating Charges* (Cmnd 1017) (1960).

³⁸ Even if just to attract a small proportion of investment that would otherwise end up south of the border.

³⁹ In addition, London’s status as a world financial hub gives English law significant appeal too.

⁴⁰ Which, as indicated below, has been the subject of a Scottish Law Commission project with respect to moveable transactions – see Scottish Law Commission, *Report on Moveable Transactions* (Scot Law Com No 249, 2017). The Scottish Law Commission are also now examining the law of security over land – see <https://www.scotlawcom.gov.uk/law-reform/law-reform-projects/heritable-securities/>.

Another positive element is that there is a large body of law from the rest of the UK that can be drawn upon as regards corporate insolvency matters. This is particularly useful in a small jurisdiction such as Scotland that produces a relatively small amount of case law. The interrelationship between Scotland and England and the largely shared system of corporate insolvency law means that English authorities are frequently called upon. Although the authority emanating from the English courts will only be persuasive rather than binding, the UK Supreme Court is the highest court in both the Scottish and English systems⁴¹ and its decisions will (almost certainly) apply in both jurisdictions if it is dealing with legislative provisions applicable in England and Scotland. Even if the UK Supreme Court is examining provisions that are only similar to those applicable elsewhere in the UK, there may be a desire to interpret them in a way that is as consistent as possible with those other, similar provisions.

It is understandable that there is more divergence between Scots law and English law in relation to personal insolvency. There is far less of a commercial incentive for uniformity of laws across the jurisdictions and no substantial cross-border “market” for personal insolvencies. In relation to individuals, effect can also be given to differing policies that the Scottish Government and Scottish Parliament wish to pursue in comparison to those being pursued at Westminster. Policymakers within the relevant systems can even learn from one another in terms of the approaches adopted and their successes and failures.

4. Challenges

Having identified various advantages of the current system, it is necessary to further consider challenges that arise for insolvency law in Scotland due to the constitutional arrangements and the differences between Scots law and English law.⁴² As will be seen, a number of the issues could have been, and can be, avoided or ameliorated.

When UK legislation is drafted for insolvency matters, the particularities of Scots law are often overlooked or given insufficient attention. It is perhaps understandable that greater attention is paid to how legislation will apply under English law rather than Scots law, due to England’s larger size and economic and political clout. However, more regard could certainly be paid to how legislation largely designed with English law in mind will operate in a Scottish context, due to differences in areas such as property law and the law of rights in security. The failure to do so leads to uncertainty and can produce a lack of coherence between the introduced law and the underlying Scots law.

As one example, the impact of administration on diligence in Scots law is unclear. The moratorium in administration provides that no legal process (including diligence) may be “instituted or continued against the company or property of the company” except with the

⁴¹ And its membership includes justices from Scotland. The current President of the UK Supreme Court, Lord Reed, and the Deputy President, Lord Hodge, are Scottish.

⁴² These are in addition to some of the matters referred to in section 2 above.

consent of the administrator or with the permission of the court.⁴³ Yet the effect of administration on diligences already executed is not mentioned in the legislation and it is unknown whether diligence creditors are entitled to priority payments as a form of secured creditor.⁴⁴ While the moratorium provision may be viewed as treating diligence as equivalent to execution and distress in English law, and they certainly do have certain similarities, diligence confers property rights which justify particular attention and provision.

It would be unfair to say that Scots law is being deliberately disregarded⁴⁵ and it is clearly a difficult task to pass legislation in a shared area of law that interacts with rather different background laws in multiple jurisdictions. It would also be wrong to suggest that an insufficient consideration of Scots law is only an issue with Britain- or UK-wide legislation. In the rush to emulate seemingly appealing aspects of English law, inadequate regard can be paid to how the new law will fit with the surrounding Scots law. A prime example of this is the transplant of the floating charge into Scots law by legislation in 1961.⁴⁶ While there was a strong wish to replicate the commercial advantages of the floating charge, there have been significant doctrinal problems in fitting it into Scots law.⁴⁷ Insolvency-related legislation passed by the Scottish Parliament is also often far from flawless. There are, for instance, various provisions of the Bankruptcy and Diligence etc (Scotland) Act 2007 that are opaque, produce undesired consequences or have not been brought into force for political or commercial reasons.⁴⁸

A further point is that legislative interventions by the UK Parliament in insolvency law can produce more substantial consequences in Scotland than elsewhere in the UK due to differences in areas of law connected to insolvency. The Finance Act 2020 reintroduced the Crown's status as a preferential creditor by making Her Majesty's Revenue and Customs (HMRC) a secondary preferential creditor for certain taxes that the debtor has collected for onward transfer to HMRC, including value added tax, pay as you earn income tax and employee national insurance contributions.⁴⁹ Preferential debts have priority over

⁴³ Insolvency Act 1986, Sch B1, para 43(6). Also see Insolvency Act 1986, s A21(1)(e), inserted by the Corporate Insolvency and Governance Act 2020, s 1, for a similar moratorium on diligence.

⁴⁴ Albeit that this is possible and desirable – for further discussion, see A D J MacPherson, "The Circle Squared? Floating Charges and Diligence after *MacMillan v T Leith Developments Ltd*", *Juridical Review* (2018) 230.

⁴⁵ Especially since Scots law concepts are often specifically referred to and there are often specific provisions catering for Scotland. See, eg, Insolvency Act 1986, Sch B1, paras 112-116 for administration.

⁴⁶ By virtue of the Companies (Floating Charges) (Scotland) Act 1961. This followed the rejection of floating charges at common law in Scotland – see *Carse v Coppen* 1951 SC 233.

⁴⁷ See A D J MacPherson, *The Floating Charge* (Edinburgh Legal Education Trust, Edinburgh, 2020). Also note the case of *Sharp v Thomson* 1997 SC (HL) 66 mentioned below.

⁴⁸ Part 2 of the Bankruptcy and Diligence etc (Scotland) Act 2007 (ss 37-49) on floating charges has not been brought into force, in part due to successful lobbying by banks south of the border, which also demonstrates the commercial interconnectedness of Scotland with the rest of the UK. Part 4 of the Bankruptcy and Diligence etc (Scotland) Act 2007 (ss 79-145), which would replace the diligence of adjudication for debt with land attachment and residual attachment, has also not been brought into force, mainly due to fears regarding debtors potentially losing their homes.

⁴⁹ See the Finance Act 2020 ss 98-99.

the claims of ordinary unsecured creditors and floating charge holders but rank behind the claims of fixed security holders. In comparison to English law, it is difficult to obtain fixed security in Scots law, as a result of the formal requirements to constitute such security.⁵⁰ This means that there could be a greater impact on debt financing in Scotland arising from the change: lenders may be less willing to provide finance if they cannot acquire security that will enable them to rank ahead of HMRC's claims.⁵¹ If this is viewed as a negative consequence, then the Scottish Government must bear some responsibility too. The law of security rights in Scotland, which is a devolved matter, is inadequate and disadvantageous when compared with the equivalent English law. The Scottish Law Commission examined the law of moveable transactions and produced a report in 2017 with an accompanying draft Bill seeking to give effect to its recommendations.⁵² These included modernising the current law and introducing a new form of non-possessory security right to be known as a "statutory pledge", which would be created by registration in a new register.⁵³ The Scottish Government has not yet acted upon the recommendations and no draft legislation has come before the Scottish Parliament at the time of writing.⁵⁴

The UK Supreme Court is the apex court for insolvency matters throughout the UK. This is beneficial in certain respects, as outlined in the previous section. However, there have been occasions when that court or its predecessor, the House of Lords, interpreted points of Scots law in a way that was in greater conformity with English law but at the expense of coherence with the rest of Scots law. A notable example is *Sharp v Thomson*,⁵⁵ that involved the question of whether a floating charge attached to (or crystallised over)⁵⁶ a sold flat following the appointment of a receiver. The property transfer had not been completed by registration when the receiver was appointed, yet the property transfer document (the "disposition") had been given to the buyers and they had taken possession and paid the sale price. The House of Lords held that the floating charge did not attach. This case is one of the most controversial in Scottish legal history and raised considerable doubts regarding the extent to which equitable doctrines were being accepted in Scots

⁵⁰ See, eg, G L Gretton and A J M Steven, *Property, Trusts and Succession* (3rd ed, Bloomsbury, London, 2017), Ch 21.

⁵¹ The impact of the change on floating charge holders has been criticised elsewhere. See R Caldwell, "Enterprise Goes into Reverse for Floating Charge-holders", *Juridical Review* (2019) 103.

⁵² Scottish Law Commission, *Report on Moveable Transactions* (Scot Law Com No 249, 2017).

⁵³ The suitably named Register of Statutory Pledges.

⁵⁴ See <https://www.parliament.scot/parliamentarybusiness/CurrentCommittees/113651.aspx>. The Scottish Government have, however, indicated that they intend to introduce implementing legislation "early in the new Parliament" – Scottish Government, *A Fairer, Greener Scotland: Programme for Government 2021-22* (2021), 77, available at <https://www.gov.scot/publications/fairer-greener-scotland-programme-government-2021-22/documents/>.

⁵⁵ 1997 SC (HL) 66.

⁵⁶ "Attachment" is the term used in the legislation for floating charges in Scotland – see, eg, Companies Act 1985, s 463 (liquidation); Insolvency Act 1986, ss 53(7) and 54(6) (receivership); and Insolvency Act 1986, Sch B1, para 115 (administration). However, the English law term "crystallisation" is often used in practice. Provisions of the Insolvency Act 1986, inserted by the Corporate Insolvency and Governance Act 2020, also use the crystallisation terminology (see ss A21(3), A22 and A52(1)).

law, in place of its fairly strict dichotomy between personal rights and real rights.⁵⁷ A later House of Lords case, *Burnett's Tr v Grainger*,⁵⁸ that involved similar facts to *Sharp* but concerned personal insolvency, rejected a wide application of the decision in *Sharp* and re-emphasised the "traditional" Scottish approach and effectively confined the *ratio* of *Sharp* to the law of floating charges. There is thus a divergence between personal insolvency and corporate insolvency with respect to facets of the transfer of property.

It is evident that the relationship between Scotland and the rest of the UK pertaining to insolvency law and adjacent legal areas has created a number of challenges. Often, however, the issues have been compounded by legislative, executive and judicial inattention to rules and principles of Scots law which differ from English law. The positive elements arising from a large degree of alignment with English law have been discussed in the previous section. However, although uniformity with English law can be an important factor, it does not override the desirability of insolvency law rules being consistent and cohering with the rest of Scots law. Failure to respect this also gives rise to unpredictability and uncertainty. Fortunately, the challenges can be overcome in many cases by giving specific regard to how aspects of insolvency law will operate in Scots law and how they will interact with other areas, such as property law. In various contexts, this will require more receptiveness to input from experts on insolvency law in Scotland; a willingness not to consider uniformity with English law as the overriding or principal objective; and a need for closer working between those involved in insolvency law reform in the Scottish and UK Parliaments and Governments.

5. The future of insolvency law in Scotland

It should be clear by now that the insolvency law position in Scotland is a complicated puzzle. Simply perusing the Insolvency Act 1986 will demonstrate this. Some provisions apply to Scotland and the rest of Great Britain or the UK; others apply to Scotland or England and Wales only; some provisions involve different versions having effect depending on which part of the UK is concerned; and personal insolvency for England and Wales is contained in the Insolvency Act 1986 while it is entirely absent (from that Act) for Scotland. This is a reflection of the constitutional position regarding insolvency as well as the differences between the laws in different parts of the UK.

Certainly, if someone were to design an insolvency system from the outset, this is not the system that would be produced. As has been outlined already, the current system has its distinct challenges. Nevertheless, there are particular benefits too, which should not be overlooked. It is true that it is tricky to balance the commercial advantages of significant levels of alignment between the law in different parts of the UK with the need for consistency and coherence with the wider body of Scots law that differs in significant

⁵⁷ In Scottish Law Commission, *Report on Sharp v Thomson* (Scot Law Com No 208, 2007), para 1.9 it is stated: "Few cases in Scottish legal history have generated so much academic debate as *Sharp*." For relevant literature, see App B of the Report. And for more recent discussion, see A D J MacPherson, *The Floating Charge* (Edinburgh Legal Education Trust, Edinburgh, 2020), Ch 7.

⁵⁸ [2004] UKHL 8; 2004 SC (HL) 19.

respect from the other UK jurisdictions. Yet this can be achieved to a large extent if these matters are given proper (and direct) care and attention when producing legislation and deciding cases.

Recent years have, however, witnessed constitutional tumult in the UK. As well as Brexit, Scottish independence is on the agenda. Despite rejecting independence in a referendum in 2014,⁵⁹ some opinion polling in the wake of the COVID-19 crisis has shown majority support in favour of independence.⁶⁰ If Scotland were to leave the UK in the near future, there would be a number of serious issues to contend with. Some of these would be reminiscent of issues that the UK has had to face when leaving the EU, such as whether the UK Supreme Court should continue to decide matters affecting Scotland; the extent to which existing UK law would be retained for Scotland; how closely associated Scotland would continue to be with the rest of the UK legally and economically; and so on. The difficulties would, in fact, likely be even greater than those involved in the UK exiting the EU, as the UK union is longer lasting with more depth.

Decisions would need to be made as to whether Scotland would continue to align with the rest of the UK in company law and corporate insolvency law matters. Certainly, there would be significant commercial and economic sense in doing so. However, if an independent Scotland sought to become a member of the EU, then it could be faced with a need to bring its laws more closely in line with EU Member States, setting it on a different path from the UK. Such a course of action would not be without considerable risks but perhaps there could be opportunities too, especially if Scotland could capitalise on its close connections with the remainder of the UK while also obtaining the advantages of being a member of the EU.

Of course, the future path of Scotland remains uncertain, not least because the longer-term political consequences of the COVID-19 pandemic are still unknown. There is consequently a necessary element of speculation involved here. However, in any event, there will remain financial and economic pressure for a significant degree of alignment with the rest of the UK for the foreseeable future, even if Scotland did become independent. This would represent a significant weight upon any policymakers who wished to chart an alternative course and would require to be measured appropriately against the possible advantages of other options.

6. Conclusion

Scots insolvency law is the product of its unique historical development as well as economic and political forces. On the surface, its complicated constitutional position and relationship with the other systems in the UK may create a negative impression. Yet there

⁵⁹ The question was "Should Scotland be an independent country?". The result was no: 55.3%; and yes: 44.7%. For further details, see <https://www.bbc.co.uk/news/events/scotland-decides/results>.

⁶⁰ For recent opinion polls on Scottish independence, see <https://whatscotlandthinks.org/questions/how-would-you-vote-in-the-in-a-scottish-independence-referendum-if-held-now-ask/?removed>.

are advantages to a system for which there is considerable alignment with the rest of the UK in corporate insolvency matters but which allows for a distinct approach in various respects. There have been challenges as a result of the arrangements, not least where inadequate regard has been given to peculiarly Scots law matters, but these are surmountable issues. This is particularly true if the need for certainty and coherence with wider Scots law is recognised in various contexts.

Broader developments, most notably Brexit, the COVID-19 pandemic and the increasing possibility of Scottish independence, raise questions about how insolvency law in Scotland will be affected. Although constitutional changes will create new opportunities and challenges, many of the same pressures for alignment with the rest of the UK will continue to apply. It is reasonable to assume that if Scotland were to become independent, decisions about whether corporate insolvency law should increasingly diverge from the position elsewhere in the UK would be a microcosmic reflection of questions that wider society would be wrestling with. Those questions would be neither simple nor easily resolved.

A reconsideration of directors' liability for wrongful trading in the United Kingdom and the European Union in the COVID-19 era

By Hamiisi Junior Nsubuga, Middlesex University London, United Kingdom*

Abstract

This paper analyses directors' liability for wrongful trading in the United Kingdom and the European Union (specifically looking at Germany and France) and the temporary suspension of the wrongful trading rules in these jurisdictions in light of COVID-19-induced measures. This article explores whether these temporary suspensions were at all desirable and considers their potential impact on directors' business decision-making during the COVID-19 crisis period.

1. Introduction

The outbreak of the COVID-19 pandemic caused havoc on a global scale - not only to the health sectors, but also to the economic and financial sectors of almost every sovereign state worldwide.¹ This created a sense of urgency for these states to put measures in place, not only to combat the spread of the coronavirus, but also to safeguard against subsequent financial and economic impact or crises that the COVID-19 pandemic might cause. The United Kingdom (UK) and some European Union (EU) Member States, such as Germany and France, acted swiftly to put measures in place with a view of curbing / limiting the pandemic's aftermath. These measures included, *inter alia*, reviews of respective national laws and processes in the area of company and insolvency laws to ensure that businesses across these states were not heavily impacted by the pandemic.

Among the more notable changes were the temporary suspensions to the law / rule(s) on directors' liability for wrongful trading during the COVID-19 crisis period. As the UK fast-tracked the passage of the Corporate Insolvency and Governance Act 2020 (CIGA)² as a measure mitigating the impact of COVID-19 on its businesses and the economy at large, the German federal government passed the *Covid-19-Insolvenzaussetzungsgesetz* (COVInsAG),³ while the French government passed the French Emergency Act 2020,⁴

* PhD (Law), LL.M, MA, LLB, FHEA. Lecturer in Law, School of Law, Middlesex University London, UK.

¹ D M Collins, "Insolvency Act 1986 Section 214: A Suspension", *International Company and Corporate Law Review* (2020) 31(8) 441 446.

² CIGA, Ch 12.

³ Act to Temporarily Suspend the Obligation to File for Insolvency and to Limit Directors' Liability in the Case of Insolvency Caused by the COVID-19 Pandemic (COVID-19 - Insolvenzaussetzungsgesetz - COVInsAG) of 27 March 2020.

⁴ Emergency Law No 2020 - 290 of 23 March 2020 to deal with the COVID-19 pandemic.

followed by Ordinance No 2020-341⁵ and Ordinance No 2020-596,⁶ that introduced amendments to insolvency laws during the pandemic period.

This paper analyses directors' liability for wrongful trading in the UK and EU (specifically looking at Germany and France), and the temporary suspension of trading rules in these jurisdictions in light of COVID-19 induced measures. This article explores whether these temporary suspensions were at all desirable and considers their potential impact on directors' business decision-making during the COVID-19 crisis period.

2. Wrongful trading - an overview

UK and EU company and insolvency laws embody a legal framework of duties that directors of companies ought to observe while in office. This is due to the fact that the issue of directors' duties and the relationships between the company and external stakeholders are of paramount importance, not only in the solvent state of the company, but also the insolvent state. Therefore, both jurisdictions' legal frameworks on insolvency law prescribe, as a minimum, general duties which include *inter alia*, taking reasonable business decisions that would promote the success of the company by avoiding negligent conduct that might threaten the viability of the company.⁷ This seeks to ensure that the interests of the company, and those of creditors, are protected.

In situations where the company is faced with the likelihood of insolvency, directors are specifically tasked with the obligation to take immediate steps with the view of minimalising loss for creditors, workers, shareholders and other stakeholders, and to have due regard to creditor and other stakeholder interests.⁸

During the solvent state of companies, directors are bound to execute their duties in accordance with certain statutory duties and obligations. As an example, in France, the French Commercial Code⁹ (that codified directors' duties), sets out how directors should execute their duties and also provides applicable sanctions for any breaches of duties. In Germany, the *Aktiengesetz (AktG)*¹⁰ and the *Gesetz für Gesellschaften mit Beschränkter Haftung (GmbHG)*¹¹ (that codified directors' duties), sets out duties for directors of both private and public companies to observe. Key amongst these, are the duties to act in good

⁵ Ordinance No 2020 - 341 of 27 March 2020 adapting rules relating to difficulties of businesses and farms to health emergencies and amending certain provisions of criminal procedure (Ordinance No 2020-341).

⁶ Ordinance No 2020 - 596 of 20 May 2020 adapting rules relating to difficulties of businesses and farms to the consequences of the COVID-19 pandemic (Ordinance No 2020 596).

⁷ C Gerner-Buerle and E P Schuster, "The Evolving Structure of Directors' Duties in Europe", *European Business Organization Law Review* (2014) 15 (2) 191, 233.

⁸ K J Hopt, "Directors' Duties? and Shareholders' Rights? in the European Union: Mandatory and / or Default Rules?", *Rivista Delle Società* (2016) 61 13-32.

⁹ Commercial Code, arts L223-22 and L223-25.

¹⁰ Stock Corporation Act of 6 September 1965, Federal Law Gazette I, Index No 4121-1.

¹¹ Act on Limited Liability Companies, as consolidated and published in the Federal Law Gazette III, Index No 4123-1.

faith and diligence¹² and to manage the company in line with the company's articles of association and subsequent shareholder resolutions.¹³ In the UK, directors' statutory duties are codified in the Companies Act 2006 (CA 2006).¹⁴ These include duties to promote the success of the company¹⁵ and to exercise reasonable care, skill and diligence.¹⁶

Overall, directors' duties in all three jurisdictions require the director to act diligently and with good commercial judgment so as to avoid negligent business decisions (equivalent to wrongful trading) which could affect the financial viability of the company that might lead to insolvent liquidation. If this were the case, the director might be liable for civil sanction of wrongful trading for breach of duties or mismanagement of the company business.

2.1 Directors' liability for wrongful trading in the UK

When a company experiences financial difficulties and is at risk of becoming insolvent in the UK, directors are expected to act swiftly to minimise potential losses to the company itself, and to creditors, by discontinuing to trade. A director who continues trading whilst the company is likely to enter into insolvent liquidation, could be liable for civil sanction for wrongful trading as set out in the Insolvency Act 1986 (IA 1986).¹⁷ Therefore, if at some point before the commencement of the winding up process it is established (by the liquidator / receiver)¹⁸ that a director knew, or ought to have concluded, that there was no reasonable prospect of the company avoiding insolvent liquidation, and the company continued to incur liabilities nonetheless, the court on the application of the liquidator / receiver, may declare the director to be personally liable to contribute to the assets of the company to the extent that it is worse off as a result of the continuation of trading.¹⁹

This liability, however, may be absolved where a director can show that at that moment in time, he took every step necessary, which any other diligent person ought to have taken, to minimise the potential loss to creditors.²⁰ Nevertheless, the decision to absolve liability is subject to an objective standard premised on reference to the knowledge, skills and experience of the director in question.²¹

¹² *GmbHG*, s 43, para 1.

¹³ *AktG*, s 93.

¹⁴ CA 2006, ss 171 to 177.

¹⁵ *Idem*, s 172.

¹⁶ *Idem*, s 174.

¹⁷ IA 1986, ss 214 and 246ZB. The former provides the rule for companies in (insolvent) liquidation while the latter for companies in administration.

¹⁸ For example, under IA 1986, s 212(3).

¹⁹ *Idem*, s 214(1) and (2).

²⁰ *Idem*, s 214(3). See also, the reasoning in *Ralls Builders Limited (in Liquidation)* [2016] EWCH 1812 (Ch). (*Re Ralls Builders*).

²¹ IA 1986, s 214(4).

Per Snowden J in *Re Ralls Builders Ltd (in Liquidation)*:²²

“[a] director who wishes to take advantage of the defence ... needs to demonstrate not only that continued trading was intended to reduce the net deficiency of the company, but also that it was designed appropriately so as to minimise the risk of loss to individual creditors.”²³

Otherwise liability may not be absolved under section 214(3), and the director may be ordered to contribute to the assets of the company.

2.1.1 COVID-19 suspension on wrongful trading in the UK

Prior to the COVID-19 outbreak, the UK government undertook consultations in 2016²⁴ and 2018²⁵ in a bid to reform its insolvency laws and rescue processes, as many of its insolvency laws and procedures had remained unchanged since 2004 (and through the global financial crisis of 2007-2008).²⁶ These consultations were fast-tracked by the government and debated by parliament following the COVID-19 outbreak in a bid to foster legislative changes to guide and support businesses during the COVID-19 crisis period.²⁷ The debates led the UK government to publish the Corporate Insolvency and Governance Bill (the Bill)²⁸ on 20 March 2020 with provisions intended to provide businesses with increased flexibility and opportunities to continue trading during the COVID-19 period.

The Bill was granted Royal Assent and enacted into the CIGA²⁹ on 25 June 2020, implementing key insolvency and business measures to support and steer businesses and the economy through the COVID-19 crisis period. One of the most notable provisions introduced by the CIGA was the temporary suspension of liability on company directors for wrongful trading (between 1 March 2020 and 30 September 2020).³⁰

The suspension period was reintroduced by the UK government to cover the period between 26 November 2020 and 30 April 2021, pursuant to The Corporate Insolvency and Governance Act 2020 (Coronavirus) (Suspension of Liability for Wrongful Trading and

²² *Re Ralls Builders* [2016] EWCH 1812 (Ch).

²³ *Idem*, at 245.

²⁴ The Insolvency Service, *A Review of the Corporate Insolvency Framework: A Consultation on the Options for Reform*, (May 2016) (Government Consultation).

²⁵ “Insolvency and Corporate Governance”, Department for Business, Energy and Industrial Strategy, March 2018.

²⁶ Government Consultation, Executive Summary, para 24, per Sajid Javid.

²⁷ See, eg, the press release to this effect by the UK Business Secretary Alok Sharma announced on 28 March 2020, available at <https://www.gov.uk/government/news/regulations-temporarily-suspended-to-fast-track-supplies-of-ppe-to-nhs-staff-and-protect-companies-hit-by-covid-19>.

²⁸ Corporate Insolvency and Governance HC Bill (2019-21) available at <https://services.parliament.uk/Bills/2019-21/corporateinsolvencyandgovernance/documents.html>.

²⁹ CIGA, Ch 12.

³⁰ *Idem*, s 12.

Extension of the Relevant Period) Regulations 2020. The rationale behind this temporary suspension might be premised on the need to urge company directors to avoid irrational business decisions to file unnecessary insolvency proceedings during the COVID-19 crisis period in fear of potential wrongful trading liabilities.

The suspension could also prevent directors from “shutting business doors” to the public too early, even when there was a likelihood that the company could trade out of its financial difficulties during the COVID-19 crisis period. Hence, the suspension could promote business continuity and economic sustainability during the crisis period. Additionally, there was concern that, during the COVID-19 period, markets for going-concern sales of financially insolvent but viable businesses would be limited as the economy at large would be affected by financial ramifications. The government strategy was timely and welcomed to avoid unnecessary insolvency filings which were costly even in non-crisis times.

This approach by the government was, however, met with varied reactions from academics and practitioners and questions were raised as to whether the suspension of wrongful trading rules would have significant impact on the business sector and the economy at large during the pandemic.³¹ This is analysed below, following a discussion on Germany and France.

2.2 Germany

Germany is one of the EU Member States affected by the COVID-19 pandemic and it acted promptly in revising its insolvency and company laws to guard against the financial / economic impact that the pandemic presented to its economy. There are two main statutes in the German legal system that deal with public and private companies and directors’ duties. These are the *AktG* and the *GmbHG*. Both sets of legislation provide distinct rules on directors and the pursuance of their duties. The *AktG*, for example, mandates that company directors must act in good faith by observing the provisions of the company’s articles of association and shareholders’ resolutions so that company and shareholder interests are upheld and protected.³² The *GmbHG* also mandates that company directors must act in good faith and diligently in the execution of their duties.³³

However, under insolvency settings, the most prominent sanctions on directors for negligent actions or / business decisions are mandated in the *Insolvenzordnung (InsO)*.³⁴ Under the *InsO*, A company director may be sanctioned for “*insolvenzverschleppung*”: failing to file for insolvency proceedings within three weeks of inability to pay / honour

³¹ D M Collins, “Insolvency Act 1986 Section 214: A Suspension”, *International Company and Corporate Law Review* (2020) 31(8) 441, 446; and E Vaccari, “Changes to UK Insolvency Rules in the Wake of Covid-19: A Much-Needed Help for Businesses or an Unjustified Harm to the Rule of Law?” in C Ferstman and A Fagan, *Covid-19, Law and Human Rights: Essex Dialogues*, 127- 136.

³² *AktG*, s 93.

³³ *GmbHG*, s 43(1).

³⁴ Insolvency Statute of 5 October 1994 (Federal Law Gazette - Index 311-13).

outstanding debts upon demand from creditors.³⁵ This sanction is also parallel to the *Bürgerliches Gesetzbuch (BGB)* (the German Civil Code),³⁶ which provides for a civil sanction for failure to observe legislative procedure enacted for the protection of other constituents. A director who intentionally, or by gross negligence, fails to or postpones the filing of insolvency proceedings, is denied relief from these sanctions and is therefore, held liable.³⁷

In addition to civil sanctions, a director may also be liable for criminal sanction for criminal conduct related to the insolvency of the company under the *Strafgesetzbuch (StGB)* (the German Criminal Code). The *StGB* prescribes a personal criminal liability upon a director where damages are incurred by the company due to the director's negligent or reckless business conduct.³⁸ Therefore, similarly to the UK provisions, these German legislative provisions (both civil and criminal), are designed to ensure that directors act diligently to avoid negligent business decisions which may have an impact on the company's viability.

2.2.1 COVID-19 suspension on wrongful trading in Germany

Germany also acted swiftly to review its company and insolvency laws to support companies through the COVID-19 crisis period. Consequently, on 27 March 2020, the federal government passed the *COVInsAG*. This Act came into force with retrospective effect as of 1 March 2020. The most significant impact of the *COVInsAG* is the temporary suspension of the obligation on company directors to file for insolvency proceedings as originally mandated under the *InsO*³⁹ and under the *BGB* (the German Civil Code),⁴⁰ between 1 March 2020 and 30 September 2020.⁴¹

This suspension is only invoked where directors can prove that (i) the insolvent state of the company was triggered by the effects of the COVID-19 pandemic; and (ii) there was a real prospect of the company overcoming these financial difficulties. Provided that the director or managers of the company can prove that the company was not insolvent as at 31 December 2019, they can successfully utilise the provision to suspend their obligation to file for insolvency proceedings, which may then provide some breathing space for the company to navigate through its financial challenges.

The tangible benefit of this suspension is that, during this period, company directors are not liable for any sanctions arising out of their failure to timely file insolvency proceedings. In addition, directors and managers would be absolved of liability arising from violation of statutory payments prohibitions made during the ordinary course of business, courtesy of

³⁵ *Idem*, s 15(a).

³⁶ Civil Code promulgated on 2 January 2002, Federal Law Gazette (*Bundesgesetzblatt*), s 823, para 2.

³⁷ *InsO*, s 290, para 1.

³⁸ *StGB*, ss 283 - 283d.

³⁹ *InsO*, s 15a.

⁴⁰ *BGB*, s 42, para 2.

⁴¹ *COVInsAG*, s 1.

the *GmbHG*,⁴² and the *AktG*.⁴³ As such, payments would be considered to facilitate the going-concern operation of the business during the COVID-19 crisis period.

2.3 France

France is another EU Member State with an established modern insolvency law regime that enshrines the principles of corporate rescue and business continuity as mandated in the Company Rescue Act, No 2005-845 of 26 July 2005, and its decree No 2005-1677 of 28 December 2005 which came into force on 1 January 2006. These principles ensure that companies experiencing financial difficulties have at least three preventive insolvency procedures at their disposal to utilise before descending into formal insolvency. The first is the safeguard procedure (*procédure de sauvegarde*) with two variants: the accelerated financial safeguard procedure (*sauvegarde financière accélérée*)⁴⁴ and the accelerated safeguard procedure (*sauvegarde accélérée*).⁴⁵

The safeguard procedure also incorporates a debtor-in-possession mechanism, thereby affording the company (directors) opportunities to initiate pre-insolvency restructuring mechanisms prior to formal insolvency (*en cessation de paiements*).⁴⁶ The second procedure is the *ad hoc* mandate (*mandat ad hoc*),⁴⁷ and the third is the conciliation (*conciliation*).⁴⁸

To utilise these procedures, the company and its directors must observe certain obligations, such as those arising from directors' duties to act faithfully in promoting the success of the company and from directors' duties to avoid negligent business decisions that might affect the viability of the company.⁴⁹ It should be noted that, under French law, company directors are under an obligation to file for insolvency proceedings within 45 days upon cessation of payment (*en cessation de paiements*).⁵⁰

Company directors risk liability for wrongful trading when they continue trading in circumstances where the company is unable to pay its debts / invoices (when presented by creditors) for more than 45 days.⁵¹ These directors could be ordered to compensate

⁴² *GmbHG*, s 64, sentence 1.

⁴³ *AktG*, s 92, para 2.

⁴⁴ Law No 2010-1249 of 22 October 2010.

⁴⁵ Ordinance No 2014-326 of 12 March 2014.

⁴⁶ C Dupoux and D Marks, "Chapter 11 à la Française: French Insolvency Reforms", *International Corporate Rescue* (2004) 1 74.

⁴⁷ Commercial Code, Arts L611-1 to L611-16.

⁴⁸ *Ibid.*

⁴⁹ P Omar, "French Insolvency Law: Remodelling the Reforms of 2005", *International Company and Commercial Law Review* (2009) 6 225.

⁵⁰ Commercial Code, Art L631-1.

⁵¹ C Dupoux and D Marks, "Chapter 11 à la Française: French Insolvency Reforms", *International Corporate Rescue* (2004) 1 74.

creditors for any additional losses that they incur as a result of continued trading.⁵² In addition, directors may also face liability for granting or extending credit to a company that faces imminent insolvency in a situation where the directors are endeavouring to continue trading, rather than filing for insolvency.⁵³

2.3.1 COVID-19 suspension on wrongful trading in France

Following the outbreak of the COVID-19 pandemic, the French government passed the French Emergency Act⁵⁴ on 23 March 2020 to address the potential impact and aftermath of the pandemic, including, *inter alia*, the impact on the business sector. Pursuant to this Act, the French government enacted Ordinance No 2020-341⁵⁵ and Ordinance No 2020-596,⁵⁶ which introduced amendments to insolvency laws during the pandemic period.

These legislative provisions temporarily suspended the duty on the debtor (directors) to file insolvency proceedings in circumstances where the company suffered cash-flow insolvency between 12 March 2020 and 24 August 2020. They also reinforced protective measures for a debtor undergoing proceedings such as conciliation,⁵⁷ to adapt moratoria protection from creditor recovery actions (up to 31 December 2020) and facilitating the rescheduling of debts with creditors.⁵⁸

As a result of these temporary suspensions, financial difficulties experienced by companies during this period were not procedurally deemed “cash-flow insolvency” and did thus not invoke obligations on directors to initiate insolvency proceedings within 45 days. The main advantage of these temporary suspensions was the avoidance of unnecessary commencement of insolvent liquidation proceedings by directors. This afforded directors the flexibility to assess the financial position and viability of the company in order to assess whether to continue trading the business or not, without fear of liability for wrongful trading.

3. Were the suspensions necessary?

The key objectives of the UK, Germany and France in suspending the wrongful trading provisions in their respective national laws were no doubt based on good intentions. These steps were clearly taken to support business continuity and corporate rescue by limiting unnecessary insolvency filings due to directors’ fear of potential liability for

⁵² On this aspect see P Omar, “Defining Insolvency: the Evolution of the Concept of ‘Cessation de Paiements’ in French Law”, *European Business Law Review* (2005) 16 311.

⁵³ F Baumgartner and A Dupuis, “Chapter 9: France” in D S Bernstein, *The Insolvency Review* (Law Business Research 2019) at 103, 111.

⁵⁴ Emergency Law No 2020 - 290 of 23 March 2020 to deal with the COVID-19 pandemic.

⁵⁵ Ordinance No 2020 - 341 of 27 March 2020 adapting rules relating to difficulties experienced by businesses and farms in health emergencies and amending certain provisions of criminal procedure.

⁵⁶ Ordinance No 2020 - 596 of 20 May 2020 adapting rules relating to difficulties experienced by businesses and farms due to the consequences of the COVID-19 Pandemic.

⁵⁷ Commercial Code, arts L611-1 to L611-16.

⁵⁸ Ordinance No 2020 - 596, art 2.

wrongful trading in the COVID-19 crisis period. However, the suspensions ought to have been approached with caution, especially from the perspective of unsecured creditors, whose debt recovery rights might be impacted by mechanisms such as moratoria protection by the debtor upon corporate insolvency.

There are concerns that the suspensions may encourage directors, who would otherwise be risk-averse⁵⁹ in the COVID-19 crisis period, to “let loose” knowing that regardless of the business decisions they make during this period, no sanctions for wrongful trading would apply. This would arguably amount to abuse of the rule of law already established and tested in their respective domestic legal systems. This might affect possible debt workouts or renegotiations between the company and creditors for new debts (investment) or debt extensions, if creditors are aware that directors may not be held liable for negligent / reckless business decisions during the suspension period that could impact their investment.

It is arguable that in the UK there was good intention in the government’s suspension of the wrongful trading rules to promote corporate rescue and continuity during the pandemic crisis period. However, questions arise as to why the government opted to suspend wrongful trading rules but no other potential sanctions for directors’ breach of their duties, such as those for fraudulent trading under the IA 1986.⁶⁰ The government also did not impose a temporary suspension to the operation of the misfeasance action in terms of the IA 1986,⁶¹ notwithstanding that this provision is as broad in scope as the section on wrongful trading.⁶²

Past or present officers⁶³ of a company may be compelled by a court (on application of the official receiver or liquidator, *etcetera*) to make a contribution to the assets of the company by way of compensation in respect of the misfeasance or breach of fiduciary or other duty, as the court thinks just.⁶⁴ The term “other duty” is a wider concept which may include, *inter alia*, the duty of care such as that under the CA 2006:⁶⁵ to exercise reasonable care, skill and diligence which resonates with claims based on negligence on the part of the director and which may include wrongful trading.⁶⁶ Consequently, where a director continues trading in circumstances where there is no reasonable prospect of avoiding insolvent

⁵⁹ A “risk-averse” company is one that chooses to invest in business transactions with known risks that may provide lower returns than unknown risks with higher predictable returns.

⁶⁰ IA 1986, s 213.

⁶¹ *Idem*, s 212.

⁶² *Idem*, s 214. Also see D M Collins, “Insolvency Act 1986 section 214: A Suspension”, *International Company and Commercial Law review* (2020) 31(8) 441 446.

⁶³ The term officer is defined in IA 1986, s 251 as “Officer, in relation to a body corporate, including a director, manager or secretary”. This is, arguably, a broad definition which would include “[any] person who in the affairs of the company exercises a supervisory control in the running of the company, or the general administration of it, within the meaning of management.” See, *Re a Company (No 00996 of 1979)* [1980] Ch 138 at 144.

⁶⁴ IA 1986, s 212 and in particular s 212(3).

⁶⁵ CA 2006, s 174.

⁶⁶ Per the reasoning in *Re D’Jan of London Ltd* [1993] BCC 646.

liquidation and a claim is brought against the director for negligence or breach of duty, the director may still be personally liable.⁶⁷

Liability for misfeasance⁶⁸ may be absolved if a director's actions were drawn on professional advice, such as from certified accountants or business consultants. One example of this is where, during the course of proceedings for negligence or breach of duties or trust, the court is satisfied that such a director acted honestly, reasonably and, in the circumstances, ought to be absolved of liability.⁶⁹ This rule may be employed to ensure that directors properly exercise their duties.⁷⁰ Changes to the rule on wrongful trading also ought to have been extended to the rule on exclusion of liability for misfeasance.⁷¹

In Germany, the temporary suspension by the *COVInsAG* of the rule requiring directors to file insolvency within three weeks of any inability to pay debts⁷² did not provide for a comprehensive exemption from liability for other directors' breaches of duties. As an example, sanctions for criminal liability on a company director for damages or loss incurred by the company due to a director's negligent or reckless business conduct⁷³ remained in operation and were not suspended.

The position was the same in France, where amendments to French insolvency law, courtesy of Ordinance No 2020-341 and Ordinance No 2020-596, generally suspended the obligation upon the debtor (directors) to file insolvency within 45 days, but left other sanctions for directors' breaches operative.

4. Conclusion

The timely suspension of the rules for wrongful trading by the UK, Germany and France, as analysed in this article, is intended to safeguard these economies from the pandemic's unknown impact. However, questions / discussions arise as to whether the suspensions provided the right balance to corporate continuity and rescue, *vis-a-vis* creditor protection. The suspension raises concerns that some company directors may recklessly undertake negligent business transactions with impunity, since potential liability for such negligent business decision-making is temporarily suspended which might have negative consequences for businesses and general commercial morality.

In addition, there is no definitive timespan as to when the COVID-19 pandemic will be over, which causes uncertainty in the corporate / business world. This presents challenges in assessing the overall impact that the pandemic will present to businesses. This

⁶⁷ IA 1986, s 212.

⁶⁸ *Ibid.*

⁶⁹ CA 2006, s 1157.

⁷⁰ On this perspective, see the reasoning in *Re Continental Assurance Co of London plc (No.4)* [2007] 2 BCLC 287.

⁷¹ IA 1986, ss 214 and 212 respectively.

⁷² *InsO*, s 15a.

⁷³ In terms of *StGB*, s 283.

perspective may be evidenced by the decision of the UK government to reintroduce the suspension of liability for wrongful trading on directors between 26 November 2020 and 30 April 2021, that had previously ended on 30 September 2020.

In Germany, although the duty on company directors of illiquid companies to file for insolvency within three weeks was retrospectively suspended until 30 September 2020; that of directors of over-indebted⁷⁴ companies was suspended until 31 December 2020. However, this has now been extended until 31 January 2021 provided that (i) the company had filed an application for state aid in the period 1 November to 31 December 2020 and is waiting an outcome; or (ii) for legal or factual reasons, the company was eligible to apply for state aid but was unable to submit an application within the period of 1 November 2020 to 31 December 2020.

Therefore, the sum of all these uncertainties calls for a balanced approach to business rescue / continuity *vis-à-vis* creditor protection during the COVID-19 crisis period. The concern is that although the suspension / relaxation of the wrongful trading liability was without a doubt done with good intentions, leaving other sanctions for directors' breach of their duties operative during the COVID-19 crisis period may send mixed messages to both company directors and the business / corporate world.

On the other hand, the outbreak of the COVID-19 pandemic occurred around the time Directive 2019/1023/EU on preventive restructuring frameworks (PRD) was adopted.⁷⁵ The PRD tasks company directors with the duty to avoid negligent decision-making (equivalent to wrongful trading under the CA 2006⁷⁶ in the UK), that may heavily impact upon the company's business stability, leading to insolvency.⁷⁷ However, it remains to be seen what impact this will have upon directors' liability for wrongful trading in EU Member States once fully implemented and harmonised, either during or after the pandemic crisis period.

⁷⁴ Pursuant to *Ins0*, s 19.

⁷⁵ Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, [2019] OJ L 172/18-55 (PRD).

⁷⁶ CA 2006, s 214.

⁷⁷ PRD, art 19.

Corporate governance challenges facing the chief restructuring officer

By Mary Plahouras, Canada¹

Abstract

A chief restructuring officer encounters numerous challenges in its attempt to successfully restructure a corporation in financial distress. The author explores the doctrine of corporate governance challenges facing the chief restructuring officer. The author also touches more generally on Canadian restructuring statutes and reviews emerging issues in corporate governance and restructuring. The author concludes that although the appointment of a chief restructuring officer is not necessary in all corporate restructurings, in the right circumstances the impact of a chief restructuring officer's expertise in strategic decision making may ultimately mean the survival of the corporation.

1. Introduction

The chief restructuring officer (CRO) plays a dynamic and critical role in corporate restructuring in Canada. The CRO's role can differ widely from corporation to corporation but their main duty is to oversee the restructuring of the financially distressed corporation through a senior executive leadership role which may include restructuring both the corporation's balance sheet and the corporation's operations. Notwithstanding that it may be difficult to determine if a corporation is solvent or insolvent strictly on a balance sheet basis, if the operational problems are not corrected, fixing the balance sheet will only result in a temporary solution to the corporation's financial distress.

There are two principal restructuring statutes available to insolvent corporations under Canadian law: (i) the Bankruptcy and Insolvency Act (BIA); and (ii) the Companies' Creditors Arrangement Act (CCAA). The BIA is available to insolvent corporations that owe at least CAD 1,000 in unsecured debt and are unable to meet their obligations as they generally become due. The CCAA is restricted to more complex restructuring of larger corporations or affiliated corporations that are insolvent or bankrupt and have claims against them exceeding CAD 5,000,000. To be eligible to take proceedings under the CCAA, the company must be incorporated in Canada or have assets in or do business in, Canada.²

Although the CRO is in charge during the restructuring, the corporation's management is often free to operate the business. Some discussions that may take place between the

¹ I am grateful to Dr Jennifer L L Gant of University College Cork, Cork, Ireland for her support of the INSOL ERA Publication Project and for the invaluable mentorship which she provided to me in finalising this paper. I am also grateful to Professor Stephanie Ben-Ishai of Osgoode Hall Law School, York University, Ontario, Canada, for the exceptional learning experience which she provided to me in Bankruptcy and Insolvency Law and to Edward A Sellers for his teaching excellence on Governance Responsibilities in Insolvency at Osgoode Hall Law School, York University.

² Excluded are banks, railway, insurance, trust and loan companies.

corporation's chief financial officer and the CRO with respect to debtor-in-possession (DIP) financing during the CCAA proceedings may include how DIP will be prioritised in the initial order; the interest rate to be charged on the DIP loan; the terms, length and amount of the loan; reporting requirements (including to whom and when); notice to existing lenders of a DIP lender; court approval for DIP financing, and remedies available to the DIP lender in the event of a breach of covenant.

The Canada Business Corporations Act (CBCA)³ contains four principals with respect to the duties of a corporate director. They include: (i) the fiduciary duty to the corporation; (ii) duty of care to the corporation; (iii) duty not to oppress; and (iv) duty to manage or supervise the affairs of the corporation.

It was held in *BCE Inc.*,⁴ and in *Peoples Department Stores Inc.*,⁵ that the directors of a corporation have a fiduciary duty to act in the best interest of the corporation by giving a broad range of consideration to a broad range of people. As a result of *BCE Inc* and *Peoples Department Stores Inc*, current and future directors would be well advised to exercise due diligence and fulfil their duty of care and their fiduciary duty to the corporation pursuant to the CBCA and related Provincial Corporations Act by relying upon the advice of the CRO.

This paper will survey corporate governance challenges facing the CRO from a theoretical and practical perspective drawing on Canadian case law. This paper will examine, among other things, how the CRO manages the restructuring of a distressed corporation; why there is a need for a CRO; the terms governing the appointment of the CRO; the scope of the CRO's duties; and the qualities of a successful CRO.

2. Why the need for a chief restructuring officer?

When a corporation is experiencing financial losses on its operations and threats from other various sources, or when it is lacking talented senior management and reliable data and is running out of time to retain control of its restructuring, the CRO is often viewed by the secured lender as an independent skilled professional that can help the corporation regain some level of confidence in restructuring its operations.

The CRO is typically a chartered public accountant, a chartered insolvency and restructuring professional, a certified turnaround professional, or a lawyer with expertise in corporate restructuring,. The CRO is often hired by the directors at the request of the corporation's secured lender to address the corporation's crisis and attempt to return it to a viable and profitable business.

³ CBCA, (R.S.C., 1985, c. C-44) ss 102(1), 122(1) and 241.

⁴ *BCE Inc* [2008] 3 SCR 560, 2008.

⁵ *Peoples Department Stores Inc (Trustee of) v Wise* [2004] 3 SCR 461, 2004.

Despite the fact that the directors and management may be comprised of individuals with appropriate education, financial knowledge and experience, the initial appointment of a CRO may be due to a corporate governance response to lender concerns that the directors and / or management may not have the skillset or expertise to deal with a restructuring;⁶ or it may be due to lack of trust between the directors, management and the corporation's secured lender. A CRO may be needed to implement actions against opposing forces such as the corporation's own board of directors, management, employees, unions, creditors and other stakeholders.

In certain corporate restructurings there may be a special need for a skilled CRO to implement internal governance changes by reconfiguring the corporation's existing governance processes. This can be accomplished by placing the audit committee on alert to the warning signs of financial distress;⁷ establishing a special committee free of conflicts whose members would have the expertise to examine the principal issues causing the corporation's financial distress; and retaining an independent advisor such as a financial advisory firm to oversee the corporation's existing accounting, auditing, and financial reporting systems.⁸ In the case of *Consumers Packaging Inc*, the board established an independent restructuring committee to assess the corporation's financial distress. The committee hired a CRO who assumed operational control of the corporation under the supervision of the court during the CCAA proceedings.⁹

The CRO can assist the directors in re-establishing a level of trust with the corporation's stakeholders by facilitating direct meetings with stakeholders to confirm their intentions.¹⁰ Retention of a CRO is a recommended course of action where the lender is concerned about management's capabilities. In these circumstances, in addition to the CRO's role of managing the restructuring, the CRO may be requested to supervise the corporation and offer advice or direct its operations¹¹ where directors are unwilling or unable to restructure; there has been a communication breakdown between the directors, management, employees, and stakeholders; there has been employee exodus; or the corporation has had prolonged periods of severe cash flow difficulties.

In *Atlas Cold Storage* the resignation of the chief executive officer and the chief financial officer as officers and directors as a result of a restructuring caused by "financial statement misstatement", the hiring of a CRO and appointment of interim directors had a beneficial effect on the ability of the company to address governance issues.¹² In *Aveos Fleet*

⁶ JP Sarra, "Governance of the Insolvency Corporation During the CCAA Proceedings" in JP Sarra, *Rescue! The Companies Creditors Arrangement Act* (2nd ed, Thomson Reuters, Toronto, 2013) at 350.

⁷ *Idem*, 393 to 395.

⁸ As explained by E A Sellers, Osgoode Hall Law School, 6 February 2015. Hollinger international Inc established a special committee to investigate the company's affairs.

⁹ JP Sarra, "Governance of the Insolvency Corporation During the CCAA Proceedings" in JP Sarra, *Rescue! The Companies Creditors Arrangement Act* (2nd ed, Thomson Reuters, Toronto, 2013) at 351.

¹⁰ WE Aziz, EM Grudzinski and EA Sellers, "Practical Aspects of Governing Distressed Enterprises in Canada" in JP Sarra, *Annual Review of Insolvency Law: 2006* (Thomson Carswell, Toronto, 2007) at 399.

¹¹ *Idem* at 346.

¹² *Idem* at 401.

Performance Inc.,¹³ the court appointed a CRO when all the directors save one resigned a few hours after the company filed for protection from its creditors under the CCAA.¹⁴

3. Who appoints the chief restructuring officer?

Prior to accepting an appointment as a CRO, it is imperative that the CRO be free from actual or perceived conflict of interest. The appointment of the CRO is typically influenced by the corporation's secured lender whose covenant has gone into default and as a result will not advance further funds to the corporation unless the corporation retains a CRO to act as the corporation's advisor and solve the problems at hand. In *iMarketing Solutions Group Inc.*,¹⁵ the DIP lender required the appointment of a CRO to manage the day-to-day operations of the company, including formulating and implementing a restructuring plan for the company.

The CRO's appointment may also be at the request of the directors, or it may be by order of the court under the CCAA pursuant to the court's inherent jurisdiction and its general statutory power to make any order that it considers appropriate. If the CRO is appointed by the court, or the terms of the CRO's appointment have been approved by the court (notwithstanding that the CRO may formally report to the directors), the CRO has a reporting obligation to the court and must act neutrally with a responsibility to all stakeholders.¹⁶

A CRO can be appointed before or after a corporation takes proceedings under the CCAA to institute pre-event preparations such as establishing adequate diagnostic and reporting systems; determining sources of liquidity; preparing communication plans; identifying the stakeholders whose combination of claims can carry or veto a potential restructuring plan; and engaging with the stakeholders in building consensus to a proposed plan of action to resolve the corporation's financial distress and lead it to a successful restructuring.¹⁷

Unlike a monitor appointed by the court under the CCAA, whose mandate is to be the "eyes and ears" of the court, the CRO is an advocate for the corporation with a role in formulating and carrying out a restructuring plan for the benefit of the corporation. Early intervention and allowing a corporation to restructure, rather than go into receivership or bankruptcy, may result in the retention of jobs for employees, continuation of contracts for suppliers, and collection of crown debts by municipal, provincial and federal government agencies.

¹³ J P Sarra, "Governance of the Insolvency Corporation During the CCAA Proceedings" in J P Sarra, *Rescue! The Companies Creditors Arrangement Act* (2nd ed, Thomson Reuters, Toronto, 2013) at 352.

¹⁴ CCAA, RSC 1985, c C-36.

¹⁵ *iMarketing Solutions Group Inc et al.* Initial order of Justice Newbold, 12 April 2013.

¹⁶ J P Sarra, "Governance of the Insolvency Corporation During the CCAA Proceedings" in J P Sarra, *Rescue! The Companies Creditors Arrangement Act* (2nd ed, Thomson Reuters, Toronto, 2013) at 353.

¹⁷ W E Aziz, E M Grudzinski and E A Sellers, "Practical Aspects of Governing Distressed Enterprises in Canada" in J P Sarra, *Annual Review of Insolvency Law: 2006* (Thomson Carswell, Toronto, 2007) at 411.

4. Terms of the chief restructuring officer's appointment

The terms of the CRO's appointment may be found in the engagement letter, or in the court order if the corporation is undergoing proceedings pursuant to the CCAA, and will typically include the terms of the CRO's financial compensation, indemnification from liability, the scope of the CRO's role and their powers.

The engagement letter should make it clear that the CRO has the authority to carry out their responsibilities. In *Aveos Fleet Performance Inc.*,¹⁸ the court appointed a CRO with authority to carry on, manage, operate and supervise the management of the business and affairs of the corporation subject to the execution of an engagement letter with the CRO on terms satisfactory to the monitor and to the third-party secure lender.

The financial terms of a CRO's engagement can be very expensive. This may be due in part to the fact that the CRO's job is a temporary position. The CCAA¹⁹ authorises the court to make any order it considers appropriate declaring that all or part of the property of the corporation is subject to a security charge to cover any financial, legal or other experts engaged by the corporation for the purpose of the CCAA proceedings. Hence, the CRO can be assured of receiving compensation.²⁰ If the CRO is ultimately successful in restructuring the corporation and returning it to profitability, the benefits of engaging a CRO should result in tremendous value to the corporation. In *Consumers Packaging Inc.*, the restructuring generated a value of more than CAD 61,000,000 greater than the corporation's estimated liquidation value.²¹

5. The successful chief restructuring officer

CROs may share similar personal traits, yet have significantly different skill sets that are imperative to addressing the needs of a financially distressed corporation. An effective and successful CRO needs to be a highly skilled financial advisor and negotiator familiar with all of the techniques required to save a corporation and reduce the risk of financial distress re-occurrence. A CRO's successful restructuring of a financially distressed corporation centers on an assessment and analysis of the corporation's affairs, resulting in the formation and execution of a speedy restructuring plan. The CRO will need to have the practical experience and knowledge required to stabilise a financially distressed corporation and possibly lead it to increased value.

A CRO may recommend whether a corporation should be saved or whether there should be a receivership sale or liquidation of the corporate assets; identify early in the process the financial and operational problems of the distressed corporation; communicate to the directors and to the stakeholders a restructuring plan that will address the existing

¹⁸ *Aveos Fleet Performance Inc.*, 2012 CarswellQue 1449 (Que SC).

¹⁹ CCAA, RSC 1985, c C-36, s 11.52(1).

²⁰ J P Sarra, "Governance of the Insolvency Corporation During the CCAA Proceedings" in J P Sarra, *Rescue! The Companies Creditors Arrangement Act* (2nd ed, Thomson Reuters, Toronto, 2013) at 352.

²¹ *Ibid.*

underlying problems with the operations of the business; advise the directors as to whether the corporation has the resources to execute a restructuring plan; and maintain appropriate communications with the stakeholders throughout the process and ensure that the stakeholders have confidence in the integrity and capabilities of the directors and of management.

6. The governance role of the chief restructuring officer

When a corporation retains a CRO there is an expectation that the CRO is in full control of the corporation, has a high level of independence and displays a duty of care to the corporation. Although a CRO can take formal appointments on the board of directors, the CRO is independent of the board and of the corporation's management team. Granting the CRO the executive powers that they need (such as joining the board) is good governance practice as it may provide for a more meaningful discussion of the pertinent issues that will need to be addressed as part of the restructuring process.

The increasingly common role of the CRO is prevalent in Canada in the context of both informal restructurings and court-supervised insolvency restructurings. In proceedings under the CCAA, the CRO can be appointed by either the court or by the corporation for the period of those proceedings. During the CRO's appointment, the CRO may be faced with complex governance issues in deciding how to best provide their specialised restructuring skills to effectively deal with the corporation's financial distress.²² It is imperative that the CRO establishes and maintains, for the duration of their term, a renewed rapport and good relations with the corporation's directors, management, employees and its other stakeholders if the restructuring is to succeed.

In determining whether the corporation is viable, the CRO will need to determine the degree of reliability of the financial statements and whether the corporation has sufficient liquidity and necessary financing in place to successfully restructure its business. The ultimate goal of the CRO's role, in parallel with the directors, is to save the corporation by re-engineering its operations while avoiding a short-term quick fix. The CRO may be responsible for the entire operation of the corporation, or the CRO may have a role that is restricted to specific aspects of the restructuring plan.

7. The scope of the chief restructuring officer's duties

When a CRO takes on the role of the corporation's restructuring professional, the CRO becomes part of the governance structure of the corporation. Typically, in a private appointment by the secured lender or by the corporation's directors, the CRO will formally report to the secured lender and / or to the directors. In *US Steel Canada Inc.*,²³ the court approved the appointment of a CRO with responsibility for directing the restructuring

²² W E Aziz, E M Grudzinski and E A Sellers, "Practical Aspects of Governing Distressed Enterprises in Canada" in J P Sarra, *Annual Review of Insolvency Law: 2006* (Thomson Carswell, Toronto, 2007) at 367.

²³ *Idem*, at 397.

process in conjunction with the corporation's senior management and reporting directly to the board. The court further ordered that the appointed CRO shall not be deemed to be a director or employee of the corporation. However, in proceedings under the CCAA the CRO can replace the chief executive officer. In circumstances where an immediate change in management is needed, the retention of a CRO may be the better approach either because of time constraints in searching for new management personnel, or because qualified permanent candidates will not accept the position until the restructuring has been completed.²⁴

An experienced and objective CRO will bring renewed credibility to the corporation in its dealings with its stakeholders. Ideally, the CRO will have the skills and knowledge to address large restructuring issues and help stabilise the corporation. Appointing an experienced CRO to conduct a "look-see" or viability analysis of the corporation may bring a fresh perspective to the corporation, from the balance sheet to financing and operations, while allowing management to focus on the day-to-day operations of the business.

It has been reported that effective CROs share certain characteristics such as people skills, management skills, strategic skills, and job knowledge.²⁵ The job of a CRO is not for the faint-hearted, nor for the individual who is not skilled in the area of corporate restructuring. The job is for the individual who is committed to fulfilling duties to the corporation with due regard for the interest of the affected stakeholders, while seeking to achieve a successful outcome in resolving the corporation's financial distress and minimising personal exposure for the directors and the stakeholders.

The CRO's mandate can be found in the CRO appointment letter or court order and is subject to the degree of empowerment given by the corporation's directors and / or the stakeholders. Typically, a CRO's mandate is to execute operational improvements and usually entails identifying the causes of the corporation's financial distress and the possible solutions in meeting the objectives of stabilising the corporation and ensuring that there is sufficient cash flow or outside sources of capital to steer the corporation through the crisis. The mandate typically further includes preparing cash flow projections and outlining financing or restructuring alternatives to the directors and to the stakeholders; overseeing management and the corporation's operations including maintaining supplier and customer relations; participating in the sale of assets; approving and negotiating credit terms with lenders and trade creditors to ensure continuing supply; managing legal actions including initiating or continuing legal proceedings by or against the corporation, terminating leases, contracts and employees; formulating a "roadmap" for restructuring; executing the restructuring plan; preserving market share; and identifying and establishing new business opportunities.

Where the corporation is undergoing CCAA proceedings, the CRO will work closely with the court-appointment monitor. In a restructuring under the CCAA the court, under its

²⁴ *Ibid.*

²⁵ *Ibid.*

inherent jurisdiction, may grant specific powers to the CRO. These powers may include taking all necessary steps to carry out a restructuring of the distressed corporation; having full access to the property of the distressed corporation to the extent that it is necessary to adequately assess the corporation and its financial affairs; and evaluating the restructuring, sale, or recapitalisation alternatives.

In *Aveos Fleet Performance Inc.*,²⁶ the court granted the CRO broad powers, including the power of a “CRO signing officer” in respect of all of the corporation’s bank accounts and the power to control the corporation’s receipts and disbursements; retain employees or terminate employment contracts; and represent the corporation in negotiations with any party. In *Ivaco Inc.*,²⁷ the court permitted the participation of a CRO in the sales process to assess the various bids and make recommendations.²⁸

In *Northstar Aerospace Canada Inc.*,²⁹ the order appointing the CRO under the CCAA included provisions limiting liability and providing the requisite powers and authority to allow the CRO to carry out their mandate. These provisions provided that neither the CRO nor any officer, director, employee or agent of the CRO are deemed to be a director or officer of the corporation; incur any liability or obligation as a result of their appointment or carrying out their mandate; and the debtor company was required to indemnify and hold harmless the CRO and any officer, director, employee or agent of the CRO who may have assisted the CRO with the exercise of their powers and obligations. It was provided that this indemnity should be secured by a charge on the debtor company’s assets, usually as part of the directors and officer charge. Any actions or other proceedings against the CRO should be stayed except with leave of the court and the CRO should be permitted to resign or the debtor company should be permitted to seek an order terminating the appointment of the CRO at any time.³⁰

7.1. Obtaining the facts

The nature, quantity and quality of internal and external information available to the CRO upon their appointment will affect the quality of the decisions made and the process that the CRO will follow to implement a restructuring plan.

A primary focus of the CRO is to ensure that accurate, complete, and reliable information necessary for informed decision-making is available on a timely basis. Acting on an informed basis will limit omissions and errors and allow the CRO to exercise sound business judgment in carrying out their mandate. The CRO will keep a formal record of all material matters pertaining to the corporation’s restructuring, including the accuracy and completeness of the information; documentation considered; and the risks associated

²⁶ *Aveos Fleet Performance Inc.*, 2012 (Que SC).

²⁷ *Ivaco Inc.*, 2004 3 CBR (5th) 33 (Ont SCJ [Commercial List]).

²⁸ J P Sarra, “Governance of the Insolvency Corporation During the CCAA Proceedings” in J P Sarra, *Rescue! The Companies Creditors Arrangement Act* (2nd ed, Thomson Reuters, Toronto, 2013) at 351.

²⁹ *Northstar Aerospace Canada Inc et al.* Initial order of Justice Morawetz, 14 June 2012.

³⁰ *Ibid.*

with decisions taken, hence, bringing clarity and efficiency to decisions that are implemented.

7.2. Management, stakeholders and external resources considerations

The CRO may be an instrumental force in establishing and / or enhancing the corporation's diagnostic and reporting systems³¹ so that reports and other reliable information necessary for informed decision making are available to the directors and stakeholders. The CRO may also be instrumental in ensuring that the corporation is capable of attracting and retaining talented and committed management, stakeholder co-operation and adequate external financial resources.

7.3. Assessing the corporation's debt restructuring alternatives

For a successful restructuring, the CRO will need to assess the corporation's debt-servicing capabilities. It is imperative that the CRO builds a rapport and good relations with the corporation's secured lender and communicates with the stakeholders the amount of debt-servicing capabilities that the corporation will have when it has been stabilised and returned to profit.

7.4. The chief restructuring officer can help the corporation's directors exercise their due diligence defense

Where a corporation is in financial distress or is approaching insolvency and undertakes to restructure its business, a CRO understands the nature and extent of the statutory liabilities facing the directors for source deductions, unpaid wages, unpaid vacation pay, unfunded pension contribution, and environmental liabilities. The CRO can assist and advise the directors by conducting an internal assessment of the risk factors associated with the statutory liabilities, so that the directors can understand the extent of their potential liabilities as part of their informed decision-making process and as to whether or not they should continue to serve as directors or resign during the restructuring. For instance, in *Afton Food Group Ltd*,³² the initial court order under the CCAA indemnified the directors to keep them in office and secured that indemnity by a third ranking charge on assets.

The CRO may also assist the directors in establishing controls such as establishing a segregated account to pay directors' liabilities from the available cash flow and implementing operational processes requiring an officer of the corporation to certify that the required statutory payments have been made. In *Peoples Department Stores Ltd*,³³ the Supreme Court of Canada held that where a CRO takes over the management of the affairs

³¹ WE Aziz, EM Grudzinski and EA Sellers, "Practical Aspects of Governing Distressed Enterprises in Canada" in JP Sarra, *Annual Review of Insolvency Law: 2006* (Thomson Carswell, Toronto, 2007) at 374.

³² *Idem*, at 390.

³³ JP Sarra, "Governance of the Insolvency Corporation During the CCAA Proceedings" in JP Sarra, *Rescue! The Companies Creditors Arrangement Act* (2nd ed, Thomson Reuters, Toronto, 2013) at 353.

of the corporation, the CRO will acquire a statutory duty of care and should consider the interest of the stakeholders who have an interest in the restructuring.

8. Conclusion

In conclusion, while the appointment of a CRO is not necessary in all corporate restructurings, in the right circumstances the impact of a CRO's expertise and his power to veto strategic decisions on behalf of a distressed corporation may mean the survival and profitability of the company; the retention of jobs for employees; continuation of contracts for suppliers; the collection of crown debts by municipal, provincial and federal government agencies; and the removal of the corporation from the immediate dangers of a receivership or bankruptcy.

The modern role of insolvency practitioners amidst globalisation and the changing concept of the “professional”

By Elizabeth Streten, Queensland University of Technology, Australia*

Abstract

A growing volume of literature is currently considering professionals in this era of globalisation and technology. Social and cultural assumptions, which had previously grounded the epithet “professional”, are now subject to unprecedented uncertainty and arguable incompatibility with the contemporary world.¹

Insolvency practitioners have conceivably been the subject of under-confidence from their regulators, stakeholders and the general public for some time.² The question has now become how insolvency practitioners can manage their complex role amidst the ongoing disruption of modern technology, changing social expectations and the general loss of unquestioning trust and confidence once afforded to the respected class of the “professional”.³

1. Introduction

This paper reflects upon the challenges facing insolvency practitioners in the 21st century amid globalisation and digital transformation. It confronts the future of the profession and the practitioners’ challenge to maintain relevance and value, notwithstanding the redefinition of what it means to be a consumer and what it means to be a provider of professional services and expertise. It does this by considering the common transformative influences affecting industry generally, and by considering impacts upon the insolvency profession more specifically. Section 2 of this paper contemplates the meaning of “professional” and whether insolvency practitioners fall within the definition of being professionals. Section 3 considers the meaning and impact of globalisation. It does this by first undertaking a general consideration of globalisation before deliberating upon the concept of globalisation within the insolvency profession. Section 4 addresses the redefinition of consumer and professional. Finally, Section 5 deliberates upon the future of the insolvency profession.

* Dr Elizabeth Streten, Queensland University of Technology. With thanks to Lachlan Robb who also provided some research assistance in identifying some relevant material in relation to section 3.2.

¹ M Dent and S Whitehead, “Introduction: Configuring the ‘new’ professional” in M Dent and S Whitehead (eds), *Managing Professional Identities Knowledge, performativity and the ‘new Professional* (1st ed, Routledge, London, 2002) 1 at 1.

² E Streten, “Insolvency Practitioners: A Phenomenological Study”, *Insolvency Law Journal* (2021) 29 83 at 86; E Streten, “Practitioners’ Perspectives: Experiences Adhering to Legal and Ethical Regulatory Standards” (PhD thesis, Queensland University of Technology, 2019) available at https://eprints.qut.edu.au/134254/1/Elizabeth_Streten_Thesis.pdf.

³ J Dickfos, “AI and the Insolvency Profession: The State of Play”, *Insolvency Law Journal* (2018) 26 172.

2. The concept of a “professional”

This topic requires some consideration as to the historical and modern-day meanings attributed to “professions” and “professionals”. Arguably, there is no clear and precise universal definition of a “profession” nor of a “professional”,⁴ notwithstanding attempts to provide a standard definition. Cogan has contended that any attempt to define the concept of a profession is “to invite controversy”.⁵ Indeed, historically, a number of academics have refrained from volunteering any definition at all,⁶ and those who have endeavoured to do so have often been met with staunch criticism.

Extensive literature over 100 years has considered what it means to be a professional and what constitutes a profession; there is widespread deliberation upon professional origins, upon the distinctive characteristics of professions, and upon the historical and contemporary challenges of professions.⁷ Notwithstanding a sociological literature debate over the past 100 years or more, there has been a failure to reach any resolution on a collective understanding or classification for the term profession.⁸ Therefore, the terms “profession” and “professional” remain only loosely defined.

Freidson describes a profession as having: (i) a body of knowledge based on various abstract concepts; (ii) the exercise of considerable discretion; (iii) occupationally controlled division of labour; (iv) processes for credentialisation; (iv) processes for training; and (v) ethics which emphasise doing good above financial benefit.⁹ This description is very similar to the 1915 criteria proposed by Flexner: (i) intellectual operations coupled with large individual responsibilities; (ii) raw materials drawn from science and learning; (iii) practical application; (iv) an educationally communicable technique; (v) tendency towards self-organisation; and (vi) increasingly altruistic motivation.¹⁰

A profession has been described as a particular kind of occupation with special characteristics that are associated with an implied importance of trust-worthiness and confidentiality.¹¹ Generally, professions are considered to be knowledge-based service industries and professionals are considered to be those persons who work within such

⁴ O Garceau, “Some Aspects of Medical Politics” (PhD thesis in the Department of Government, Harvard University, 1939) at 4.

⁵ M L Cogan, “The Problem of Defining a Profession”, *Ethical Standards and Professional Conduct* (1955) 297 105.

⁶ *Ibid*, referring to A M Carr-Saunders and P A Wilson.

⁷ L Scanlon, “‘Becoming’ a Professional” in L Scanlon (ed) *Becoming a Professional: An Interdisciplinary Analysis of Professional Learning* (Springer Netherlands, 2011) 13 at 17.

⁸ *Idem*, at 18.

⁹ E Freidson, *Professionalism. The third logic* (University of Chicago Press, Chicago, 2001) at 180; and L Scanlon, “‘Becoming’ a Professional” in L Scanlon (ed) *Becoming a Professional: An Interdisciplinary Analysis of Professional Learning* (Springer Netherlands, 2011) 13 at 19.

¹⁰ A Flexner, “Is Social Work a Profession?”, *School and Society* (1915) 1 904; and M L Cogan, “The Problem of Defining a Profession”, *Ethical Standards and Professional Conduct* (1955) 297 105 106.

¹¹ J Evetts, “Short Note: The sociology of professional groups new directions”, *Current Sociology* (2006) 54(1) 133-143.

industries with requisite tertiary education and formal credentialing while holding a requisite agreed standard of ethical behaviour or moral code.¹²

A consideration of these general definitions and criteria suggests that insolvency practitioners fall within the parameters of “professionals” and that the insolvency profession falls within the parameters of a “profession”. Insolvency practitioners are specialised practitioners holding expert qualifications, experience, knowledge and skills in insolvency. They provide solvency and / or insolvency services while abiding by ethical and legal standards, often through self-organised professional bodies amongst other things, and there are general processes for both training and accreditation. Often exercising *quasi*-judicial positions as officers of the court,¹³ insolvency practitioners expedite and facilitate insolvency processes by applying law in accordance with statutory and other priorities and through the exercise of necessary discretions.

The role of an insolvency practitioner changes depending upon the nature of each appointment. However, the main task is often to formulate and to implement an effective strategy to restore a person or company to solvency / profitable trading or, where that is not possible, to take control of assets, investigate the person or company in a timely, fair and efficient manner maximising returns to creditors and, with respect to corporate insolvency, to members.¹⁴ In undertaking that role, practitioners must maintain independence, confidentiality and confidence of all involved parties. Whilst insolvency practitioners may be private accountants or lawyers undertaking their role for financial gain, there are also altruistic or semi-altruistic responsibilities within their function, such as in the completion of assetless administrations where there may be no expected financial return.

There is an argument that insolvency work is not within a discrete profession on the basis that it may be undertaken by general accountants as only part of a broader accountancy role.¹⁵ However, the insolvency profession would seem to fall within the description of a profession, by being a knowledge-based service industry. Furthermore, insolvency practitioners meet the description of professionals, by being persons working with the insolvency profession who are generally obligated to obtain requisite tertiary education and accreditation and to abide by set moral standards in the provision of solvency and insolvency services. Empirical research undertaken in Australia suggests that insolvency practitioners, at least in part, hold their qualification and ethical standards to be an

¹² *Idem*, at 135.

¹³ *Tanning Research Laboratories Inc v O'Brien* [1990] 18 ACLC 248.

¹⁴ E Streten, “Practitioners’ Perspectives: Experiences Adhering to Legal and Ethical Regulatory Standards” (PhD thesis, Queensland University of Technology, 2019) available at https://eprints.qut.edu.au/134254/1/Elizabeth_Streten_Thesis.pdf.

¹⁵ V Finch and D Milman, *Corporate Insolvency Law: Perspectives and Principles* (3rd ed, Cambridge University Press, United Kingdom, 2017) at 168.

important aspect of their professional identity.¹⁶ This is consistent with research undertaken by Wackerhausen in the medical fields - Wackerhausen considers professional identity to include the qualities designated and required of an individual to become a fully acknowledged member of their profession.¹⁷

For these reasons listed above, it is submitted that insolvency practitioners have the combined attributes which fulfil the general criteria and definitions designated to the concepts of professions and professionals.

3. Globalisation of industry

The second relevant concept is "globalisation". "Globalisation" is a now common descriptor for the collection of processes impacting upon life and business in modern times.¹⁸ This term has become popular in the past few decades in describing this phenomenon: "in the early 1990s, the US Library of Congress catalog[ue] listed [fewer] than fifty publications per year related to globalization, but from 2002 to 2014, there were more than a thousand every year".¹⁹

A multitude of definitions for globalisation have been suggested by journalists, academics, and commentators.²⁰ One influential definition in business and economics literature was provided by Held *et al*, who described it as a process (or set of processes) which embodies a transformation "generating transcontinental or interregional flows and networks of activity, interaction, and the exercise of power".²¹ Another way to describe globalisation is as the changing connectivity of the world, where information, knowledge, technology and culture are shared and are accessible internationally.²² The result is the merging of culture and finance globally as technology and connectivity transcend time zones, locality and domestic markets.

Recent decades have seen a rise in globalisation with the world changing at an increasing rate. This has resulted in the removal of barriers, thus creating opportunities for businesses (including conservative professions such as law and accounting), to move beyond local or

¹⁶ E Streten, "Practitioners' Perspectives: Experiences Adhering to Legal and Ethical Regulatory Standards" (PhD thesis, Queensland University of Technology, 2019) available at https://eprints.qut.edu.au/134254/1/Elizabeth_Streten_Thesis.pdf.

¹⁷ S Wackerhausen, "Collaboration, professional identity and reflection across boundaries", *Journal of Interprofessional Care* (2009) 23(5) 455.

¹⁸ J Davis, "Rethinking Globalisation", *Race and Class* (1999) 40(2-3) 37.

¹⁹ P Ghemawat and S A Altman, "Defining and Measuring Globalization" in P Ghemawat (ed) *The Laws of Globalization and Business Applications* (Cambridge University Press, Cambridge, 2017) 11 at 12.

²⁰ *Ibid*.

²¹ D Held *et al*, *Global Transformations: Politics, Economics and Culture* (Stanford University Press, Stanford, 1999) at 16.

²² I Khoutyz, "Academic Mobility Programs as Part of Individual and Professional Development in a Globalised World: Uncovering Cultural Dimensions" in F S Topor (ed) *Handbook of Research on Individualism and Identity in the Globalized Digital Age* (IGI Global, Hershey, 2016) 168 at 169.

domestic borders to pursue international trade and customers.²³ It has correspondingly also increased competition and introduced a new series of business challenges.

Industry upheaval is not unprecedented. Schwab believes this is the fourth industrial revolution, with previous revolutions having addressed animal power, mass production and the introduction of digital capabilities.²⁴ However, he describes the current industrial revolution as one driven by the continued development of digital technologies.²⁵ This has the potential to connect people around the world in an unparalleled way and is characterised by new fusions of digital and physical worlds – thereby challenging every facet of economy, industry and even what it means to be human.²⁶ Competition is changing with globalised distribution and cross-border flow of information in real time by “creating a fast-moving competitive environment with a focus on consumer satisfaction”.²⁷

Schwab believes this contemporary industrial revolution is distinguishable from prior revolutions because there are not necessarily incremental changes adopted over time, but rather some accelerating digital technologies adopted at a disruptively fast and large-scale pace so that they fundamentally change business and social customs very quickly.²⁸ This challenges the ability for industries and people to adapt swiftly in response.

3.1 Globalisation of the insolvency profession

The insolvency profession is not immune to these changes, nor to the associated challenges. Cross-border business failure, or insolvency, is inevitable as a result of rapidly increasing globalisation, international commerce, electronic assets, global digital communication and the global transfer of assets. This creates complexities in the administration of insolvencies by insolvency practitioners.

There are different and varied economic and regulatory models across domestic regions which must somehow be co-ordinated. Practitioners must grapple with diverse national public policies, territorial approaches and emerging local laws which may lack the facility to co-ordinate multiple, even competing, proceedings across domestic boundaries.²⁹ There is also an increased opportunity for private parties’ free choice in determining

²³ See for example the consideration of the globalisation of law by E Godfrey, “The Globalisation Debate”, *International Business Law* (1995) 23(11) 507.

²⁴ K Schwab, *The Fourth Industrial Revolution* (1st ed, World Economic Forum, United Kingdom, 2016).

²⁵ *Ibid.*

²⁶ *Ibid.*

²⁷ R King and L Fitzgerald, “Challenges facing the accounting profession: maintaining relevance in a changing environment” in A Wilkinson, D Hislop, C Coupland (eds) *Perspectives on Contemporary Professional Work* (Edward Elgar Publishing Ltd, Cheltenham, 2016) at 188.

²⁸ Commonwealth (Cth), Productivity Commission 2016, *Digital Disruption: What do governments need to do*, Commission Research Paper (Mr Peter Harris AO, Chairperson) Canberra, June 2016 at 13.

²⁹ This was discussed by the past-president of INSOL International: G Stewart, “Insol President on cross-border insolvency challenges”, *International Financial Law Review* (2013) Mar.

applicable law and “forum shopping”,³⁰ and increased business opportunities and competition for insolvency firms and practitioners.

Modernisation of the insolvency industry and the regulation of insolvency practitioners, is a contemporary concern.³¹ Insolvency systems need to remain effective and relevant in response to changes in business practices and global trends and advancements. In response, recent years have seen significant reforms or reviews in this respect, for example in Singapore,³² New Zealand,³³ and Australia.³⁴ The recent global COVID-19 pandemic of 2020 has also resulted in global reconsideration of insolvency laws and practices and the introduction of numerous reforms and measures to support distressed businesses through the pandemic crisis.³⁵

3.2 Changing technology within the insolvency profession

One of the transformative processes of modern globalisation is the digitalisation of industry. Digital technology can have a substantial influence: it can impact upon the provision of goods, services and their value and it can alter the operations of, and profitability of, an entire industry.³⁶ Digitalisation can therefore pose numerous challenges for industry business models, pricing strategies customer relationships and other facets of business.³⁷

The modernisation and globalisation of the insolvency profession as a result of advances in digital technology may have significant repercussions for insolvency practitioners. While the profession is not subject to the same extreme impacts of digital transformation affecting some industries, such as the newspaper industry,³⁸ the insolvency profession is part of the globalised business eco-system and is therefore subject to the demands and constraints of the modern disrupted market.

³⁰ L Enriques and M Gelter, “How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law”, *Tulane Law Review* (2007) 81(3) 577 581.

³¹ C Robinson, “An Early Response to Regulatory Changes under the ILRA 2016 (Cth): A Survey of Registered Liquidators and Registered Trustees”, *Insolvency Law Journal* (2019) 27(4) 211.

³² Insolvency, Restructuring and Dissolution Act 2018 (Singapore).

³³ Insolvency Practitioners Regulation Act 2019 (NZ); and Insolvency Practitioners Regulation (Amendments) Act 2019 (NZ).

³⁴ Insolvency Law Reform Act 2016 (Australia Cth).

³⁵ A guide to the measures taken by different nations in response to this pandemic has been published by INSOL International and the World Bank Group and is available within INSOL International’s technical library: “Global Guide: Measures adopted to support distressed businesses through the COVID-19 crisis”.

³⁶ B Stewart, R Schatz, A Khare, “Making Sense of Digital Disruption Using a Conceptual Two-Order Model” in A Khare, B Stewart, R Schatz (eds), *Phantom Ex Machina: Digital Disruption’s Role in Business Model Transformation* (Springer International Publishing Switzerland, Cham, 2017) at 3.

³⁷ A Khare, B Stewart, R Schatz (eds), *Phantom Ex Machina: Digital Disruption’s Role in Business Model Transformation* (Springer International Publishing Switzerland, Cham, 2017).

³⁸ B Stewart, R Schatz, A Khare, “Making Sense of Digital Disruption Using a Conceptual Two-Order Model” in A Khare, B Stewart, R Schatz (eds), *Phantom Ex Machina: Digital Disruption’s Role in Business Model Transformation* (Springer International Publishing Switzerland, Cham, 2017) at 6.

Digital disruption has brought a new dynamic to the way insolvency practitioners are able to undertake their role and function with the proliferation of new technology. One example of this is machine-learning and enhanced artificial intelligence which, among other things, have the potential to ascertain whether a company has indicators of insolvency,³⁹ and to facilitate technology aided reviews and / or auditing.⁴⁰ Other examples include cloud computing which offers practitioners flexible and affordable digital services over the internet⁴¹ and technology such as drones which may assist in locating, monitoring and / or counting assets.⁴² These are some examples of the potential ways in which insolvency practitioners can apply digital and other technological advancements in their day-to-day practices.

Insolvency practitioners must be able to adapt their practices swiftly in response to the rapid advances in technology, which can impact upon insolvency practitioners and their provision of solvency / insolvency services. This includes addressing the increased risk associated with cyber security, which has been predicted to cost in excess of USD 6 trillion globally by 2021.⁴³ It also includes strategies to manage the difficulties associated with recognition of the legal status of cyber assets, as well as difficulties in classifying, locating, accessing, protecting and realising such assets.⁴⁴

By way of one example, insolvency practitioners must manage a number of challenges in insolvency administrations associated with cryptocurrencies, such as Bitcoin. Bitcoin is a cryptocurrency that uses public ledgers operating blockchain technology and is "a digital asset designed to act as a store of value or medium of exchange in the digital economy".⁴⁵ These currencies are not regulated by any single authority, there is no centralised issuer or manager with respect to them and they can, in some circumstances, be issued without any major approval process.⁴⁶

Insolvency practitioners may need to investigate, locate, classify and realise Bitcoin assets. However, there is arguably no international consensus regarding the classification of

³⁹ See, eg, M Ayyoub and A Riaz, "The Artificial Neural Network Method: A Practical Guide for Business Research", *Journal of Business Strategies* (2017) 11(1) 113; and K Smith and J Gupta, "Neural Networks in Business: Techniques and Applications for the Operations Researcher", *Computers & Operations Research* (2000) 27(11) 1023.

⁴⁰ F Assaf, "Bits and Bots at Work - the Impact of AI on the Legal and Insolvency Professions", *INSOL World* (2018) 19.

⁴¹ A Aljabre, "Cloud Computing for Increased Business Value", *International Journal of Business and Social Science* (2012) 3(1) 234.

⁴² D McCance, "EY to Take to the Sky with New Audit Drones" (Economia, 13 June 2017).

⁴³ S Morgan (ed in chief), *2019 Official Annual Cybercrime Report* (Herjave Group, 2019) available at <https://www.herjavegroup.com/wp-content/uploads/2018/12/CV-HG-2019-Official-Annual-Cybercrime-Report.pdf>.

⁴⁴ C Deppert, "Bitcoin and Bankruptcy: Putting the Bits Together", *Emory Bankruptcy Developments Journal* (2015) 32(1) 123; and J Sara and L Gullifer, "Crypto-claimants and bitcoin bankruptcy: Challenges for recognition and realization", *International Insolvency Review* (2019) 28(2) 233.

⁴⁵ J Sara and L Gullifer, "Crypto-claimants and bitcoin bankruptcy: Challenges for recognition and realization", *International Insolvency Review* (2019) 28(2) 233 at 235.

⁴⁶ *Ibid.*

Bitcoin as property or otherwise, with different jurisdictions taking inconsistent standpoints.⁴⁷ In the United Kingdom (UK), Bitcoin has been held intangible and this raises the difficulty of taking possession of an intangible.⁴⁸ The Canadian court approved the preservation of an order in a case seeking damages with respect to alleged misappropriation of Bitcoin from a company, suggesting Bitcoin might be considered proprietary in nature.⁴⁹ Similarly, in Australia, it is likely that Bitcoin and other cryptocurrency satisfy the definition of “property” within the relevant corporate insolvency legislation.⁵⁰ However, in Japan, the Tokyo District Court held that Bitcoin units could not be an object of ownership, because ownership was considered limited to tangible objects.⁵¹

These inconsistent approaches can result in added complexity in the administration of insolvency involving digital assets such as Bitcoin, especially across a number of different jurisdictions that classify digital assets incompatibly. International insolvency law needs to adapt in response to complications from such kinds of digital transformation. In this respect it is noted that international institutes are considering responses to digital concerns, such as the *Institut International pour l’Unification de Droit Privé* (International Institute for the Unification of Private Law), commonly known as UNIDROIT, which has established a working group that intends to develop a future legal instrument containing principles and guidance regarding private law and digital assets.

Another example is the complexity that arises with respect to social media. Technological advances have facilitated mass communication through mutual data communication and social media forums.⁵² This has impacted upon the professional life and the methods of communication between professionals, stakeholders and customers. It has also seen the blurring of personal and professional lives, that were once kept separate.⁵³

The prevalence of social media forums such as Facebook, Twitter and blogs provide opportunities not only in new forms of advertisement and / or communication, but also in the creation of virtual learning events such as web casts and virtual learning environments that are offered by professional and other bodies to educate and train the practitioners.⁵⁴

⁴⁷ *Idem* at 242.

⁴⁸ *Idem* at 244; *OBG Ltd v Allan* [2007] UKHL 21; *Gray v GTP Group Ltd; In re F2G Realisations Ltd* [2010] EWHC 1772 (Ch); and *Your Response Ltd v Datateam Business Media Ltd* [2014] EWCA Civ 281.

⁴⁹ J Sara and L Gullifer, “Crypto-claimants and bitcoin bankruptcy: Challenges for recognition and realization”, *International Insolvency Review* (2019) 28(2) 233 at 246; and *Shair.Com Global Digital Services Ltd. v Arnold* 2018 BCSC 1512 (BCSC).

⁵⁰ L Pascoe and J Scott, “Identifying & Dealing with Cryptocurrency Assets in Corporate Insolvency”, *Australian Restructuring & Turnaround Association Journal* (2018) (September) 18 19.

⁵¹ J Sara and L Gullifer, “Crypto-claimants and bitcoin bankruptcy: Challenges for recognition and realization”, *International Insolvency Review* (2019) 28(2) 233 253, referring to Tokyo District Court, Heisei 26 (Year of 2014), (Wa)33320, Judgement of Civil Division 28 of 5 August 2015 (Year of Heisei 27).

⁵² U Gunduz, “The effect of Social Media on Identity Construction”, *Mediterranean Journal of Social Sciences* (2017) 8(5) 85.

⁵³ G Scott, “Social Media is blurring professional boundaries”, *Nursing Standard* (2013) 27(52) 1.

⁵⁴ C Coupland and M Boyle, “Professions under pressure: voices from the field’ in A Wilkinson, D Hislop, and C Coupland (eds) *Perspectives on Contemporary Professional Work* (Edward Elgar Publishing Ltd,

It also provides new opportunities for consumers to offer negative statements directly to the public, with fast-paced and broad-sweeping re-posting or re-tweeting facilitating the rapid spreading of such statements to a very broad audience.⁵⁵ This negative posting behaviour has been linked to the direct release of negative emotions by frustrated and dissatisfied customers (or stakeholders).⁵⁶

The insolvency profession has not avoided the trend of social media venting. For example, in an empirical study in Australia, one insolvency practitioner described how social media had made it more difficult for her to manage disgruntled stakeholders who used social media as a “forum of negativity” and “culture of complaining” to lash out in fear and heat of the moment anger, or even to threaten self-harm or suicide based on practitioner decisions or outcomes.⁵⁷ The practitioner described frustration at her inability to ignore notifications / messages on her phone late at night.⁵⁸ There is a need for insolvency practitioners to adapt strategies to manage this social media trend.

3.3 Reticence to adopt new technologies

There is a clear need for insolvency practitioners to adapt swiftly to technological advances, such as those exemplified above. However, there is some evidence that insolvency practitioners, particularly more senior practitioners, are challenged by this need to adapt. The pace of globalisation and technological advancement has arguably created a societal and cultural variance between generations.⁵⁹ The speed of this change has been more readily embraced by younger generations by adopting new language, music, arts and use of technology in the construction of their lives and business.⁶⁰ However, it has been difficult for more seasoned generations who are more comfortable with older traditions and approaches.

This concept is demonstrated in empirical research conducted in Australia in 2017 where 23 insolvency practitioners were interviewed for a phenomenological study.⁶¹ This research suggested a general reticence by some Australian insolvency practitioners,

Cheltenham, 2016) at 127; G Fowlstone, “Managing Social Media in a Crisis”, *Australian Restructuring Insolvency & Turnaround Association Journal* (2017) 29(1) 30 at 32.

⁵⁵ Y S Yen, “Factors enhancing the posting of negative behaviour in social media and its impact on venting negative emotions”, *Management Decisions* (2016) 54(10) 2462 2462.

⁵⁶ *Idem*, 2478.

⁵⁷ E Streten, “Insolvency Practitioners: A Phenomenological Study”, *Insolvency Law Journal* (2021) 29 83 at 100; E Streten, “Practitioners’ Perspectives: Experiences Adhering to Legal and Ethical Regulatory Standards” (PhD thesis, Queensland University of Technology, 2019) available at https://eprints.qut.edu.au/134254/1/Elizabeth_Streten_Thesis.pdf.

⁵⁸ *Ibid.*

⁵⁹ J Matthewman, *The Rise of the Global Nomad How to manage the new professional in order to gain recovery and maximize future growth* (Kogan Page, London, 2011) at 14.

⁶⁰ *Ibid.*

⁶¹ E Streten, “Insolvency Practitioners: A Phenomenological Study” *Insolvency Law Journal* (2021) 29 83 at 101; E Streten, “Practitioners’ Perspectives: Experiences Adhering to Legal and Ethical Regulatory Standards” (PhD thesis, Queensland University of Technology, 2019) available at https://eprints.qut.edu.au/134254/1/Elizabeth_Streten_Thesis.pdf.

particularly older practitioners, to embrace new technologies in their insolvency practices; despite expressing frustration with non-user friendly costly and antiquated software, various interviewed insolvency practitioners in Australia discussed a reluctance by practitioners to adopt alternative technologies proactively and instead choosing to continue using inadequate software.⁶²

A similar finding was made in another Australian empirical study where 27 practitioners and 45 bankruptcy trustees were surveyed throughout July 2017 to February 2018.⁶³ Among other things, the survey results showed that:

- (a) 45 per cent said that they had not held electronic creditor meetings;
- (b) 36.2 per cent said that they did not look to the experience of other industries or professions for guidance in managing digital disruption;
- (c) 23.2 per cent said they had not previously considered reflecting upon other industries or professions for guidance in managing digital disruption;
- (d) 55 per cent said they had considered how regulatory technology changes might impact upon insolvency staff, clients and processes, but few gave distinct signs of implementing specific changes to manage that impact;
- (e) 79.2 per cent agreed that technology had altered how they conducted investigations in a positive way, however there did not appear to be application of innovative technologies when investigating insolvencies; and
- (f) 38.9 per cent said that they had altered their staff recruitment requirements in relation to employing technology-savvy staff.⁶⁴

This reluctance to adopt new technology has significant consequences with respect to the professional identity of insolvency practitioners. Empirical research undertaken within the insolvency profession in Australia raises concerns that practitioners' professional identity can be weakened by rapidly changing work environments and by any inability to respond to such change.⁶⁵

⁶² E Streten, "Practitioners' Perspectives: Experiences Adhering to Legal and Ethical Regulatory Standards" (PhD thesis, Queensland University of Technology, 2019) available at https://eprints.qut.edu.au/134254/1/Elizabeth_Streten_Thesis.pdf.

⁶³ J Dickfos, "AI and the Insolvency Profession: The State of Play", *Insolvency Law Journal* (2018) 26 172. There may be some dual registrations not taken into account in these figures.

⁶⁴ *Ibid.*

⁶⁵ E Streten, "Practitioners' Perspectives: Experiences Adhering to Legal and Ethical Regulatory Standards" (PhD thesis, Queensland University of Technology, 2019) available at https://eprints.qut.edu.au/134254/1/Elizabeth_Streten_Thesis.pdf.

The term “professional identity” relates to a professional’s self-image and refers to how individuals define themselves in their role, philosophy and approach to others within and outside of their profession.⁶⁶ It draws upon social identity theory and enables members of different professions to distinguish themselves by forming their own unique sense of identity.⁶⁷ Arguably, a strong professional identity is imperative to facilitate job satisfaction, productivity, success and commitment by engendering personal adequacy, satisfaction and autonomy in the interpretation and performance of practitioners’ professional role.⁶⁸

The general reluctance to change in response to upheaval has been considered within the context of the medical profession. Medical literature has established that reluctance to change is a natural part of practice, because professional identity is, in some ways, “driven by the force of habit” and there is a “trauma” involved in the self-questioning needed to adapt in response to change.⁶⁹ Similarly, Susskind and Susskind believe that there can be a professional reticence to comprehend the significant transformational influence of digital disruption, which they describe as “AI fallacy”.⁷⁰ They describe the potential for automation to replace tasks performed by people. Technology has certainly made a number of aspects of insolvency more automated, but human insolvency practitioners remain at the forefront of insolvency management. The challenge is for practitioners to adapt to the changing world and to embrace advances in technology that can improve their practices, improve confidence in their practices, and strengthen the professional identity of practitioners.

4. The changing concept of the “professional”

A significant challenge for insolvency practitioners relates to the changing social and cultural expectations that accompany globalisation. In the 21st century, insolvency practitioners are faced with the process of “deprofessionalisation”: being “the loss by professional occupations of their unique qualities, in particular their monopoly over knowledge, public trust, autonomy and authority over their client base.”⁷¹ An example of deprofessionalisation within the insolvency profession is the provision of solvency and insolvency services by non-professionals (sometimes labelled “specialised general

⁶⁶ L Sperry, *Mental Health and Mental Disorders: an Encyclopedia of Conditions, Treatments and Well-Being* (Greenwood, Santa Barbara, 2016) at 874.

⁶⁷ H Tajfel and J Turner, “An integrative Theory of Intergroup Conflict” in W G Austin, S Worchel (eds) *The social psychology of intergroup relations* (Brooks/Cole Pub. Co, Monterey, 1979); and J Tsakissiris, “The Role of Professional Identity & Self-Interest in Career Choices in the Emerging ICT Workforce” (Thesis by Research, Queensland University of Technology, 2015).

⁶⁸ R White and C E Ewan, *Clinical teaching in nursing* (Nelson Thornes, 1997) at 190.

⁶⁹ S Wackerhausen, “Collaboration, professional identity and reflection across boundaries”, *Journal of Interprofessional Care* (2009) 23(5) 455.

⁷⁰ R Susskind and D Susskind, *The Future of the Professions: How Technology Will Transform the Work of Human Experts* (1st ed, Oxford University Press, Oxford, 2015) 278 at 279.

⁷¹ L Scanlon, “Introduction” in L Scanlon (ed) *Becoming a Professional: An Interdisciplinary Analysis of Professional Learning* (Springer Netherlands, 2011) 6 referencing P Halmos, *Professionalisation and social change* (University of Keile, Keile, 1973).

professionals")⁷² such as pre-insolvency advisors and other advisors. The registered and qualified insolvency practitioner is no longer the sole trusted provider of solvency and insolvency solutions, and alternative advisors are viewed as potential options by those seeking solvency or insolvency services.

Dent and Whitehead argue that changing social and cultural assumptions are subject to unprecedented uncertainty and that the standards and traditions of the past century are incompatible with the modern world.⁷³ They believe that there is a new rigorous scrutiny of all things, with customers and stakeholders deconstructing and questioning ideologies and assumptions that once grounded the "professional".⁷⁴ There is now greater access to information through advancing technology, which means that professionals such as insolvency practitioners are no longer the "sole custodians" of specialist insolvency knowledge and expertise.⁷⁵

Arguably, the unquestioning trust that was previously bestowed upon professionals has been lost and insolvency practitioners must now promote their value to consumer and stakeholder.⁷⁶ This is because digital technology and globalisation enable greater access to information about products, services, prices and expert knowledge that was once only available to specialist professionals.⁷⁷ This facilitates consumer and stakeholder empowerment.⁷⁸

Yet, access to information through the internet and other technology is not enough to empower consumers and stakeholders. There also has to be a meaningful awareness and understanding both of how to use the technology and of how to apply the information to positive ends.⁷⁹ It also raises the possibility of so called "armchair experts" who assert knowledge about a subject without having any true understanding of that subject. Misinformation and poor advice are readily available along with any valuable information on the internet and the layperson may find it difficult to discern one from the other.

⁷² H M Kritzer, "The professions are dead, long live the professions: Legal practice in a postprofessional world", *Law & Society Review* (1999) 33(3) 713 715.

⁷³ M Dent and S Whitehead, "Introduction: Configuring the 'new' professional" in M Dent and S Whitehead (eds), *Managing Professional Identities Knowledge, performativity and the 'new' Professional* (1st ed, Routledge, London, 2002) 1 at 1.

⁷⁴ *Ibid.*

⁷⁵ J Dickfos, "AI and the Insolvency Profession: The State of Play", *Insolvency Law Journal* (2018) 26 172.

⁷⁶ M Dent and S Whitehead, "Introduction: Configuring the 'new' professional" in M Dent and S Whitehead (eds), *Managing Professional Identities Knowledge, performativity and the 'new' Professional* (1st ed, Routledge, London, 2002) 1; and G D Pires, J Stanton and P Rita, "The internet, consumer empowerment and marketing strategies", *European Journal of Marketing* (2010) 40(9) 936 at 937.

⁷⁷ T Harrison, K Waite and G L Hunter, "The internet, information and empowerment", *European Journal of Marketing* (2010) 40(9) 972 973.

⁷⁸ G D Pires, J Stanton and P Rita, "The internet, consumer empowerment and marketing strategies", *European Journal of Marketing* (2010) 40(9) 936; R Deshpande, "Performance Companies", *International Journal of Medical Marketing* (2002) 2(3) 225; and M Sawhney and P Kotler, "Marketing in the age of information democracy" in D Iacobucci (ed) *Kellogg on Marketing* (Wiley, New York, 2001) 386.

⁷⁹ G D Pires, J Stanton and P Rita, "The internet, consumer empowerment and marketing strategies", *European Journal of Marketing* (2010) 40(9) 936.

4.1 Consumer empowerment, examples from the medical profession

The positives and negatives of increased consumer empowerment have been considered within the context of the medical profession.⁸⁰ There may be a number of benefits such as an improved ability for informed patients who can communicate with doctors⁸¹ and the improved ability to treat patients in remote areas and across different time zones.⁸² However, there are concerns regarding misdiagnosis from the use of disreputable medical information, which may in turn result in poor health treatments, patients failing to seek proper medical care, patient anxiety and frustration among medical professionals.⁸³ By obtaining advice from “Dr Google” instead of trained professional practitioners, patients may not be receiving the best medical advice and also may not be appreciative of the expertise of registered medical practitioners.

4.2 Consideration of the insolvency profession

Similar issues may arise with respect to the insolvency profession, where unqualified “turnaround specialists” such as pre-insolvency advisors may provide advice in order for a company to avoid the consequences of insolvency. These advisors might even provide advice to strip a business of its assets and to transfer them to a new entity in the form of illegal phoenix activity to facilitate ongoing trade without the burden of corporate debt, much to the detriment of creditors.⁸⁴

Insolvency practitioners are generally required to maintain their independence and to retain the confidence of all parties, while managing a broad range of competing stakeholders with their own distinct interests and expectations.⁸⁵ It is a complex role, requiring practitioners to balance their own profiteering self-interests and the interests of numerous other parties. There is arguably low confidence in insolvency practitioners’ ability to achieve this requisite independence and neutrality.⁸⁶

⁸⁰ See, eg, the discussions of what is colloquially called “Dr Google” in J Escarrabill, T Marti and E Torrente, “Good morning, Doctor Google”, *Revista portuguesa de pneumologia* (2011) 17(4) 177.

⁸¹ M Ferguson, “Patients that use “Dr Google” are better off: Doctor Google gets a pretty bad wrap but new research shows that patients who do their own research online to diagnose symptoms are better able to communicate with their doctors”, *Seven News, Australia*, 20 August 2018.

⁸² J Escarrabill, T Marti and E Torrente, “Good morning, Doctor Google”, *Revista portuguesa de pneumologia* (2011) 17(4) 177.

⁸³ J Astrup, “Doctor Google will see you now”, *February Community Practitioners* (2018) 28 at pp 28-29.

⁸⁴ H Anderson and J Hedges, “Catching Pre-Insolvency Advisors: The Hidden Culprits of Illegal Phoenix Activity”, *Company and Securities Law Journal* (2017) 35(8) 486.

⁸⁵ C Anderson, “Miracle workers or ambulance chasers? The role of administrators in the Part 5.3A process”, *Insolvency Law Journal* (2004) 12(4) 238; and United Nations Commission on International Trade Law, *Legislative Guide on Insolvency Law*, pp175-176.

⁸⁶ Under-confidence in UK insolvency solutions is discussed for example in J M Wood, “Assessing the effectiveness of the UK’s insolvency regulatory framework at deterring insolvency practitioners’ opportunistic behaviour”, *Journal of Corporate Law Studies* (2019) 19(2) 333. Under-confidence in Australian insolvency practitioners is demonstrated by stakeholder survey commissioned by the Australian Securities and Investments Commissions, where insolvency practitioners received the lowest rating for

This has not been assisted by recent high-profile cases of insolvency practitioner misconduct,⁸⁷ allegations of insolvency practitioners colluding with pre-insolvency advisors in order to attract future business,⁸⁸ and concerns regarding insolvency practitioners' high fees.⁸⁹ In a contemporary world where expertise is more accessible and affordable than ever before, practitioners must find a way to promote the value of their professional expertise and to educate as to the possible risks of misinformation sourced from alternative technologies and / or providers.⁹⁰

Part of the difficulty in promoting insolvency practitioners and their expertise in the provision of insolvency solutions, is the trauma involved in bankruptcy and insolvency generally. Insolvency is a traumatic experience for those involved, given the inherent loss and distress involved. It is therefore unsurprising that practitioners may be attributed blame for disappointing outcomes.⁹¹ This is especially unsurprising where practitioners may be seen to be profiting from the misery of others, through their collection of high fees.⁹² Directors, stakeholders and others may therefore seek out alternative solutions through the internet or otherwise.

Arguably, the overarching cause of under-confidence in practitioners is attributed to unrealistic expectations of practitioner performance and outcomes.⁹³ Insolvency academics Brown and Anderson theorise that the general lack of confidence in the insolvency profession is due to a broad social issue in the absence of realistic community and stakeholder understanding of insolvency practice.⁹⁴ These excessive public expectations have significant ramifications upon the public's determination of blame. In

perceived integrity; available at <https://asic.gov.au/about-asic/what-we-do/how-we-operate/stakeholder-liaison/stakeholder-surveys/>.

⁸⁷ See, eg, the UK case of *Re Polly Peck International plc (in administration) (No 2) Marangos Hotel Co Ltd and Others v Stone and Others* [1998] 3 All ER 812 where accountants from Coopers & Lybrand and its chairman did not reveal extensive links to Polly Peck and its chairman Asil Nadir. Also see the case of *Australian Securities and Investments Commission v Stuart Karim Ariff* [2009] NSWSC 829 (18 August 2009) where Australian practitioner Stuart Ariff was banned as an official and registered liquidator for life and received a six year jail sentence following conviction on 19 criminal charges.

⁸⁸ H Anderson and J Hedges, "Catching Pre-Insolvency Advisors: The Hidden Culprits of Illegal Phoenix Activity", *Company and Securities Law Journal* (2017) 35(8) 486; and *Australian Securities and Investments Commission v Franklin (liquidator), in the matter of Walton Constructions Pty Ltd* [2014] FCAFC 85.

⁸⁹ See, eg, the discussion of monopoly, secrecy of charge-out rates and high practitioner fees discussed in J Cousins *et al*, *Insolvent Abuse: Regulating the Insolvency Industry* (Association for Accounting and Business Affairs, Essex, 2000) 12 - 17; also see L Jacobs, "Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy?", INSOL International, *Special Report* (August 2020).

⁹⁰ R Susskind and D Susskind, *The Future of the Professions: How Technology Will Transform the Work of Human Experts* (1st ed, Oxford University Press, Oxford, 2015) 278 at 2.

⁹¹ E Streten, "Practitioners' Perspectives: Experiences Adhering to Legal and Ethical Regulatory Standards" (PhD thesis, Queensland University of Technology, 2019) available at https://eprints.qut.edu.au/134254/1/Elizabeth_Streten_Thesis.pdf.

⁹² L Jacobs, "Corporate Insolvency Practitioners, ethics and remuneration: Not a case of moral bankruptcy?", INSOL International, *Special Report* (August 2020).

⁹³ C Brown and C J Anderson, "Mind the Insolvency Gap: Lessons to Be Learned from Audit Expectations Gap Theory", *Insolvency Law Journal* (2014) 22(4) 178.

⁹⁴ *Ibid*.

the absence of public understanding about the reality of insolvency practice, the public's unmet expectations, together with the trauma resulting from the innate losses associated with insolvency, cause the public to attribute blame directly to the insolvency practitioners.⁹⁵ This is done regardless as to whether blame is warranted or not.

This attribution of blame to practitioners is arguably exacerbated by the combination of globalisation, connectivity through advancing technology, and the erosion of public trust with more knowledgeable and empowered consumers and stakeholders. It is argued that these changes undermine the power and status of the professional,⁹⁶ including the insolvency professional.

5. The future for insolvency practitioners: closing reflections

The question arises as to how insolvency practitioners might manage their complex role amidst the ongoing disruption of modern technology, changing social expectations and the general loss of unquestioning trust once conferred upon the elevated class of the professional.⁹⁷ Practitioners, professional bodies, and the insolvency profession itself need to adapt to the new dominant culture of globalised consumer-orientated practice.⁹⁸

The first steps are recognising and understanding the challenges before proactively modifying practices in order to maintain relevance and valued status within the contemporary new world. This requires deeper research into the current practices and the challenges faced within international and domestic insolvency markets, including the adoption of, and difficulties caused by, advancing technologies and including the new expectations and relationships between practitioners, stakeholders and insolvency regulators. It is imperative that the insolvency profession is responsive to a changing environment. This requires a collective understanding of what changes and challenges the future of the profession now faces.

⁹⁵ *Idem*, 179-181.

⁹⁶ A Wilkinson, D Hislop and C Coupland, "The changing world of professions and professional workers" in Adrian Wilkinson (ed) *Perspectives on Contemporary Professional Work* (Edward Elgar Publishing Ltd, Cheltenham, 2016) at 3.

⁹⁷ J Dickfos, "AI and the Insolvency Profession: The State of Play", *Insolvency Law Journal* (2018) 26 172.

⁹⁸ M Dent and S Whitehead, "Introduction: Configuring the 'new' professional" in M Dent and S Whitehead (eds), *Managing Professional Identities Knowledge, performativity and the 'new Professional'* (1st ed, Routledge, London, 2002) 1 at 3.

Pension reforms in England: Should insolvency practitioners be concerned?

By Eugenio Vaccari, Royal Holloway and Bedford Colleges, University of London, United Kingdom*

Abstract

This paper looks at the impact of the Pension Schemes Act 2021 on corporate insolvency practice, particularly in light of the reforms introduced by the Corporate Insolvency and Governance Act 2020. It shows that the lack of co-ordination in the rationales and objectives underpinning the two statutory instruments is likely to give rise to implementation problems and conflicting guidance to directors and insolvency practitioners.

1. Introduction

Given their ability to block access to capital, growing pension deficits have placed an increasing strain on companies' cash flows. Coupled with the financial impact of the COVID-19 pandemic, pension schemes that rely on a flourishing sponsoring employer will be thinking hard about what they should do to help the sponsor and protect their members.

Following the approval by both Houses of Parliament, the Pension Schemes Act 2021 received Royal Assent on 11 February 2021. It brings with it many changes to the Pensions Act 2004 – affecting pension scheme trustees, employers, and advisers. Some of these changes also affect insolvency practitioners and anyone else who is involved in the running of a pension scheme or the restructuring of an employer's company or group of companies.

This paper focuses on the consequences of the Pension Schemes Act 2021 for corporate insolvency practice. It is preliminarily appropriate, however, to discuss whether there was a real need for the adoption of sweeping changes to the legislation – at least from the perspective of insolvency practice – before discussing to what extent the main changes introduced by the Pension Schemes Act 2021 address ongoing concerns and share the rationale and goals underpinning the recent reforms in the area of corporate insolvency law.

* Dr Eugenio Vaccari is a Lecturer in Law (Royal Holloway and Bedford Colleges, University of London). This paper covers literature and case law published before 1 February 2021. A shorter version of this paper was published on 21 February 2021 on the [Department of Law and Criminology's blog page](#) at Royal Holloway, University of London. The usual disclaimer applies.

2. Was a new Pension Schemes Act needed?

The recent collapse of high street retailers Arcadia (in December 2020)¹ and evidence of employers withholding contributions to pension schemes,² has once again brought to the fore a long-standing problem: the protection of employees' pensions, particularly on occasion of the employer's failure.

In order to assess the need for reform of the existing system, this paper first focuses on the types of pension schemes currently available on the market. It then discusses the powers provided to the Pensions Regulator (TPR) against insolvent funders and connected parties to protect existing employees and retired workers under the pension scheme.

2.1 Pension schemes

There are two main types of private pensions in the United Kingdom (UK). More recently, employers have moved towards defined contribution (DC) pension schemes. In DC pension schemes, employees contribute with part of their salaries to a workplace or private pension through their employers. These contributions are usually made on a monthly basis. The money is put into an investment by the pension provider and the value of the employee's pension varies depending on the performance of such investment. The return to the employee depends on how much was paid into the scheme and on the performance of the investment.

The employer's liquidation or administration is unlikely to affect the DC scheme, provided that contributions remained current throughout the employment. The scheme is independent from the employer. Unpaid employment contributions can be claimed from the National Insurance Fund. If the pension provider that runs the scheme enters into a formal insolvency proceeding, the employee can seek compensation from the Financial Services Compensation Scheme.

The traditional type of private pension, however, has always been the defined benefit (DB) pension scheme. A DB pension (also called a "final salary" pension) is a type of workplace pension that pays a retirement income based on the salary and the number of years that the employee has worked for the employer. The amount of money the employee contributed to the pension is irrelevant. Nowadays, most private sector DB pension schemes are closed to new members or new accruals. However, DB pension schemes remain an integral part of the UK pensions system, with an estimated 10.4 million members relying on them.³

¹ J Cumbo, "Arcadia collapse: what it means for 10,000 staff pensions" *Financial Times* (London, 1 December 2020) available at <https://on-ft-com.ezproxy01.rhul.ac.uk/3drF1nb>.

² J Cumbo, "Many UK companies delay investing worker pension contributions" *Financial Times* (London, 14 August 2020) available at <https://on-ft-com.ezproxy01.rhul.ac.uk/37wH3hW>.

³ Department for Work and Pensions, *Pension Schemes Bill 2020 Impact Assessment: Summary of Impacts* (January 2020) available at <https://publications.parliament.uk/pa/bills/lbill/58-01/004/5801004-IA-Summary-of-Impacts.pdf> para 6.

DB pension schemes can have one or more sponsoring employers. DB pension schemes are more advantageous for the employees, provided that employers do not default on their payments. In fact, the collapse of the employer may have significant adverse consequences for the beneficiaries of a DB pension scheme. In a DB pension scheme, the employer is responsible for ensuring that there is enough money in the scheme at the time of the employee's retirement. The employer's failure may uncover a deficit in the DB pension scheme.

Shortfalls in DB pension schemes are far from uncommon. According to the latest figures available on PwC's Skyval index,⁴ the funding deficit for the UK's 5,000-plus corporate DB pension schemes was in the region GBP 120 billion in January 2021.

If the employer fails, the insolvency practitioner appointed over the company must give notice of the insolvency to TPR, the Pension Protection Fund (PPF) and the trustees or managers of the pension scheme (a "section 120 notice").⁵

On a company's insolvency, the DB pension scheme is protected by the industry lifeboat fund run by the PPF.⁶ Created by the Pensions Act 2004, the PPF is an insurance arrangement and a statutory public corporation accountable to Parliament through the Secretary of State for the Department for Work and Pensions (DWP). The PPF is funded by levying an insurance premium on all DB pension schemes and by accepting the assets of schemes from insolvent employers. This ensures that pensions are paid without interruption.

Should the sponsoring employer(s) of a DB pension scheme enter into a formal insolvency procedure, the scheme will enter an assessment period to determine whether it is eligible for protection by the PPF. In the case of an affirmative outcome of such assessment, the PPF provides most current pensioners with their full existing payments, although future inflation uplifts will be reduced. It pays around 90 per cent of the promised initial pension to members below pension age, but again with reduced annual inflation increases and with a current maximum amount of GBP 41,461 per year.⁷

These two models place all the risks and associated costs – economic, financial, and longevity – with either the sponsoring employer or PPF (DB pensions schemes), or the individual member (DC pension schemes). The argument to reform such system is, therefore, unquestionable.

⁴ "PwC Pension Funding Index - new funding approach could leave DB pension schemes £70bn in the black, analysis shows" (2 February 2021) available at <https://www.pwc.co.uk/press-room/press-releases/pwc-pension-funding-index-new-funding-approach-could-leave-db-pension-schemes-70bn-in-the-black-analysis-shows.html>.

⁵ Pensions Act 2004, s 120.

⁶ See, eg, <https://www.ppf.co.uk/>.

⁷ "Changes to the compensation cap 2020/21" (1 April 2020) available at <https://www.ppf.co.uk/news/changes-compensation-cap-2020/21>.

2.2 The Pensions Regulator's regulatory powers

TPR is the body that regulates work-based pension schemes. Its statutory objectives include to protect the benefits of pension scheme members, to reduce the risk of calls on the PPF, and to promote good administration of work-based pension schemes.⁸ These include new grounds on which TPR can issue contributory notices in relation to a DB pension scheme, as well as the introduction of new offences in relation to such schemes. TPR became operational on 6 April 2005.

As stated above, the insolvency practitioner has to inform TPR if an insolvency event occurs, in order to determine if the PPF has to step in and identify any potential liability on the previous directors of the company.

With reference to contribution notices, TPR used to have the power to issue them⁹ as a result of being of the opinion that the "material detriment" test was met.¹⁰ TPR issued the Code of Practice 12 to set out the circumstances in which the regulator is expected to issue a contribution notice.¹¹ According to such Code of Practice, a contribution notice for breach of the material detriment test can be issued if:

- the act, or failure to act, has been materially detrimental to the likelihood of the accrued scheme benefits being received (whether the benefits are to be received as benefits under the scheme or otherwise);
- the statutory defence is not met in relation to the act, or failure to act; and
- it is reasonable to impose liability on the person to pay the sum specified in the contribution notice.

An alternative test (the "main purpose" test) allows TPR to challenge an act or failure to act designed to prevent the recovery of all or part of a debt due to the scheme under the Pensions Act 1995 (a so-called section 75 debt),¹² or prevent such a debt from becoming due, or reduce or compromise that debt.

A section 75 debt is the money that the employer needs to pay to the pension scheme when he withdraws from it, for instance as a result of the employer's insolvency.¹³ This debt is calculated on a "buy-out" basis, that tests whether there would be sufficient assets in the

⁸ Pensions Act 2004, s 5(1).

⁹ *Idem*, s 38.

¹⁰ *Idem*, s 90.

¹¹ The Pensions Regulator, *Circumstances in relation to the material detriment test* (Code of Practice No. 12, Mat 2009).

¹² Pensions Act 1995, s 75.

¹³ On the impact of s 75 debts in administrations, see *BESTrustees Plc v Kaupthing Singer & Friedlander (in administration)* [2013] EWHC 2407 (Ch).

pension scheme to secure all the member benefits by buying annuity contracts from an insurance company.

Contribution notices can be issued up to six years after an act, or failure to act, took place. Where section 75 debt notices are issued by the PPF against the insolvent company and rank as unsecured credits, with little chance of being paid, contribution notices are issued by TPR against persons who are associates of or connected with pension scheme employers. There are, therefore, greater chances of them being paid for the benefit of the scheme members.

Overall, it can be observed that the circumstances under which TPR can impose this power have proven to be very narrow to date. This had raised problems for TPR in trying to use these contribution notices to target some of the individuals involved in activities which clearly undermine the security of members' benefits.¹⁴

To support a scheme in deficit, TPR can also issue a financial support direction.¹⁵ This is possible where the sponsoring employer is unable to support the scheme and where an associated party has been deriving financial gain from the sponsoring company (often a parent company or a company within the group structure).

In those situations, TPR can call on that party to put in place a long-term financial support plan for the scheme. TPR can issue a financial support direction if the scheme's employer was either a service company or "insufficiently resourced"¹⁶ at the relevant time. The procedure can start only up to two years after the relevant time.

TPR's power to issue contribution notices for failure to comply with the material detriment test as well as financial support direction were seen as being largely ineffective. This emerged clearly in the cases of *Nortel* and *Lehman*,¹⁷ as well as in the *Bernard Matthews* affair.¹⁸

¹⁴ L Amin, "TPR's new powers - a proportionate response or a major constraint on corporate activity?" *LCP* (London, 17 January 2021) available at <https://www.lcp.uk.com/our-viewpoint/2021/01/tpr-s-new-powers-a-proportionate-response-or-a-major-constraint-on-corporate-activity/>.

¹⁵ Pensions Act 2004, ss 43-50.

¹⁶ "Insufficiently resourced" means that an employer's resources are valued at less than 50% of its estimated s 75 debt to the scheme at the relevant time. There also needs to be one or more associated or connected entities that have enough value to make up the difference. See <https://www.thepensionsregulator.gov.uk/en/about-us/how-we-regulate-and-enforce/anti-avoidance-powers#8d28d91ec6d14ad59e99473428b1ced5>.

¹⁷ *Re Nortel and Lehman Brothers* [2013] UKSC 52.

¹⁸ For a detailed analysis, see M Thomas, "Bernard Matthews Limited - the Pensions Regulator's investigation following the company's insolvency", *Company Secretary's Review* (2020) 44(5) 65; and M Brown, "Bernard Matthews pension scheme: regulatory intervention report", *PLC Magazine* (2020) 31(8) 75.

3. Regulatory changes introduced by the Pension Schemes Act 2021

In order to address the issues described in the previous section of this paper, the Government recommended the adoption of a new pension scheme, as well as the introduction of new regulatory powers to TPR. This section also briefly covers the new offences introduced under the Pension Schemes Act 2021, in order to demonstrate the extent to which they contribute to the establishment of a culture aimed at preventing pension scheme deficits.

3.1 New pension scheme

In order to overcome the limits of the existing pension schemes, the Government created a third option called collective defined contribution (CDC) pension schemes. Under CDC schemes, referred to as “collective money purchase schemes” (CMPS),¹⁹ risk is entirely with the members but shared between them collectively, as both employers and employees contribute to the same pot. As the investment risk is spread collectively across all members, this reduces volatility and there is no need to move investments to lower risk (and less profitable) bonds closer to the retirement age.

First introduced under the Pension Schemes Act 2015, CDC schemes had not been implemented because they were embedded in wider changes to the legislative framework for all private pensions. The Pension Schemes Act 2021 provides a framework within which these schemes will be regulated.

Drawing from foreign examples from Canada, Denmark and the Netherlands, a CDC scheme will pay a regular income from the member’s retirement age, based on a “target amount”. However, the amount would not be guaranteed like an annuity and the pay-outs could also fall over time, even if some foreign schemes attempt to increase payments to keep pace with inflation.

Royal Mail, one of the driving forces behind enabling CDC schemes under UK law, is likely to create a CDC plan and start accepting contributions to it in the second half of the next financial year.²⁰ The workers’ union CWU seems to be supportive of the introduction of a CDC / DB pension scheme.²¹ It is too early to say whether the CDC scheme will work in practice, but this reform seems to be promising.

¹⁹ Pensions Act 2004, Pts 1-2, ss 1-102.

²⁰ “Pension update: Pension Bill receives Royal Assent” (11 February 2021) available at <https://www.royalmailgroup.com/en/press-centre/press-releases/royal-mail-group/pension-update-pension-bill-receives-royal-assent/>; “Royal Mail CDC scheme closer to reality as consultation launches” (23 September 2021) available at <https://www.pensions-expert.com/DB-Derisking/Royal-Mail-CDC-scheme-closer-to-reality-as-consultation-launches>.

²¹ “Royal Mail CDC pensions ‘could outperform DB as well as DC’” (7 October 2020) available at <https://www.cwu.org/news/royal-mail-cdc-pensions-could-outperform-db-as-well-as-dc/>.

3.2 New regulatory powers

Even if the CDC scheme works as expected, the *Lehman*, *Nortel* and *Bernard Matthews* cases showed the need to address the inadequacy of TPR's regulatory powers. This problem was dealt with by the Pension Schemes Act 2021.

In this area, one of the most prominent changes introduced by the Pension Schemes Act 2021 is the power to issue contribution notices if either the "employer insolvency" or the "employer resources" tests, are met.²² These two new tests intend to catch a much broader spectrum of behaviours and corporate activity than the old regime.

The "employer insolvency test" will be met if TPR is of the opinion that both of the following conditions are met:

- immediately after an event occurred, the value of a scheme's assets is less than the value of its liabilities; and
- if a section 75 debt²³ had fallen due from the employer immediately after the event, the act or failure to act would have materially reduced the amount of the debt likely to be recovered by the scheme.

For the purposes of this test, the value of a scheme's assets and liabilities and the estimated amount of any section 75 debt (had one fallen due) will be whatever TPR estimates them to be.

Conversely, the "employer resources test" will be met if TPR is of the opinion that both of the following are met:

- an act or failure to act reduced the value of resources of the employer; and
- the reduction was a material reduction relative to the estimated section 75 debt in the scheme if a debt had fallen due immediately before the act or failure to act occurred.

As is the case with the employer insolvency test, the value of a scheme's assets and liabilities and the amount of any estimated section 75 debt (had one fallen due) will be whatever TPR estimates them to be. What constitutes an employer's resources, and the value of those resources, will be set out in regulations.

There is a statutory defence to avoid personal liability. This defence operates if the target of the contribution notice can demonstrate that they:

²² Pension Schemes Act 2021, s 103, which added to the Pensions Act 2004, ss 38C-F.

²³ Under the Pensions Act 1995, s 75 as subsequently amended, participating employers become liable for what is known as a "section 75 employer debt" when they withdraw from the scheme.

- considered the potential impact of the act or failure to act on the pension scheme; and
- reasonably considered there would be no impact; or
- took appropriate steps to mitigate such impact.

In relation to the employer insolvency test only, there is an additional defence that the scheme's liabilities were not less than its assets at the time of the event. While this statutory defence is problematic in its application, the expansion of TPR's regulatory powers in case of the funder's insolvency, is welcome news.

3.3 New criminal offences

To further support the activity of the regulator and discourage wilful or grossly reckless practices on the eve of insolvency, the Pension Schemes Act 2021 introduced two new criminal offences for the improper running of DB schemes: (a) avoidance of an employer debt; and (b) conduct risking accrued scheme benefits.²⁴ The offences do not just apply to company directors. They extend to shareholders, lenders, trustees and their advisers. Furthermore, these offences apply whether or not the perpetrators are aware of the likely consequences of their actions.

The offence of avoidance of an employer debt includes any act or failure to act intended to prevent the recovery of the whole or any part of a section 75 debt. This includes preventing such a debt from becoming due, compromising its amount, or reducing the amount of a debt that would otherwise become due. The reference to a section 75 debt includes any contingent amount.

The offence of conduct risking accrued scheme benefits includes any act or failure to act that detrimentally affects in a material way the likelihood of accrued scheme benefits being received where the person knew, or ought to have known, that such a course of action would be likely to have that effect.

Particularly the latter offence is very broadly defined and wide-reaching. It applies to any individual who knew or ought to have known that their conduct would have affected the pension scheme and had no reasonable excuse for their actions. As a result, there seems to be lack of co-ordination between the approach adopted by the legislator and the high threshold of "recklessness" or disregard which was all part of the earlier rhetoric in the Department for Work and Pensions's March 2018 White Paper.²⁵

²⁴ Pension Schemes Act 2021, s 107, which added to the Pensions Act 2004, ss 58A-D.

²⁵ Department for Work and Pensions, *Protecting Defined Benefit Pension Schemes* (Cm 9591, March 2018) at 10.

Both of these offences carry the risk of a criminal penalty of an unlimited fine and / or imprisonment of up to seven years. Alternatively, TPR could use its civil fining powers and fine a person committing one of these offences up to GBP 1 million.

Other powers conferred to TPR do not directly affect insolvency practice and, therefore, are not covered in this paper.

4. Consequences for insolvency practice

The Pension Schemes Act 2021 expands TPR's powers to impose contribution notices on companies or directors, requiring them to make one-off and substantial contributions to pension schemes. These powers increase the chances of recovering money from failed employers and third parties beyond the preferential status granted to the pension contributions in the last four months before the company's collapse. However, they also present a significant obstacle for effective rescue procedures.

There are some additional issues that arise from these reforms.

The new tests have been incorporated into the Pensions Act 2004 in such a way that the six-year look-back period is available to TPR, even though the Pensions Act 2004 is not expressly retrospective. Also, the employer insolvency test is triggered if the value of the scheme's assets is less than the value of its liabilities as of the date that the employer became insolvent.²⁶ It is not clear, however, how this balance-sheet imbalance should be calculated, as courts have only provided occasional guidance on the notion of assets.²⁷

One option is to rely on the case law on balance-sheet insolvency, described in the Insolvency Act 1986.²⁸ Under the balance-sheet insolvency test, courts have clarified that the test must include contingent and prospective liabilities,²⁹ but not contingent and prospective assets.³⁰ This is not, however, the only possible solution.

TPR could rely on the debt-to-asset ratio used for international accounting standards. If that was the case, it would be harder to prove that a scheme is balance-sheet insolvent. This is because international accounting standards determine the existence of a balance-sheet imbalance by comparing debts and contingencies with a more broadly defined notion of assets.

²⁶ *BESTrustees Plc v Kaupthing Singer & Friedlander Ltd (In Administration)* [2012] EWHC 629 (Ch).

²⁷ *Re Storm Funding Ltd (in administration)* [2013] EWHC 4019 (Ch).

²⁸ Insolvency Act, s 123(2).

²⁹ The balance-sheet test, however, remains the only applicable test once the court has to move beyond the near future: *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL Plc* [2013] UKSC 28; and K Baird and P Sidle, "Cash Flow Insolvency", *Insolvency Intelligence* (2008) 21 40.

³⁰ *Byblos Bank v Al-Khudhairi* [1986] 10 WLUK 281; and *Evans v Jones (aka Re Rococo Developments Ltd (in liq))* [2016] EWCA Civ 660.

Furthermore, TPR could make reference to the eligibility criteria for a pension scheme to be transferred to the PPF. One of such conditions is that the scheme's assets must be less than the level of the scheme's protected liabilities. The protected liabilities are the compensation that would be paid to the scheme members if the scheme goes into the PPF (in many cases, less than the benefits that would have been paid under the scheme rules). Such an approach would make it even harder for TPR to prove the funder's balance-sheet insolvency, thus maiming the effectiveness and *raison d'être* of the test.

While it is unlikely that courts will hold directors accountable for normal business activity, the same directors may nevertheless feel uncomfortable in taking swift and radical decisions to turn around their companies on the eve of insolvency absent any professional advice from independent experts. When time is of the essence, as in corporate restructurings and in a very complex geo-political climate caused by the COVID-19 pandemic, this may result in increased rates of business failures.

New offences could be applicable to a variety of players, including insolvency practitioners and other professional advisors (such as trustees and company doctors)³¹ commonly involved in a restructuring. Their only defence against personal liability and an order to contribute would be to demonstrate that they acted with "reasonable excuse" – a term not defined in the legislation.

The major issue, however, is represented by the potential risk of a civil claim and fines of up to GBP 1 million. This may well be a risk that insolvency practitioners and company doctors are not willing to accept when seeking to restructure a company that has a DB pension scheme. It may also push lenders to reject calls for additional corporate funding during restructuring. This is as their requests for additional security to support high-risk lending facilities during turnaround efforts may later be challenged as "conduct risking accrued benefits".

Finally, the Pension Schemes Act 2021 should not be considered in isolation. Less than a year before its introduction, the Corporate Insolvency and Governance Act 2020 (CIGA 2020) also introduced significant changes to the corporate insolvency framework.

One of the most notable changes in the CIGA 2020 is the introduction of a new free-standing moratorium. This causes the directors to remain in control of the company under the supervision of a monitor (a licensed insolvency practitioner) whilst the directors themselves seek to rescue the company. The moratorium is granted for an initial period of 20 days, but further extensions for a period of up to one year are possible. The CIGA 2020 provides that notice should be given to both the trustees of the pension schemes as well

³¹ V Finch, "Corporate rescue processes: the search for quality and the capacity to resolve", *Journal of Business Law* (2010) 6 502 (listing company doctors as specialists in turnaround practices).

as the PPF. Both the trustees and the PPF (for PPF-eligible schemes only)³² will be asked to consent to those extensions.

The moratorium provides for a stay on any debts due at the date it was first granted. While the moratorium does not cover contributions to pension schemes arising during that period (at least with reference to employees' contributions), it covers pre-moratorium debt. The guidance from the Insolvency Service on the CIGA 2020 suggests that liabilities such as contribution notices and financial support directions under the Pensions Act 2004 should be considered to be pre-moratorium debts with a payment holiday. This is the case even if the request to pay arises after the moratorium. As a result, they will not be paid during the moratorium. Such choice is in line with the treatment of other unsecured debts but detrimentally affects DB pension schemes, with the result that the Pensions and Lifetime Savings Association (PLSA) prompted the Government to introduce changes to their treatment in free-standing moratoria.³³

Finally, a moratorium is not a "qualifying insolvency event" for the purposes of triggering a section 75 debt or the start of a PPF assessment period. The purpose behind the moratorium is to give the company breathing space while it seeks rescue as a going concern (even if such moratorium can last for as long as one year). For this reason, the trustees and PPF will not be able to seize any contingent asset during the moratorium. Additionally, debt incurred by the company during the moratorium will take "super priority" status as an expense of the procedure should the company fail in its negotiations with the creditors and file for liquidation. This would certainly leave less money for other creditors - including the pension schemes - than in the event that the company filed for another formal insolvency procedure from the beginning.

Another notable change is the introduction of "part 26A restructuring plans", mutated from the schemes of arrangement.³⁴ Despite the existence of a cross-class cram-down option, the creditors will need to vote on the plan. The trustees (or the PPF for PPF-eligible schemes) will be included in a class, review the plan and consider the fairness of the proposals in the context of the treatment of other classes of creditors and shareholders.

As stated above, a key element of the new part 26A restructuring plan is the ability to cram-down dissenting creditors. This is only possible if the dissenting creditors are no worse off in the plan than they would be in the "relevant alternative". Additionally, one or more creditors who have an economic interest in the relevant alternative should have approved the plan. As a result, the plan may well be approved in face of the trustee or PPF's

³² The Pension Protection Fund (Moratorium and Arrangements and Reconstructions for Companies in Financial Difficulty) Regulations 2020 made under the CIGA 2020 (7 July 2020) allow the PPF to exercise the voting rights of the trustees in relation to both a moratorium and a part 26A restructuring plan.

³³ J Stapleton, "PLSA urges government to amend Insolvency Bill to avoid 'serious consequences' for schemes" *Professional Pensions* (London, 15 June 2020) available at <https://www.professionalphensions.com/news/4016511/plsa-urges-government-amend-insolvency-avoid-%E2%80%98-consequences%E2%80%99-schemes>.

³⁴ Companies Act 2006, Pt 26.

opposition. At the same time, the plan should result in the survival of the sponsoring employer as a going concern, which should be a positive outcome for the pension scheme.

The CIGA 2020 should have the effect of facilitating employers to remain in business if their companies or businesses are viable. The members of any DB scheme are likely to benefit from the survival of the sponsoring employer in the long-term. At the same time, the trustees or PPF's position as unsecured creditors means that their negotiating position is weaker in comparison to other key creditors. If, however, the position of the sponsoring employer deteriorates further during the moratorium or plan, it is likely that TPR may consider contribution notices against the company's directors. Such notices, however, are unlikely to be successful, as decisions in these procedures are generally taken under the supervision of a court or insolvency practitioner, and with the consent of the majority of creditors.

5. Concluding remarks

One of the key challenges in the UK has been the inability to agree deals with the DB pension scheme trustees to reduce or manage the pension liabilities so as to avoid an insolvency process. Part of the reason for lack of restructuring of pension liabilities is that TPR and the PPF have fairly rigid requirements for agreeing to proposals that involve the latter taking over plans as the statutory lifeboat. For this to happen, insolvency must be "inevitable" within a short timeframe, pension scheme members will need to be "significantly better off" than they would be if the sponsor actually commenced formal insolvency proceedings, and the PPF may also require a debt-for-equity in the restructured company. Additionally, the process is rather lengthy, as parties such as the scheme's trustees need to be heard during the negotiations.³⁵

There are some elements that may suggest a renewed, pragmatic approach for all the parties involved in the restructuring of companies and their pension schemes. For instance, the PPF recently updated its guidance for restructuring and insolvency professionals³⁶ to prevent pension schemes from entering the PPF where another solution could produce a better return for both the scheme members and the PPF.³⁷ The PPF showed willingness to engage with changes to existing DB pension schemes, for instance in the recent company voluntary arrangement of Arcadia³⁸ as well as in TPR's approval of a major restructuring of the British Steel Pension Scheme.³⁹ At the same time, the guidance

³⁵ *Trustees of Lehman Brothers Pension Scheme v Pensions Regulator* [2012] 6 WLUK 264.

³⁶ Available at: <https://www.ppf.co.uk/restructuring-guidance>.

³⁷ For an analysis, see: M Thomas, "The Pension Protection Fund - updated guidance on employer restructuring and insolvency", *Company Secretary's Review* (2019) 43(6) 56.

³⁸ M Thomas, "The Pension Regulator's report into the Arcadia Group Limited's company voluntary arrangement", *Company Secretary's Review* (2020) 43(10) 151. More generally, on the PPF's approach to company voluntary arrangement proposals, see M Jenkins and G Flannery, "The rise and rise of CVAs: impact on pension schemes", *PLC Magazine* (2019) 30(9) 27.

³⁹ M Thomas, "The British Steel Pension Scheme restructuring", *C.S.R.* (2018) 41(11) 161.

still explains that the PPF will take part in a restructuring effort only if the pension scheme is significantly better off than it would have been in case of the company's liquidation.⁴⁰ Finally, previous cases show that TPR will not refrain from using its anti-avoidance powers if this will help to protect the members of a UK DB pension scheme.⁴¹ The Pension Schemes Act 2021 does not address this barrier to effective restructuring of existing DB liabilities, as it does not address the issues raised in the recent case of *Hughes* regarding the inadequacy of the PPF compensation metrology.⁴²

However, this paper also showed that the UK's decision to follow the approach to pension schemes adopted in other jurisdictions such as Canada, Denmark and the Netherlands, is a welcome and promising one.

With reference to TPR's new regulatory powers, it is likely that they will push employers to seek more frequent clearance for future transactions. The ensuing greater trustee involvement may not necessarily protect employees. Opportunities to turn around businesses might be missed, with the results that jobs could be lost.

The same "side-effects" could be observed with the introduction of new criminal offences and related high civil fines. Finally, the purposes of the Pension Schemes Act 2021 (enhancing TPR's powers and ensuring greater protection for pension schemes) sit at odds with the goals advocated by the CIGA 2020 (promoting the rescue of distressed and viable businesses and enforcing fair and reasonable plans on dissenting creditors).

To conclude, it is hard to overlook the apparent conflicting and unprincipled approach followed by the legislator in reforming this area of law. Conflicting guidelines are likely to give rise to implementation and co-ordination problems for directors, insolvency practitioners, trustees, and regulators. This may well mean that further reforms are needed.

⁴⁰ *Idem*, 57.

⁴¹ M Thomas, "The Pension Regulator publishes its report on the Nortel insolvency case", *Company Secretary's Review* (2017) 41(5) 65.

⁴² *Hughes v Board of the Pension Protection Fund* [2020] EWHC 1598 (Admin).

Using artificial intelligence in financial distress: Opportunities and obstacles in the implementation of AI / ML-based methods as early warning tools

By Annika Wolf, University of Applied Sciences Emden / Leer, Germany*

Abstract

The EU Directive on Restructuring and Insolvency (EU 2019/1023)¹ requires Member States to have an early warning system to allow companies in financial distress to detect distress early (enough) to engage in a restructuring, thereby avoiding insolvency. With the absence of a common model at Member State level, this paper analyses the opportunities for artificial intelligence / machine learning-based methods at a corporate level. It is in a company's interest to implement a system that will alert the management to the need to take action and prevent a distress situation.

The introduction sets the scene while part two discusses the theoretical framework of artificial intelligence / machine learning-based methods and distinguishes between artificial intelligence / machine learning and prediction models. Part three refers to the goal of the EU Directive on Restructuring and Insolvency for Member States to provide alert mechanisms for companies through financial distress prediction models. In Part four, the opportunities and obstacles are investigated through an empirical study with qualitative data, collected from German experts on the current status of (German) companies with respect to implementing artificial intelligence / machine learning as an early warning tool. The study finds that companies see opportunities for using artificial intelligence / machine learning-based methods as early warning tools. The conclusion summarises that there are obstacles to overcome in order to identify financial irregularities and to provide indications for future action to avoid or prevent financial distress.

1. Introduction

Digital transformation challenges existing business models and companies not adapting face financial distress.² The recognition of financial distress is based on company retrospective accounting data and consolidated key performance indicators. Statistical methods with complex mathematical operations allow forward-looking estimates of the probability of default. With the development of faster computing capacities and intelligent

* Professor of Corporate Finance, Project Finance and Entrepreneurship, University of Applied Sciences Emden / Leer (Germany).

¹ Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency), OJ L 172, 26.6.2019 (Directive (EU) 2019/1023).

² This market-based prerequisite is even more challenged by the current COVID-19 pandemic.

algorithms,³ artificial intelligence (AI) and machine-learning (ML) -based methods may assist in identifying financial irregularities in accounting data earlier.⁴ With the availability of data in a cloud-based system, companies have the possibility of using their data analysis in a target-oriented way.⁵ Microeconomic and firm-specific key results can be collected from entities in real time. Key firm-specific information may be not only be quantitative but also qualitative, for example industrial risk (the health / future potential of the industry); management risk (organisational structure / managers' capabilities); financial flexibility (company cash flow); credibility (company reputation / credit scores); competitiveness (company market position / competitive advantages); and operating risk (production efficiency).⁶

Macroeconomic data from third-party institutions can be added resulting in holistic company data acquisition. By applying fast processing methods to data with internal and external risk triggers, scenario probabilities would deliver a tool to recognise early warning signals of financial distress⁷ and give proper indications of future action in order to avoid or prevent distress.⁸

2. Artificial intelligence theoretical framework

AI has been defined as "making a machine behave in ways that would be called intelligent if a human were so behaving"⁹ and "the science of making machines do things that would require intelligence if done by men."¹⁰ A more recent approach that captures the technological aspects defines AI as "a system's ability to correctly interpret external data, to learn from such data, and to use those learnings to achieve specific goals and tasks through flexible adaptation."¹¹ There are different levels of AI and, furthermore, differences between AI, ML and deep learning (DL).

³ M Schuld, I Sinayskiy and F Petruccione, "Quantum computing for pattern classification", see DOI: 10.1007/978-3-319-13560-1_17.

⁴ M Lam, "Neural network techniques for financial performance prediction: Integrating fundamental and technical analysis", *Sciencedirect* (2014) 37(4) 567-581.

⁵ S Strahringer, "IT-Management im Zeitalter der Digitalisierung", *HMD Praxis der Wirtschaftsinformatik* (2016) 53(6) 908 909.

⁶ M Kim and I Han, "The discovery of experts' decision rules from qualitative bankruptcy data using genetic algorithms", *Expert Systems with Applications* (2003) 25, 637.

⁷ A Paliwala, "Rediscovering artificial intelligence and law: an inadequate jurisprudence?", *International Review of Law, Computers and Technology* (2016) 30(3) 107 109.

⁸ M Smith, J A Kestel and P Robinson, "Economic Recession, Corporate Distress and Income Increasing Accounting Policy Choice", *Accounting Forum* (2001) 25(4) 334 335ff.

⁹ J McCarthy, M L Minsky, N Rochester and C E Shannon "A Proposal for the Dartmouth Summer Research Project on Artificial Intelligence", *AI Magazine* (2006) 27(4) 12.

¹⁰ M Minsky, *Semantic Information Processing* (MIT Press 1958).

¹¹ A Kaplan and M Haenlein, "Siri, Siri, in my hand: Who's the fairest in the land? On the interpretations, illustrations, and implications of artificial intelligence", *Business Horizons* (2019) 62(1) 15 17f.

2.1 Artificial intelligence levels

There are three levels of AI: (i) artificial narrow intelligence (ANI), which is a weak AI below human-level intelligence and which only applies to certain areas and is unable to autonomously solve problems in other areas (only outperforming humans in specific areas); (ii) artificial general intelligence (AGI) is a strong AI equivalent to human-level intelligence applicable to several areas which has the ability to autonomously solve problems in other areas and to outperform humans in several areas; and (iii) artificial super intelligence (ASI), which is not only conscious and self-aware but is also above human-level intelligence. ASI can be applied to any area and is able to solve problems instantaneously and outperform human beings in all areas.¹² While AI is currently still at the ANI level, scientists and researchers agree that AGI is in reach in the future but probably not ASI.¹³ Nevertheless, even at the ANI level, there are convincing benefits to use the technology such as processing huge amounts of data in less time, allowing for faster, reliable results as a basis for management decisions.

2.2 The evolution of artificial intelligence

AI, ML and DL are terms that are used as widely popular acronyms in an inflationary way to refer to new data processing techniques. Despite the fact that these terms correlate with each other, there are key differences.

AI as a major term for the discipline has been mainly defined in investigations and scientific experiments since the 1950s.¹⁴ AI is trained with rules to learn, such as rules to evaluate "yes" or "no" questions using simple decision trees and make an "if-then" decision to provide a solution.

The next layer of artificial intelligence began in the 1990s with ML constructing algorithms that are trained in a process-oriented way; solving problems by utilising statistical models that gather a dataset and algorithmically build a statistical model based on that dataset.¹⁵ There is also a distinction between two types of learning: (i) supervised learning, which is applied when a dataset is labelled to produce a model that gathers all the input information to give an output prediction¹⁶ in order to determine the vectors precisely (this technique requires accurate training data); and (ii) unsupervised learning, in which input data is not labelled and the algorithm has to classify or cluster the dataset in logic vectors.¹⁷

¹² A Kaplan and M Haenlein, "Rulers of the world, unite! The challenges and opportunities of artificial intelligence", *Business Horizons* (2020) 63(1) 37-50.

¹³ A Kaplan and M Haenlein, "Siri, Siri, in my hand: Who's the fairest in the land? On the interpretations, illustrations, and implications of artificial intelligence", *Business Horizons* (2019) 62(1) 15-23.

¹⁴ A Turing, "Computing Machinery and Intelligence", *Psychology and Philosophy* (Mind OUP 1950) 433-434f.

¹⁵ A Burkov, *The Hundred Page Machine Learning Book* (Springer Series in Statistics, 2019).

¹⁶ *Idem.* See also M R Minar and J Naher, (2018) "Recent Advances in Deep Learning: An Overview" 10.13140/RG.2.2.24831.10403 1-11 ff, available at <https://doi.org/10.13140/RG.2.2.24831.10403>.

¹⁷ M R Minar and J Naher, (2018) "Recent Advances in Deep Learning: An Overview" 10.13140/RG.2.2.24831.10403 at 1-11 ff, available at <https://doi.org/10.13140/RG.2.2.24831.10403>.

The output vector is compared to the input vector to judge the accuracy of the vector in order to self-improve.¹⁸ ML is able to make much more complex decisions using computer-based systems such as random forests,¹⁹ Bayesian networks and support-vector machines as some of the prediction models. These models are capable of evaluating huge numbers of datasets and provide recommendations based on historical data.²⁰

A sub-discipline of ML is DL, which is the next evolution of AI. DL employs multiple neural network layers to progressively extract higher-level features from the input data. This approach enables decoding structures that are more complex.²¹ With specific artificial neural networks (ANN), deep belief networks or recurrent neural networks, DL is capable of solving difficult problems involving large amounts of data without human training. The self-improving algorithms are so well-programmed that they can form their own clusters from the data in order to detect irregularities, for example in financial data.

3. Alert mechanisms and financial distress prediction models

One of the main aims of the EU Directive on Restructuring and Insolvency is, in general, to give viable companies that are in financial difficulties “access to effective national preventive restructuring frameworks, which would enable them to continue operating.”²² These frameworks “should enable debtors to restructure effectively at an early stage to avoid insolvency, thus limiting the unnecessary liquidation of viable companies.”²³ For companies to actually act at an early stage, “early warning tools should be put in place to warn debtors”²⁴ and incentivise them to take early action.²⁵

3.1 Alert mechanisms

The EU Directive on Restructuring and Insolvency states that such early warning tools, developed by either Member States or private entities, could take the form of alert

¹⁸ J M Helm *et al*, “Machine Learning and Artificial Intelligence: Definitions, Applications, and Future Directions”, *Current Reviews in Musculoskeletal Medicine* (2020) 13(1) 69 70.

¹⁹ T Kam Ho, “The Random Subspace Method for Constructing Decision Forests”, *Transactions on Pattern Analysis and Machine Intelligence* (1998) 20(8) 832 834 ff. Random forests are an ensemble learning method that operates by constructing a multitude of decision trees in the training time and outputting the class that is the mode of the classes (classification) or the mean / average prediction (regression) of the individual trees.

²⁰ J M Helm *et al*, “Machine Learning and Artificial Intelligence: Definitions, Applications, and Future Directions”, *Current Reviews in Musculoskeletal Medicine* (2020) 13(1) 69 73ff.

²¹ P Collet *et al*, “Artificial Evolution”, *Lecture Notes in Computer Science* (2015) 3590; T Hastie, R Tibshirani and J Friedman, *The Elements of Statistical Learning* (Springer Series in Statistics, 2014); M Kubat, *An Introduction to Machine Learning* (Springer Books, 2017); and R Silhavy *et al*, “Artificial Intelligence Perspectives and Applications”, *Proceedings of the 4th Computer Science On-line Conference 2015* (CSOC2015), Vol 1: Artificial Intelligence Perspectives and Applications (Vol. 347).

²² Directive (EU) 2019/1023, recital 1.

²³ *Idem*, recital 2.

²⁴ *Idem*, recital 17.

²⁵ *Idem*, recital 22.

mechanisms that indicate when the debtor has not made certain types of payments.²⁶ The key financial indicators to determine a distressed situation include a suspension of dividend payments, several years of negative net operating income, major restructuring or layoffs,²⁷ negative earnings before interest and tax (EBIT), a low interest coverage ratio, successive years of negative shareholder funds or accumulated losses and selling shares to private investors.²⁸

Member States are obliged to ensure that “debtors have access to one or more clear and transparent early warning tools which can detect circumstances that could give rise to a likelihood of insolvency and can signal to them the need to act without delay.”²⁹ While the Member States begin discussing different options for alert mechanisms as early warning tools, until further notice it will remain the responsibility of companies to have their own early warning systems to detect financial distress early (enough) to engage in restructuring and to avoid insolvency.

Many prediction models of early warning signs with various modelling techniques have been introduced to predict the risk of business failure and to classify firms according to their financial health.

3.2 Prediction models

Prediction models are based on various assumptions and specific computational intricacies.³⁰ There are two main categories: (i) statistical models and (ii) AI / ML-based models.

Statistical models were the means of choice in the period from 1968 to 1990. The main models discussed in publications between 1968 and 2017³¹ are logistic regression analysis (Logit models / LR), qualitative response models (QR-model)³² and (multivariate) linear discriminant analysis (LDA).³³

²⁶ *Ibid* and at art 3(2)(a).

²⁷ H D Platt and M B Platt, “Predicting Corporate Financial Distress: Reflections on Choice-Based Sample Bias”, *Journal of Economics and Finance* (2002) 26, 184 186f.

²⁸ S McLeay and A Omar “The sensitivity of prediction models to the non-normality of bounded and unbounded financial ratios”, *British Accounting Review* (2000) 32(2) 213 214f.

²⁹ Directive (EU) 2019/1023, art 3.

³⁰ S Balcaen and H Ooghe “35 years of studies on business failure: An overview of the classic statistical methodologies and their related problems”, *British Accounting Review* (2006) 38(1), 63 64.

³¹ Y Shi and X Li, “An overview of bankruptcy prediction models for corporate firms: A systematic literature review”, *Omnia Science* (2019) 15(2) 114 115f.

³² J Künzli, “Financial Distress Prediction - A Comparison of Statistic, Econometric and Artificial Intelligence Approaches”, *SSRN Electronic Journal* (2005); F Harrell, “Regression Modelling Strategies”, *Technometrics* (2003) 45(2); and J A Ohlson, “Financial Ratios and the Probabilistic Prediction of Bankruptcy”, *Journal of Accounting Research* (1980) 18(1) 109, where the first study on financial distress prediction according to a logit model was published and his classification technique is known as O-Score.

³³ J Künzli, “Financial Distress Prediction - A Comparison of Statistic-, Econometric and Artificial Intelligence Approaches”, *SSRN Electronic Journal* available at <https://doi.org/10.2139/ssrn.3046859>; T Hastie, R Tibshirani and J Friedman, *The Elements of Statistical Learning* (Springer Series in Statistic, 2014); and E I

Prediction models based on AI / ML techniques developed through the fast processing of data by personal computers were commercially introduced in 1990.³⁴ In the literature, ANN are the most discussed. ANN is used as a main term for various techniques. With regard to financial distress, two models have attracted the most attention from researchers. Firstly, a self-organised map (SOM) which is an unsupervised learning technique that uses patterns to cluster data with a similarity based on historical data.³⁵ This model has no application in *ex-ante* forecasting although compared to statistical methods, more data (n-dimensions) and data dots can be collected and evaluated. Secondly, a multilayer-perception (MLP) network is most frequently used as a supervised ML / DL technique with several layers of many calculating elements (neurons).³⁶ MLP is also a very data-driven approach with large samples to train the network. Capacity is a challenging problem and MLP does not (yet) provide *ex-ante* assumptions either.³⁷

Other ML models include support-vector machines (SVM), being a statistical classification method based on the principles of structural risk minimisation.³⁸ SVM uses a linear model to implement non-linear class boundaries through non-linear mapping of input vectors into a high-dimensional feature space.³⁹ The mathematical approach is performed with basic calculations similar to the processing of a binary ANN. Similar to traditional statistical models, a decision boundary is generated on the basis of the classified data, that are entered into a co-ordinated system.⁴⁰ SVMs offer the advantage of classifying linear and non-linear objects by combining different techniques. By introducing an additional dimension, features can be extracted from the data set that would lead to even higher error types in other models. An example in the area of financial credit distress is additional training with macroeconomic data, that can be visualised in a three-dimensional space without affecting the original microeconomic data.⁴¹

Altman, "Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy", *Journal of Finance* (1968) 23(4) 589 561, where the Z-Score categorised five special ratios: profitability, liquidity, leverage, solvency and activity.

³⁴ M Tkáč and R Verner, "Artificial neural networks in business: Two decades of research", *Applied Soft Computing Journal* (2016) 38, 788.

³⁵ M Kubat, *An Introduction to Machine Learning* (Springer Books, 2017).

³⁶ M Tkáč and R Verner, "Artificial neural networks in business: Two decades of research", *Applied Soft Computing Journal* (2015) 38, 788 790f.

³⁷ J Künzli, "Financial Distress Prediction - A Comparison of Statistic, Econometric and Artificial Intelligence Approaches", *SSRN Electronic Journal* (2005); and G Zhang, B E Patuwo and M Y Hu, "Forecasting With Artificial Neural Networks: The State of the Art", *International Journal of Forecasting* (1998) 14, 35 37f.

³⁸ M-C Lee and C To, "Comparison of Support Vector Machine and Back Propagation Neural Network in Evaluating the Enterprise Financial Distress", *International Journal of Artificial Intelligence & Applications* (2010) 1(3) 31.

³⁹ T Hastie, R Tibshirani and J Friedman, *The Elements of Statistical Learning* (Springer Series in Statistics, 2014); and E Kirkos, "Assessing methodologies for intelligent bankruptcy prediction", *Artificial Intelligence Review* (2012) 43(1) 83 91f.

⁴⁰ A Burkov, *The Hundred Page Machine Learning Book* (Springer Series in Statistics, 2019); and T Hastie, R Tibshirani and J Friedman, *The Elements of Statistical Learning* (Springer Series in Statistics, 2014).

⁴¹ J C K Chow, "Analysis of Financial Credit Risk using Machine Learning" Aston University Dissertation (2017), available at <https://arxiv.org/ftp/arxiv/papers/1802/1802.05326.pdf>.

Decision trees, also known as classification trees, are a non-parametric data mining technique. The trees are created by a recursive process of data splitting at the transition from higher to lower levels.⁴² In decision trees, attribute values are tested one after the other according to the “if-then” principle, with the result of each test indicating what happens next: either another attribute test or a decision on the classification.⁴³ Decision trees are a fast and cost-effective solution making quick decisions with clear data. They offer the advantage of a binary decision and classification based on the financial data available in a company.

The above-mentioned prediction models are used to classify a company as being in a future distress or non-distress scenario. In order to determine which of the models is best suited to this purpose, there are some main indicators that serve this aim. The basic performance measure of the classification accuracy of current data helps to achieve the goal of determination. The accuracy of a model is determined by the total number of correctly classified cases divided by the total number of cases in the data set. These factors are determined by the model’s input vectors, which in financial distress prediction models are financial ratios. The rejection rate of incorrectly predicted cases predicting financial distress when it is not the case is the type I error rate. The type II error rate describes the opposite case.⁴⁴

3.3 Evaluation of prediction models

Evaluation of the accuracy of different models results in a better accuracy of ML-based models compared to classical statistical models.⁴⁵ While the accuracy of classical statistical models varies between 75.47 per cent (LDA) and 79.25 per cent (LR), ML-based models achieve 90 per cent (ANN) to 90 to 95 per cent (SVM) accuracy.⁴⁶ This is due to, among other things, obstacles inherent in statistical models.

3.3.1 Classical models

Considering statistical forecasting and the problems they pose, classical models can be divided into four main categories:⁴⁷ (1) classical paradigm including arbitrary definitions of failure leading to definition uncertainty, non-stationarity and data instability, and sampling selectivity (which involves over-sampling, data selection and choice of the optimisation criteria); (2), neglect of the time dimension of failure by using a single

⁴² A Gepp and K Kumar, “Predicting Financial Distress: A Comparison of Survival Analysis and Decision Tree Techniques”, *Procedia Computer Science* (2015) 54, 396 400 ff.

⁴³ M Kubat, *An Introduction to Machine Learning* (Springer Books, 2017).

⁴⁴ E Kirkos, “Assessing methodologies for intelligent bankruptcy prediction”, *Artificial Intelligence Review* (2012) 43(1) 83 93f.

⁴⁵ S S Devi and Y Radhika, “A Survey on Machine Learning and Statistical Techniques in Bankruptcy Prediction”, *International Journal of Machine Learning and Computing* (2018) 8(2) 133 134.

⁴⁶ A Kansal and S Shashank, “A Methodological Review of Financial Distress Prediction Techniques”, *4th International Conference on Advances in Management & Digital Sciences* (2017) 294 300.

⁴⁷ S Balcaen and H Ooghe, “35 years of studies on business failure: An overview of the classic statistical methodologies and their related problems”, *British Accounting Review* (2006) 38(1) 63 65f.

observation (annual account) data, fixed score output / concept of resemblance / descriptive nature and where failure is not seen as a process; (3) application focus which is divided into the categories of variable selection where empirical variables are used, and the selection of the modelling method with *ad hoc* data; and (4) other problems, including the use of a linear classification rule, use of annual account information (financial ratios) and neglect of the multidimensional nature of failure. Combining different classical forecasting models into one comprehensive higher-level model already increases the validity of the ratios but is still not considered accurate and prone to misinterpretation.

3.3.2 *Machine learning-based models*

ML-based models now address the weaknesses of the classical models. Their greater accuracy results from the advantages of the individual models. Nevertheless, even these techniques have drawbacks that need to be considered before selection. ANN has the advantage of handling function approximation, prediction, classification, clustering and optimisation tasks well as this method is intended to be modelled on the human brain. To achieve these results, ANN needs human training data and cycles in which they are processed.⁴⁸ According to the current state of research, once an ANN is classified and trained, it offers the best results. SVM offers the advantage of performing classification with few data and, if necessary, transferring them to a higher spatial model (2D-3D) to achieve a more accurate result. The disadvantage of SVMs is the choice of the right kernel and its parameters. Furthermore, the computations are very extensive due to the high algorithmic complexity and mean a slow first test phase.⁴⁹ Decision trees are based on the idea of solving a binary classification problem – offering the advantage of fast processing of data with little computing power. However, over-fitting may be a problem that needs to be balanced and this method also requires a large amount of data to achieve a high level of accuracy.⁵⁰

3.4 **Data for prediction models**

Prediction models should not only rely on historical information but actively evaluate future operating financial results in order to be eligible to be called early warning tools.

Firm-specific data can be collected from the company's accounts, including the forecast based on internal financial figures published in the annual report and financial distress risks can be assessed based on these figures. The consolidated financial ratios form a weighted combination ratio to determine whether a company is distressed / non-distressed. There are concerns when using data from a company, such as manipulation of financial figures by the management or the finance department; a going concern

⁴⁸ P Ravisankar and V Ravi, "Financial distress prediction in banks using Group Method of Data Handling neural network, counter propagation neural network and fuzzy ARTMAP", *Elsevier* (2010) 23(8) 823 824f.

⁴⁹ *Idem*.

⁵⁰ *Idem*, 826.

assumption versus prediction of financial distress; and that financial reports represent past performance and accounting standards (book value versus market value).⁵¹

3.4.1 Recommendation for prediction models

While in the past accounting- and market-based models have been the basis for identifying financial distress for many decades, hybrid ML-models now offer the possibility of processing a wide range of variables with large data sets due to strong computing power and can therefore quickly incorporate firm-specific and macroeconomic information. For a current and future assessment of business risks, key variables at the country / continent level such as the level of employment / unemployment; gross domestic product; the balance of payments; inflation; and credit supply and key interest rates must be taken into account as factors (directly or indirectly) influencing a company's performance.⁵² The means of choice for incorporating macroeconomic variables into ML-based systems are ANNs. Twelve key financial ratios supplemented with five macroeconomic variables have been shown to have an effect on financial paths in financial distress prediction models using an ANN under the influence of macroeconomic variables.⁵³ Including macroeconomic variables can improve the ability of a multi-level ML-based model to classify distress / non-distress.

Evolution from an accounting- to a market-based approach was the first step in the development of prediction models. Nevertheless, both types of models are very slow in their initial stages and are not able to detect financial distress at an early *ex-ante* stage but only *ex-post*. The second stage of evolution was introduced at the beginning of the 2000s, when the available computing power enabled the first ANN models to map several variables in real time. This opened up the possibility of creating hybrid models that combined the best of the individual models and that could reproduce the calculations in a fraction of the time to better predict an early financial distress moment.

⁵¹ V Agarwal and R Taffler, "Comparing the performance of market-based and accounting-based bankruptcy prediction models", *Journal of Banking and Finance* (2008) 32(8) 1541-1543f; and P Gharghori, H Chan and R Faff, "Investigating the Performance of Alternative Default-Risk Models: Option-Based versus Accounting-Based Approaches", *Australian Journal of Management* (2006) 31(2) 207-209.

⁵² M Hernandez Tinoco, P Holmes and N Wilson, "Polytomous response financial distress models: The role of accounting, market and macroeconomic variables", *International Review of Financial Analysis* (2018) 59, 276-279f.

⁵³ L Zhou, K K Lai and J Yen, J, "Bankruptcy prediction incorporating macroeconomic variables using neural network", *Proceedings - International Conference on Technologies and Applications of Artificial Intelligence*, TAAI 2010, 80-81: in addition to the mandatory financial ratios, the study includes the following macroeconomic variables: the gross domestic product index; personal income; and the consumer price index and the money supply index, that reflect the level of money supply in the economy. The authors conclude that the inclusion of macroeconomic variables has a positive effect on the test results of neural networks.

4. Empirical study on opportunities and obstacles

A total of 20 professionals in the fields of accounting, restructuring and insolvency were contacted by email in May / June 2020 to complete a qualitative online survey. Fourteen participants (70 per cent) responded: five consultants, four lawyers and five corporate accountants.⁵⁴ The survey included open questions on the opportunities and obstacles of different aspects of AI / ML-based methods with reference to early warning tools. A categorisation system was created using a content-analytical model. Content structuring and deductive category building analysis were used to arrive at the below discussion.

4.1 Accounting standards

4.1.1 Emergence of accounting

The importance of accounting in detecting financial distress early was recognised by all the participants. The financial situation can have a huge influence on AI / ML-based methods and thus on a company's strategy and its competitive advantage. It is recognised that these methods have the capacity to project key accounting figures, such as cash flow, and to automate repetitive tasks to supervise information in real time. The participants acknowledged that accounting will change significantly as ML helps to automate most (of today's manual) accounting processes and will be an innovation-driver towards smart auditing (with smart applications).

4.1.2 Common comprehensive definitions

There was a special focus on different definitions of a crisis and financial distress, and that a general recognition of a crisis state by a company's management was not really achieved. Even if the management recognises a distress situation, the participants admitted that the measures taken may be either inappropriate or not suitable for the current situation. Common causes of financial distress are declining revenues over a long period without appropriate alignment of cost structures; outdated business models with no adaption to digital transformation; decreasing customer demand (declining sales) due to an outdated product portfolio; decreasing working capital; deficient liquidity; ambitious financing structures (with risk of over-indebtedness and illiquidity in a changing macroeconomic environment); and deferred payments by suppliers. These are all key indicators that can be derived from an accounting data base. However, firm specific indicators need to be considered. Even with a perfect data base, one participant explained that AI / ML-based methods need extensive testing to ensure valid results of predictions of future outcomes and to detect financial irregularities early on to alert the management.

⁵⁴ The limited number of participants was due to the fact that this was a pre-study to review the applicability of the questions for a larger study.

4.1.3 Information transparency and accuracy

Most accounting systems work with an information processing time lag, which will cause a lack of information transparency and will postpone the management's recognition of financial distress. While progress in business intelligence has been made considering the interplay between accounting, controlling and auditing, the financial perspective derived from the information at hand is still mostly retrospective instead of forward-looking, which may be a disadvantage for an alert mechanism.

4.1.4 Time horizon

The participants stated that an increasing number of companies are using real-time data to steer short-term decisions but, unfortunately, do not keep sight of the long-term horizon that may be (negatively) affected by these short-term decisions. One participant remarked that the discussion should distinguish between a data-driven and a data-enabled company. Scepticism was expressed regarding data-driven companies. The main purpose of using AI / ML-based methods is to solve issues by analysing data and finding solutions (but the methods are not quite there yet). However, the data should not drive the company and its decision-makers, but should enable and support decision-makers to make better informed decisions. Concerns were raised about the quality of data, which - if not present - would lead to processing incorrect data and therefore incorrect outcomes, interpretation and measures. Without an intelligent and comprehensive algorithm, data itself is useless. A black box character where the user knows the input and receives the output results without understanding the intermediate process and algorithms, should be avoided.

4.2 Technological requirements and artificial intelligence-based methods

There is still limited acceptance within companies of AI-based methods because of the technological requirements and ignorance of the application of AI / ML for the use of companies, despite the fact that participants pointed out that it is an important field for the overall German economy.

4.2.1 Usability of artificial intelligence

In respect of AI-based methods, two participants confirmed the use of these methods in their companies. These methods include using natural language processing (NLP) for trading strategies; predictive error handling (prediction of the next failure of an IT system); and internal recording of consulting services. Two other participants stated that their companies were at an early stage in developing and implementing AI-based systems (ML) - one to develop products and the other to improve performance with a better cloud-based system. A difficult issue with the technological requirements and AI-based methods is that they are often not ready-to-use and therefore have a difficult start.

4.2.2 *Prospects of artificial intelligence*

The opportunities and promising prospects of using AI / ML-based methods are processing a large amount of data in a short time; the consolidation of numerous (transaction-based) data points to reach conclusions; self-learning capacity; and being significantly less prone to errors than employees (and thus more accurate). The participants recognised that AI and ML will drive automated and real-time processes, standardised data flows and a higher level of security, that will pave the way for innovations. In general, ML systems are already disrupting many industries by increasing efficiency, target-oriented analysis and reporting; and will gain even more importance in the future when automation will replace routine human work. For now, however, the human factor is still indispensable, especially in communication.

4.3 *Employees' acceptance of artificial intelligence*

The majority of the participants stated that in almost every industry and position, people will work with ML systems, making processes more efficient and improving products. This change will bring about different demands on employees as there will be a need for further training in the handling of the system itself, and in the validation and interpretation of data. Company management needs to invest in the skill sets of employees and experts to implement AI / ML-based systems.

4.3.1 *Accessibility, familiarity and change management*

Most management members and employees have little to no contact with, or access to, AI / ML-based methods as in daily business access thereto is restricted to members of the IT department. Companies need to actively engage in change management and include their employees early on in the process to ensure a common understanding of the company's vision and mission. Company management should not dismiss employees' fears relating to the deployment of AI / ML-based methods, but should actively explain its opportunities and limits for the company. If employees understand the implications of new technology and experience the benefits, they may be more inclined to accept it. The digital and smarter future of a company depends on employees' access to AI at various levels in the company; learning the relevant IT skills; and developing an interdisciplinary mindset.

4.3.2 *Employee training*

Training employees to work with an AI / ML system will be nothing more than training an employee to use the specific software that the company employs. However, training will be needed in two areas: (i) building AI / ML systems that work well (technically) by integrating them into the existing infrastructure, which requires knowledge and comprehensive documentation; and (ii) training managers and decision-makers to identify cases and applications where an AI / ML system can yield the most benefit.

4.3.3 *Interactions of humans and artificial intelligence*

The human factor will also play a role in interpreting results from the AI / ML-based methods currently used. One participant suggested that when technology and people successfully interact with each other, it enables companies to have a better accounting system, that will enable humans to focus on more relevant processes and aspects of accounting.

4.4 Implications

The study showed that the participants value the benefits of AI / ML-based prediction models as valid early warning tools to predict financial distress. However, before the opportunities increase there are quite a few obstacles to overcome. A company's accounting system should ensure the quality of data with an interface connected with a controlling, audit and compliance. When considering comparability, company performance measures need to ensure a coherent firm-specific data set covering all companies while still considering qualitative firm-specific measures and a single set of macroeconomic factors.

There is still a (long) way to go to ensure that the technological requirements for using AI-based methods in companies are met. The digital transformation cannot be stopped if companies want to survive in the long run. For systems to run, companies need to avoid people-based uncertainties; therefore, for successful ground work a company needs to ensure that it has skilled labour.

5. Conclusion

The EU Directive on Restructuring and Insolvency imposes an obligation on Member States to ensure access to early warning tools as an alert mechanism for companies. Prevention of financial distress is also in the interest of companies themselves and AI / ML-based methods may provide an opportunity to build a comprehensive early warning tool. If an AI / ML-based system works at corporate level, it may be scalable to Member State or European levels.

The study discussed in this paper has shown that there are multiple opportunities to use AI / ML-based systems as early warning tools, especially in accounting, in order to ensure efficiency. There are, however, also multiple obstacles that need to be overcome, such as a common set of accounting principles; quality data with defined standards; and acceptance of technology and skilled employees. Even with all of these requirements met, AI / ML will only be able to provide support for management in decision-making. The human factor will remain key in differentiating situations and considering the bigger picture for the overall benefit of the company, even in difficult or distressed situations.

Future research should explore, firstly, where (at Member State or European level, by governments or private entities) and secondly, how (data collection, storage, processes) a

data base of macroeconomic indicators should be established. For company-specific data, accounting standards should be harmonised and refined at Member State and / or European levels to ensure valid and comparable data sets.

Insolvency and arbitration in the United Kingdom: Predictable and efficient?

By Gustavo Adriano Yanez Ruales, LL.M. Durham University, United Kingdom¹

Abstract

Arbitration and insolvency law have always created controversy. The financial situation of a distressed company might compromise the survival and enforceability of an arbitration agreement. For this reason, the synergy between corporate insolvency and arbitration is highly convoluted. The parties to an arbitration agreement have a legitimate expectation that the arbitration clause will be enforced, despite the main contract being voided or terminated by the company's insolvency. While this might be predictable for the parties, efficiency relates to what courts would rule on certain matters regarding debtors and arbitration clauses. In insolvency cases, the enforceability of arbitration clauses is particularly controversial. This paper investigates English case law in this area and argues that courts in the United Kingdom have adopted an efficient approach in dealing with the enforceability of compromissory clauses in the event that one of the parties undertakes a formal insolvency procedure.

1. Introduction

Firstly, this paper will briefly outline the main characteristics of an arbitration agreement; moreover, it will introduce the dichotomy of an arbitration agreement within the insolvency context. Secondly, this paper will address the principle of arbitrability focusing on the issue of public policy and third-party rights. More importantly, the focus will move onto the fact that certain matters might not be arbitrable due to the issues covered by the arbitration agreement. Thereafter, this paper will analyse the distinction between procedural and substantive law alongside the efficient approach utilised by English courts. Lastly, the analysis will proceed to the COVID-19 global pandemic and the enactment in the United Kingdom of the Corporate Insolvency and Governance Act 2020 (CIGA 2020).

2. Arbitration agreements

An arbitration agreement should asseverate the substantive law that will be employed to the merits of the contention and the procedural law (*lex arbitri* or also called "law of the seat").² A fundamental feature of any arbitration agreement is the principle of separability which results in the arbitration agreement as being a separate contract from the main contract between the parties.³ This principle results in the survival of the arbitration

¹ LL.M. Corporate Law at Durham University; LL.B. (Hons) University of Essex.

² Arbitration Act 1996, s 6; G Born, *International Arbitration: Law and Practice* (Wolters Kluwer, 2012) at 55; and N Blackaby and C Partasides, *Redfern and Hunter on International Arbitration* (6th ed, Oxford University Press, 2015) at 158; R Nazzini, "The Law Applicable to the Arbitration Agreement: Towards Transnational Principles", *International and Comparative Law Quarterly* (2016) 65(3) 681.

³ Arbitration Act 1996, s 7; *Fiona Trust and Holding Corporation and ors v Privalov and ors* [2007] EWCA Civ 20, [2007] 1 ALL ER (Comm) 891, [2007] Bus LR 686, [2007] 2 Lloyd's Rep, [2007] ALL ER (D) 169 (Jan); and

agreement even when the main contract has become null, void or terminated. Since the insolvency of a company may render some of its clauses unenforceable, it is to be investigated under which circumstances the arbitration agreement can be voided, or not be enforced as a consequence of the debtor's financial situation. For instance, in *Baytur SA v Finagro Holdings*⁴ it was held that only when a company is dissolved will the arbitration agreement become void. However, the insolvency of a company might give an automatic stay to the arbitration without rendering the arbitration procedure null or void.

2.1 Arbitrability

An important aspect that should be analysed here is the concept of arbitrability.⁵ The simple explanation of this principle is that the subject matter of the dispute should be capable of being determined by an arbitral tribunal. Unlike other jurisdictions, English law has not established within the provisions of the Arbitration Act 1996 which kind of disputes are arbitrable. Although the insolvency of a company does not prevent an arbitration agreement from ceasing, the arbitrability of the subject matter will be questioned by the courts in case the dispute jeopardises public policy⁶ or third-party rights.⁷ For instance, in *Fulham Football Club*⁸ it was disputed whether the insolvency of a company could compromise the survival of the arbitration agreement. Nevertheless, Lord Justice Patten asserted that although an arbitrator has no jurisdiction to allow a winding up petition, it should be considered if such liquidation involves matters of public policy or third-party rights.⁹ Under English law, the arbitrability of an insolvency matter will be dependent on whether such dispute has a substantial impact on issues of public policy and third-party rights.

Issues concerning the subject matter of the dispute had arisen in *Best Beat Ltd*,¹⁰ where the claimant submitted a petition to liquidate the company. Nevertheless, the respondent

Sulamerica Cia Nacional de Seguros SA and ors v Enesa SA and ors [2012] EWCA Civ 368, [9]-[11], [2012] 2 ALL ER (Comm) 795, [2012] 1 Lloyd's Rep, [2012] NLJR 751, [2012] ALL ER (D) 145 (May), [2013] 1 WLR 102.

⁴ [1992] 2 WLR 1362 CA.

⁵ E Galliard and J Savage, *Fouchard Galliard Goldman on International Commercial Arbitration* (Kluwer Law International, 1999) at 312; and N Blackaby and C Partasides, *Redfern and Hunter on International Arbitration* (6th ed, Oxford University Press, 2015) at 110.

⁶ *Tamil Nadu Electricity Board v St-Cms Electric Company Private Ltd* [2007] EWHC 1713 (Comm); *ET Plus SA & Ors v Welter & Ors* [2005] EWHC 2115 (Comm); *Soleimany v Soleimany* [1998] EWCA Civ 285; and *Westacre Investments Inc v Jugoimport-SPDR Holding Co Ltd* [1999] 3 WLR 811.

⁷ *Larsen Oil and Gas Pte Ltd v Petroprod Ltd* [2010] 4 SLR 501. See also, *United States Lines, Inc et al (US) v American Steamship Owners Mutual Protection and Indemnity Association, Inc et al (US)* (2000) XXV YBCA 1057, 1065 (2nd Circ, 1 November 1999).

⁸ *Fulham Football Club (1987) Ltd v Richards* [2011] EWCA Civ 855 at 40, [2012] Ch 333, [2012] 2 WLR 1008, [2012] 1 ALL ER 414, [2012] 1 ALL ER (Comm) 1148, [2012] Bus LR 606, [2011] 7 WLUK 630, [2011] BCC 910, [2012] 1 BCLC 335, [2012] 1 CLC 850, [2011] Arb LR 22, [2012] CLY 517.

⁹ See also, *Amaltal Corporation Ltd v Maruha (NZ) Corporation Ltd* [2004] 2 NZLR 614 (CA); *Downer-Hill Joint Venture v Government of Fiji* [2005] 1 NZLR 554 (CA); and *Danone Asia Pacific Holdings Limited et al v Fonterra Co-operative Group Limited* [2014] NZHC 1681, [70]-[80].

¹⁰ *Best Beat Ltd v Rossall* [2006] BPIR 1387, [2006] ALL ER (D) (Mar), [2006] EWHC 1494 (Comm).

made an ordinary application in order to stay such petition based on a provision of the Arbitration Act 1996, which states that “a party to an arbitration agreement against whom legal proceedings are brought...can apply to the court to stay those proceedings”.¹¹ The lease between the parties did not state that any concerns arising as a result of rent issues would be referred to arbitration.¹² Moreover, the Arbitration Act 1996 states that on an application the court has the power grant a stay, “unless satisfied that the arbitration agreement is null and void, inoperative or incapable of being performed”.¹³ However, the court dismissed the stay since the actual dispute between the parties was whether the respondent was forced to pay compensation under the Landlord and Tenant Act 1954 and such a matter was thus not covered by the wording of the arbitration agreement between the parties. The main issue in this case was that the petition to liquidate could not materialise since the compensation of overdue rent did not fall within the power of the arbitration agreement. On the contrary, in the case of *Rusant Limited*,¹⁴ Warren J asserted that in the presence of an arbitration clause which leads to a winding up petition, he would be forced to award an injunction preventing the petition from taking place.¹⁵ Notwithstanding this, it should be under the discretion of the Companies Court to reject the petition and leave the matter to be determined by the parties at the forum chosen.¹⁶

In the case of *Salford Estates*,¹⁷ it was analysed whether the referral to arbitration included “any dispute” that arises when a company becomes insolvent. In this case, a dispute arose concerning the payment of service charges and insurance rent under a lease agreement that also contained an arbitration clause. The arbitral tribunal promulgated an award determining the amount in arrears that Altomart owed to Salford. Nevertheless, Altomart was late with the payments which encouraged Salford to threaten Altomart with a winding up petition. However, Altomart challenged the petition and claimed that the dispute had to be referred to arbitration. The High Court granted a stay of the winding up petition and asserted that there were substantial grounds to bring arbitration into play.¹⁸ Indeed, the Arbitration Act 1996 states that “[a] party to an arbitration agreement against whom legal proceedings are brought (whether by way of claim or counter claim) ...can apply to the court in order to stay those proceedings”.¹⁹ Nevertheless, the Court of Appeal held that this does not apply to winding up petitions involving the company’s inability to pay its

¹¹ Arbitration Act 1996, s 9(1).

¹² *Best Beat Ltd v Rossall* [2006] BPIR 1387 at 15, [2006] ALL ER (D) (Mar), [2006] EWHC 1494 (Comm); and I Pester, “Arbitration or insolvency: which comes first?”, *Corporate Rescue and Insolvency* (2015) 59.

¹³ Arbitration Act 1996, s 9(4).

¹⁴ *Rusant Limited v Traxys Far East Limited* [2013] EWHC 4083 (Ch).

¹⁵ *Fulham Football Club (1987) Ltd v Richards* [2011] EWCA Civ 855, at para 23.

¹⁶ I Pester, “Arbitration or insolvency: which comes first?”, *Corporate Rescue and Insolvency* (2015) 59.

¹⁷ *Altomart Ltd v Salford Estates (No.2) Ltd* [2014] EWCA Civ 1408, [2014] 6 Costs LR 1013, [2014] ALL ER (D) 342 (Oct), [2015] 1 WLR 1825, [2016] 2 ALL ER 328.

¹⁸ *Rusant Limited v Traxys Far East Limited* [2013] EWHC 4083 (Ch); *Halki Shipping Corp v Sopex Oils Ltd* [1998] 1 WLR 726, [1998] 2 ALL ER 23, [1998] 1 Lloyd’s Rep 465, [1997] 12 WLUK 449, [1998] CLC 583, (1998) 142 SJLB 44, [1998] NPC 4, [1998] CLY 246; and *Nova (Jersey) Knit Ltd v Kammgarn Spinnerei GmbH* [1977] 1 WLR 713, [1977] 2 WLUK 121, [1977] 1 Lloyd’s Rep 463, [1977] 2 ALL ER 463, (1977) 121 SJ 170, [1977] CLY 195.

¹⁹ Arbitration Act 1996, s 9(1).

debts.²⁰ Furthermore, the court held that a petition to liquidate was not a claim for the payment of a debt. By virtue of the Insolvency Act 1986, the court has the power of discretion on whether it is just and equitable to liquidate the company.²¹ Indeed, the judge stated that it was inconceivable that Parliament wanted to give the right to strike “at the heart of the jurisdiction and discretionary power of the court to wind-up companies in the public interest where companies are not able to pay their debts”.²² In light of the foregoing analysis, it can be discerned that English courts will allow an arbitration proceeding to continue, notwithstanding if one of the disputants decides to challenge the arbitration through a petition to liquidate. In terms of arbitrability, English courts will examine the insolvency of the debtor and whether the matter concerns public policy or third-party rights. An important aspect is whether the issue is covered by the arbitration clause, as in the cases of *Best Beat Ltd* and *Salford Estates*. The latter has become the leading case regarding winding up petitions and arbitration clauses which English courts have employed in recent disputes. Furthermore, the facts previously discussed concern a winding up petition brought by one of the parties; however, in case a company goes insolvent, a liquidator or administrator will be appointed to take control over the debtor. Therefore, which powers are conferred upon the liquidator in case a conflict arises between arbitration and insolvency?

3. Commencing or continuing arbitration proceedings in insolvency

The Insolvency Act 1986 provides certain powers to the liquidator²³ or administrator,²⁴ not only to wind-up the company and distribute its assets but also “to bring or defend any action or other legal proceedings in the name and on behalf of the company”,²⁵ including an arbitration.²⁶ As a result, the liquidator should evaluate whether it would be more convenient in certain circumstances to bring the matter to arbitration. On the contrary, in cases where the arbitration has progressed slowly, the insolvency practitioner should decide whether it would be beneficial to determine the conflict in the insolvency.²⁷ Unlike a members’ voluntary liquidation, in a compulsory winding up the liquidator will need the sanction of the court to bring legal (including arbitration) proceedings against another party.

²⁰ Arbitration Act 1996, s 9(1)(4). See also, R Bamforth and S Woods, “Insolvency and Arbitration”, *Insolvency Intelligence* (2016) 29(3) 33.

²¹ Insolvency Act 1986, ss 122(1)(f) and 123(1)(e); *Re Cheyne Finance Plc (in receivership)* [2007] EWHC 2402 (Ch), [2008] ALL ER 987, [51]. See also *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL Plc* [2010] EWHC 2005 (Ch), [2011] EWCA Civ 227, [2013] UKSC 28, [2013] 1 WLR 1408.

²² *Altomart Ltd v Salford Estates (No 2) Ltd* [2014] EWCA Civ 1408, [2014] 6 Costs LR 1013, [2014] ALL ER (D) 342 (Oct), [2015] 1 WLR 1825, [2016] 2 ALL ER 328, at para 45.

²³ Insolvency Act 1986, Sch 4, para 4. See also, Small Business, Enterprise and Employment Act 2015, s 120.

²⁴ Insolvency Act 1986, Sch 1, para 6.

²⁵ *Idem*, Sch 4, para 4.

²⁶ *Re Paramount Airways Ltd (in administration)* [1993] Ch 223, [1992] 3 ALL ER 1, [1992] 3 WLR 690, [1992] BCLC 710, [1992] BCC 416.

²⁷ R Bamforth and S Woods, “Insolvency and Arbitration”, *Insolvency Intelligence* (2016) 29(3) 33.

If a party chooses to commence an arbitration proceeding against an insolvent party, it has to apply for the court's permission in terms of the Insolvency Act 1986.²⁸ In the case of *Exchange Securities*,²⁹ it was established that the court will grant permission for the application to proceed unless the issue in question could be resolved more accurately in winding up proceedings. However, the court will consider the merits of the dispute and if it has high chances of being revoked before the High Court, it is less likely that the application will be granted permission to continue.³⁰ The same application must be made in administration and other procedures where a moratorium is demanded.³¹ In *Atlantic Computers*,³² the court determined the appropriate elements where it would grant permission: (i) there must be reasonable grounds for the application; (ii) the application does not affect the administration and it concerns proprietary rights; (iii) the court will balance the interest of the liquidation and those of the claimant; and (iv) the court will not decide on the legitimacy of the security unless it is evident.³³

3.1 Mandatory stay and discretionary power

English courts have taken a strong stance in terms of agreements to arbitrate by giving a mandatory stay to court proceedings. For instance, *Philpott v Lycee*³⁴ has served as a guide to analyse whether the subject matter of the dispute falls within the ambit of the arbitration agreement, and also whether it would be convenient to resolve the issue through arbitration.³⁵ A company and a school entered into a construction contract that contained an arbitration clause. Afterwards, the company went into administration and then liquidation.³⁶ The school argued that the arbitration clause was binding and enforceable, notwithstanding the administration. However, the liquidators claimed that issues concerning proof of debt fell within the power of the court. Judge Purle QC asserted that even after a liquidation has taken place, "the arbitration agreement does not become inoperative".³⁷ For this reason, if a winding up petition arises via an arbitration agreement,

²⁸ Insolvency Act 1986, s 130(2).

²⁹ *Exchange Securities and Commodities Ltd (in liquidation)* [1988] Ch 46, [1987] 2 ALL ER 272, [1987] 2 WLR, [1987] BCLC 425, [1987] LS Gaz R 979.

³⁰ *HIH Casualty and General Insurance Ltd* [2008] UKHL 21, [2008] 3 ALL ER 869, [2008] 1 WLR 852, [2012] 2 BCLC 655, [2008] Bus LR 905, [2008] Lloyd's Rep IR 756, [2008] BCC 349, [2008] BPIR 581, [2008] ALL ER (D) 116 (Apr).

³¹ *A Straume (UK) Ltd v Bradlor Developments Ltd* [2000] BCC 333, (1999) Times, 29 June.

³² *Atlantic Computer Systems plc* [1992] 1 ALL ER 476, [1992] Ch 505, [1992] 2 WLR 367, [1991] BCLC 606, [1990] BCC 859.

³³ S Frisby, "Balancing interests in administration: contributions from the courts and the coalface", *Journal of International Banking and Financial Law* (2009) 4 198.

³⁴ *Philpott and another (as joint liquidators of WGL Realisations 2010 Ltd) v Lycee Francais Charles de Gaulle School* [2015] EWHC 1065 (Ch), [2016] 1 ALL ER (Comm) 1.

³⁵ See, <https://www.newtemplechambers.com/uncategorized/arbitration-act-1996-insolvency-rules-1986-guidance-high-court/>.

³⁶ *Re Wear Engine Works Co* (1875) 10 Ch App 188 at para 191; 44 LJ Ch 256; 23 WR 735, 32 LT 314; [1874-80] ALL ER Rep Ext 1889.

³⁷ *Idem*, [20]; *Fulham Football Club (1987) Limited v (1) Sir David Richards & Ors* [2011] EWCA Civ 855, at para 98-99. See also, V Bange, "Insolvency Rules vs arbitration - which prevails?", *Construction Law* (2016) 27(1) 26 28.

it should be considered whether such debt is subsumed within the ambit of the arbitration agreement and whether it could be admitted.³⁸

In such circumstances, by reason of the Insolvency Act 1986,³⁹ the court has a discretionary power to dismiss the petition. On the other hand, in *Enron Metals*⁴⁰ the court assessed whether it should employ its discretion provided for elsewhere in the Insolvency Act 1986⁴¹ and impede a referral to arbitration. The relevant provision provides the court with the power to grant leave despite a winding up petition having been made or a provisional liquidator having been nominated. Notwithstanding the fact that the court recognised the existence of an arbitration agreement, the court assessed whether the claim had merit⁴² in order to grant leave to the applicant in arbitration proceedings.⁴³ However, the court declared that the dispute was devoid of merit and did not permit the referral to arbitration.⁴⁴ The prelation of English courts towards arbitration is elucidated through their willingness to grant a mandatory stay to insolvency proceedings. Indeed, in the case of *Philpott*, although the arbitration agreement faced an administration proceeding, which requires a compulsory moratorium, the court enforced the agreement to arbitrate. Such a pro-arbitration stance is strengthened by virtue of the discretionary power of the English courts in terms of the Insolvency Act 1986.⁴⁵ In addition to that, English courts will ultimately decide whether the case has merit to be assessed in arbitration or not.

4. Predictability: The *ratio* behind *Salford Estates*

Salford Estates has been a relevant authority for recent case law such as *Telnic Limited v Knipp Medien Kommunikation GmbH*.⁴⁶ *Telnic* and *Knipp* entered into contractual relations concerning data and software services and signed an agreement that included an arbitration clause. The latter stated that any dispute arising out of the service agreement should be referred to arbitration upon written request. The dispute arose when *Knipp* demanded money from *Telnic* due to services provided by the former; consequently, *Knipp* requested a petition to liquidate *Telnic* on grounds that the latter was unable to pay

³⁸ *Bannai v Erez (Trustee in Bankruptcy of Eli Reifman)* [2013] EWHC 3689 (Comm); [2014] BPIR 4; and *Enterprise Managed Services Ltd v Tony McFadden Utilities Ltd* [2009] EWHC 3222 (TCC); [2011] 1 BCLC 414. See also, <https://hsfnotes.com/arbitration/2015/04/30/the-english-high-court-finds-that-arbitration-clause-trumps-insolvency-rules/>.

³⁹ Insolvency Act 1986, s 122(1).

⁴⁰ *Enron Metals & Commodity Limited v HIH Casualty & General Insurance* [2005] ALL ER (D) 178 (Mar); [2005] EWHC 485 (Ch); (2005) 102(19) LSG 33.

⁴¹ Insolvency Act 1996, s 130(2).

⁴² Civil Procedure Rules, Pt 24.2.

⁴³ See also, C Piercy and A McErlean, "Insolvent companies: to adjudicate or not to adjudicate... is that still the question?", *Corporate Rescue and Insolvency* (2019) 2 43.

⁴⁴ *New Cap Reinsurance Corp Ltd v HIH Casualty and General Insurance Ltd* [2002] ALL ER (D) 413 (Feb); [2002] EWCA Civ 300; and *Re Hartlebury Printers Ltd (in liquidation)* [1993] 1 ALL ER 470; *Re Aro Ltd* [1980] 1 ALL ER 1067.

⁴⁵ Insolvency Act, s 122.

⁴⁶ [2020] ALL ER (D) 164 (Jul), [2020] EWHC 2075 (Ch). See also *Lasmos Ltd v Southwest Pacific Bauxite (HK) Ltd* [2018] 2 HKLRD 449; *Dayang (HK) Marine Shipping Co Ltd v Asia Master Logistics* [2020] HKCFI 311, and <https://www.cms-lawnow.com/ealerts/2020/09/arbitration-agreement-no-winding-up-petition>.

its debts. Sir Geoffrey Vos relied on the statement of Sir Terence Etherton C in *Salford Estates*⁴⁷ who asserted that a court should exercise its discretionary power in section 122 of the Insolvency Act 1986 consistently with the policy encapsulated in section 9 of the Arbitration Act 1996. If this was not done, parties would be able to avoid the arbitration agreement through petitions to liquidate. Furthermore, Sir Vos stated that it would be contrary to the arbitration agreement if a party would be able to threaten the debtor by virtue of winding up petitions in order to receive the overdue payment. Additionally, he asseverated that in the current scenario there were no wholly exceptional circumstances whereby a court should allow the winding up petition since the debt falls within the ambit of the arbitration clause. Besides, since Knipp was not a creditor of Telnic, it did not have *locus standi* to chase a petition to liquidate.

The provisions of the Insolvency Act 1986 have legislated an appropriate balance between the petitions to liquidate and arbitration agreements. Particularly, it confers upon the courts a discretionary power to wind up companies in case parties attempt to circumvent the arbitration agreement.⁴⁸ However, as it was established in *Salford Estates*, only in exceptional circumstances would the court be willing to wind up the company.⁴⁹ Following the analysis of Sir Vos, he concluded that there were not wholly exceptional circumstances to allow the winding up petition. Nevertheless, in the event that an exceptional circumstance is found to exist, the courts would then analyse whether the debt is disputed in good faith or on substantial grounds. The *ratio* behind this is that the court should exercise its discretion (following the provisions of the Insolvency Act 1986)⁵⁰ in order to wind up a company in accordance with the provisions of the Arbitration Act 1996. English law has always been pro-arbitration⁵¹ and the need for predictability for the parties that their arbitration agreement will be enforced, is thus significant. For instance, in a recent case of the English Commercial Court,⁵² the circumstances where a court utilises its jurisdiction to grant interim or emergency relief in support of arbitration proceedings, was analysed. In the same manner that the Insolvency Act 1986 provides certain discretionary powers to the court,⁵³ the Arbitration Act 1996 confers the court with the power to order interim injunctions.⁵⁴

⁴⁷ *Salford Estates (No.2) Limited v Altomart Limited* [2014] EWCA 1575 Civ at paras 39-41.

⁴⁸ Insolvency Act 1996, s 122(1).

⁴⁹ See also, *AnAn Group (Singapore) Pte Ltd v VTB Bank (Public Joint Stock Company)* [2020] SGCA 33; and *Fieldfisher LLP v Pennyfeathers Ltd (Fieldfisher)* [2016] EWHC 566 (Ch) [29].

⁵⁰ Insolvency Act 1996, s 122(1).

⁵¹ *Angeliki Charis Compania Maritima SA v Pagnan Spa (The Angelic Grace)* [1995] 1 Lloyd's Rep 87, [1994] 5 WLUK 206; and *AES Ust-Kamenogorsk Hydropower Plant LLP v Ust-Kamenogorsk Hydropower Plant JSC* [2014] 1 ALL ER 335, [2013] UKSC 35, [2013] 1 WLR 1889, [2010] 2 ALL ER (Comm) 1033. See also, *Continental Bank NA v Aekos Compania Naviera* [1994] 1 WLR 588, [1994] 2 ALL ER 540, [1994] 1 Lloyd's Rep 505, [1993] 11 WLUK 128, [1994] ILPr 413, [1994] CLY 3715.

⁵² *Petrochemical Logistics Ltd & Axel Krueger v PSB Alpha AG & Konstantinos Ghertsos* [2020] EWHC 975 (Comm).

⁵³ Insolvency Act 1996, s 122.

⁵⁴ Arbitration Act 1996, s 44(1). Also see *Vertex Data Science Ltd v Powergen Retail Ltd* [2006] EWHC 1340 (Comm), [2006] 2 Lloyd's Rep 591, [2006] 6 WLUK 163, [2007] CLY 245; *LauritzenCool AB v Lady Navigation Inc* [2005] EWCA Civ 579, [2005] 1 WLR 3686, [2006] 1 ALL ER 866, [2005] 2 ALL ER (Comm) 183, [2005] 2 Lloyd's Rep 63, [2005] 5 WLUK 363, [2005] 1 CLC 758, [2005] CLY 422; *Ashville Investments Ltd v Elmer*

4.1. Predictability: Enforcement of arbitration agreements

The cases previously mentioned, such as *Salford Estates* and *Telnic*, have become the foundation of the interrelation between insolvency law and arbitration clauses. The cornerstone of an arbitration agreement is the principle of party autonomy⁵⁵ (*l'autonomie de la volonté*) which translates into the parties' consent to have their issues resolved by a certain court under a specific applicable law. In such cases, the parties' expectation to have their agreement enforced must be protected due to their intention to submit themselves to an alternative dispute method.

Predictability is the notion of parties to have their agreement enforced despite the financial situation of the debtor. However, this can be compromised where the distressed company enters into administration. The Insolvency Act 1986 states that when a company is under administration "no legal process may be continued against the company or property of the company, except with the consent of the court or the administrator where one has been appointed".⁵⁶ Although this might compromise the parties' predictability, it is still possible to apply to the court for consent in order to continue the arbitration proceedings. From a certain perspective, the predictability of the arbitration agreement has not been completely jeopardised since it would be the decision of the English courts to determine whether the insolvency or arbitration proceedings should be carried on.

Parties' expectancy that their arbitration agreement will be enforced might be compromised. For instance, in the case of *Salford Estates* the claimant made a winding up petition for a non-payment which the court held it was covered by the arbitration agreement; therefore, the petition was dismissed. It is axiomatic and understandable that due to the principle of party autonomy, parties will consider their arbitration agreement enforceable notwithstanding the financial situation of the troubled company.

5. Efficiency: Procedural and substantive Law

A distinction should be made between the procedural and substantive issues between insolvency law and arbitration. In order to achieve efficiency, one must look at the procedural and substantive goals of the law. A substantive goal means that a certain area of law seeks to achieve a certain outcome, while a procedural goal focuses on "how" such outcome is achieved. In other words, the procedural law attains to achieve a fair and equitable method of the process. Mokal defined efficiency as indispensable to the

Contractors Ltd [1988] 2 ALL ER 577, [1989] QB 488, [1988] 3 WLR 867, [1988] 2 Lloyd's Rep 73, [1987] 5 WLUK 184, 37 BLR 55, 10 Con LR 72, (1987) 3 Const LJ 193, (1988) 132 SJ 1553; and *Kastner v Jason* [2004] EWHC 592 (Ch), [2004] 2 Lloyd's Rep 233, [2004] 3 WLUK 618, [2004] NPC 47.

⁵⁵ M Zhang, "Party Autonomy and Beyond: An International Perspective of Contractual Choice of Law", *Emory International Law Review* (2006) 20 511. See also, J Hil, "Determining the seat of an international arbitration: party autonomy and the interpretation of arbitration agreements", *International and Comparative Law Quarterly* (2014) 63(3) 517.

⁵⁶ Insolvency Act 1986, Sch B1, para 43(6).

procedural law;⁵⁷ indeed, he claims that once a certain group of substantial goals have been established, efficiency can be used in order to judge among a diverse range of proposed schemes in order to achieve such a goal. Afterwards, Mokal argues that in a situation in which there are two different methods to achieve a goal, (procedural) efficiency suggests choosing a method that will be less costly to implement, other things being equal.⁵⁸

Looking at this theory in context, English courts have usually been willing to stay petitions to liquidate so as to provide another type of procedural method to the dispute, such as arbitration. This being said, the specific approach utilised by English courts in cases where insolvency and arbitration are involved, is clear. The party autonomy principle provides both parties legal certainty that their willingness to refer to arbitration will be respected. However, it would be controversial in certain cases where a party tries to circumvent the arbitration agreement and refers the matter to court. Bypassing the arbitration agreement by deliberately commencing court proceedings might lead to a breach of contract. Indeed, in *Telnic* the judge regarded the petition to liquidate as a tactic to avoid the arbitration agreement. However, in cases regarding debtors and arbitration clauses, UK courts have been willing to focus on how to resolve the substantial matter and whether the dispute falls within the power of the arbitration agreement. As a matter of fact, English courts have judged cases based on their discretionary power conferred by the legislation. For instance, in *Telnic*, the judge highlighted the importance of analysing section 122 of the Insolvency Act 1986 consistently with the policy encompassed in the provisions of the Arbitration Act 1996.⁵⁹

The approach UK courts have employed in several circumstances has demonstrated the efficiency of such an approach. This has been achievable via the Insolvency Act 1986 that confers the courts with the discretionary power to provide a suitable outcome.

5.1. Efficiency: Pro-arbitration stance of English courts

Recent case law has shown the position that English courts take regarding insolvency proceedings and its impact on arbitration clauses. In *Riverrock Securities* (RSL),⁶⁰ the court granted an anti-suit injunction concerning insolvency proceedings initiated in Russia against RLS by the appointed receiver (the Deposit Insurance Agency (DIA)) of the International Bank of St Petersburg (IBSP). The disputants entered into several contracts

⁵⁷ R Mokal, "Consistency of Principle in Corporate Insolvency" (PhD thesis, University College London 2001). See also, R Mokal, "Review Article: On Fairness and Efficiency", *The Modern Law Review* (2003) 452.

⁵⁸ *Idem*, 39

⁵⁹ *Telnic Limited v Knipp Medien Kommunikation GmbH* [2020] ALL ER (D) 164 (Jul), [2020] EWHC 2075 (Ch) at 27.

⁶⁰ *Riverrock Securities Limited v International Bank of St Petersburg (Joint Stock Company)* [2020] EWHC 2483 (Comm). See also, *BPN Paribas SA v Open Joint Stock Company Russian Machines* [2011] EWHC 308 (Comm); And *Nori Holding Ltd v Public Joint-Stock Company 'Bank Otkritie Financial Corporation'* [2018] EWHC 1343 (Comm), [2018] 2 ALL ER (Comm) 1009, [2019] Bus LR 146, [2018] 2 Lloyd's Rep 80, [2018] 6 WLUK 54, [2018] 2 CLC 9, [2018] BPIR 1402, [2018] CLY 275.

concerning the purchase of credit securities in the form of notes. All of the contractual agreements provided for English law as the governing law of the main contract. In addition to that, the applicable law of the arbitration agreement was also English law and the seat appointed as London. However, due to violations and non-compliance actions under Russian banking law, IBSP's license was abrogated which eventually led to insolvency. The receiver (DIA) pursued legal proceedings to invalidate the contracts with RSL before the arbitral court in St Petersburg. Consequently, RLS applied to the English High Court seeking an interim anti-suit injunction since the expressed choice of law contained in the arbitration agreement was English law in conjunction with the LCIA arbitration rules. The court's *dicta* relied on *Enka Insaat Ve Sanayi AS v OOO "Insurance Company Chubb" and ors*,⁶¹ where the parties chose London as the legal seat of the arbitration, which meant that they had acquiesced to the English jurisdiction from certain perspectives. Indeed, England is acknowledged as a suitable seat in terms of anti-suit injunctions⁶² since this manifests the parties' willingness to submit themselves to English jurisdiction.⁶³ Furthermore, the arbitration clause in *Riverrock* affirmed that "any dispute under the Agreement or in connections with it shall be...resolved by arbitration under the LCIA Rules" and thus the clause was written in a wide enough fashion to embrace several issues that could arise from the main contract.⁶⁴ For that reason, the judge expressed that English law follows a generous approach due to the expansive terms used in arbitration agreements. Additionally, the High Court considered that the Russian proceedings were contractual in nature and thus fell within the scope of the arbitration clause.⁶⁵ Notwithstanding that the foreign insolvency proceedings were avoidance claims, it did not supersede the English approach to enforce arbitration agreements. *Riverrock* has re-affirmed the English policy in terms of arbitration clauses and insolvency proceedings, and the efficient approach that English courts have adopted in order to enforce the parties' agreement to arbitrate.

⁶¹ [2020] EWCA Civ 574.

⁶² *Econet Wireless Ltd v Vee Networks Ltd* [2006] EWHC 1568 (Comm), [2006] 2 ALL ER (Comm) 989, [2006] 2 Lloyd's Rep 428, [2006] 6 WLUK 659, [2006] CLY 458; *B v S* [2011] EWHC 691 (Comm), [2011] 2 Lloyd's Rep 18, [2011] 3 WLUK 733, [2011] 1 CLC 837, [2011] Arb LR 10, [2011] CLY 131; and *Q's Estate, Re* [1999] 1 ALL ER (Comm) 499, [1999] 1 Lloyd's Rep 931, [1999] 3 WLUK 223, (1999) 149 NLJ 442, [1999] CLY 241. See also, *Commerce & Industry Insurance Co (Canada) v Lloyd's Underwriters* [2002] 1 WLR 1323, [2002] 2 ALL ER (Comm) 204, [2002] 1 Lloyd's Rep 219, [2001] 8 WLUK 14, [2002] CLC 26, [2002] CLY 220.

⁶³ <http://arbitrationblog.kluwerarbitration.com/2020/05/05/hold-on-to-your-seats-again-another-step-to-validation-in-enka-v-chubb-russia/>.

⁶⁴ *Riverrock Securities Limited v International Bank of St Petersburg (Joint Stock Company)* [2020] EWHC 2483 (Comm) at para. 7.

⁶⁵ *Idem*, para 37. See also, *Through Transport Mutual Insurance Association (Eurasia) Ltd v New India Assurance Co Ltd* [2004] ALL ER (D) 25 (Dec), [2004] EWCA Civ 1598; and *Shipowners' Mutual Protection and Indemnity Association (Luxemburg) v Containerships Denizcilik Nakliyat Ve Ticaret AS* [2016] 3 ALL ER 697, [2016] EWCA Civ 386.

5.2. Efficiency in alternative dispute resolution and insolvency

The English approach goes beyond the arbitration practice to embrace other dispute methods such as adjudication.⁶⁶ In *Bresco Electrical Services*⁶⁷ the Court of Appeal and the Supreme Court have illustrated a controversy within the ambit of dispute resolution and insolvency law. The courts have revealed their willingness to resolve the insolvency issue via dispute resolution (adjudication) rather than insolvency. The dispute that arose in *Bresco* concerned a non-payment due to the creditors' voluntary liquidation of Lonsdale, and subsequently the dispute caused several cross-claims between the parties. In light of the rationale behind insolvency set-off,⁶⁸ Lonsdale asserted that the adjudicator did not have jurisdiction over the dispute and sought to restrain the adjudication. The Supreme Court stated that construction adjudication is not incompatible with the operation of insolvency set-off. Moreover, it asserted that the liquidator had the power to pursue a claim through arbitration and that the same rationale should be employed in an adjudication case. Furthermore, although construction adjudication is imposed by law,⁶⁹ the courts considered adjudication in the same manner as arbitration.⁷⁰

6. COVID-19 pandemic: Corporate Insolvency and Governance Act 2020

As a result of the current global pandemic, many jurisdictions have enacted legislation in order to prevent companies in financial distress from liquidation. The CIGA 2020 prevents creditors from winding up⁷¹ companies from 27 April 2020 to 31 December 2020, unless they have substantial grounds to believe and / or argue that COVID-19 has not affected the financial position of the company. Furthermore, CIGA 2020 prohibits winding up petitions against a company that is unable to pay its debts unless it is demonstrated that the inability to pay such debts is not a result of COVID-19. The moratorium will confer some

⁶⁶ J Michaelson, "Is mediation death in insolvency?", *New Law Journal* (2002) 152.

⁶⁷ *Bresco Electrical Services Limited (in liquidation) v Michael J Lonsdale (Electrical) Limited* [2020] UKSC 25, [2020] Bus LR 1140, [2020] 6 WLUK 2020, [2020] BCC 906, [2020] 2 BCLC 147, [2020] BLR 497, 190 Con LR 1, [2020] BPIR 1078, [2020] CLY 1144; *Twintect Ltd v Volkerfitzpatrick Ltd* [2014] EWHC 10 (TCC), [2014] 1 WLUK 572, [2014] BLR 150, [2014] CILL 3476, [2014] CLY 592; and *Stein v Blake* [1996] AC 243, [1995] 2 WLR 710, [1995] 2 ALL ER 961, [1995] 5 WLUK 278, [1995] BCC 543, [1995] 2 BCLC 94, (1995) 145 NLJ 760, [1995] CLY 422. See also *Balfour Beatty Civil Engineering Ltd v Astec Projects Ltd (In Liquidation)* [2020] EWHC 796 (TCC), [2020] 2 WLUK 593, [2020] TCLR 5; and *Meadowside Building Developments Ltd (In Liquidation) v 12-18 Hill Street Management Co Ltd* [2019] EWHC 2651, [2020] Bus LR 917, [2019] 10 WLUK 176, [2020] BLR 65, [2020] CLY 1150.

⁶⁸ Insolvency (England and Wales) Rules 2016, r 14.25.

⁶⁹ Housing Grants, Construction and Regeneration Act 1996, s 108.

⁷⁰ G Phillips and J Winestone, "A New 'Arb-Lit' Hybrid Process Unifies ADR and Litigation for Creative Resolution", *Alternatives to the High Cost of Litigation* (2016) 34, at p 65. See also C J Menkel-Meadow, *Dispute Processing and Conflict Resolution: Theory, Practice and Policy* (Ashate Dartmouth 2003); C J Menkel-Meadow, L Porter Love, A Kupfer Schneider, J R Sternlight, *Dispute Resolution: Beyond the Adversarial Model* (Aspen Publishers 2011) at p 526; ⁷⁰ G Brown, "A Community of Court ADR Programs: How Court-Based ADR Programs Help Each Other Survive and Thrive" *The Justice System Journal* (2005) 26 327.

⁷¹ CIGA 2020, Sch 10.

time to companies to be rescued as a going concern and protect viable businesses and also creditors in the supply chain.

In light of the economic impact of these changes, there might be an increased number of insolvency disputes in the medium to long term. As a result, arbitration could potentially expedite the resolution of insolvency issues. Nevertheless, there are outstanding aspects to consider such as the costs incurred by the arbitration proceedings and the nature of the insolvency. Depending on the industry the company is involved in, it might be hopeless to bring the issue to arbitration since the COVID-19 pandemic is likely to last longer and its economic impact might be durable. Furthermore, the extension of the moratorium will provide a temporary effect for businesses to be rescued, but companies are nevertheless at risk as soon as this time has elapsed.

CIGA 2020 has not imposed any restrictions in terms of commencing or continuing an arbitration proceeding. Similarly to the Insolvency Act 1986, under CIGA 2020 the court must give permission (such as in cases of administration and compulsory liquidation) to open and / or continue an arbitration proceeding against the main insolvency proceeding. It will be insightful to learn how the courts will judge certain matters under the CIGA 2020 and whether specific claims might create new precedents in England.

7. Conclusion

The insolvency of a troubled company does not itself impact the enforceability of an arbitration agreement. Furthermore, depending on certain circumstances, the arbitration might be permitted by the court; for instance, in case of a company entering into administration or compulsory liquidation, there must be a petition to the court or the administrator to continue the arbitration proceedings. The interaction between insolvency and arbitration has led to controversy around whether it is predictable to the disputants to have their arbitration agreement enforced and whether the English courts have provided an efficient answer to such predictability. A stay of arbitration proceedings could potentially occur in wholly exceptional circumstances depending on the discretionary power of the English courts.⁷² Furthermore, the English law policy of upholding arbitration agreements is not impeded, even though insolvency proceedings may have commenced in a foreign jurisdiction, such as in the case of *Riverrock*. The efficiency-oriented approach embraced by English courts extends to other alternative dispute resolution methods as well, such as adjudication. Due to the COVID-19 pandemic, many companies are or will be in financial distress and, therefore, the new CIGA 2020 has provided further clarification on certain issues such as the granting of a moratorium or the prohibition of future winding up petitions due to the global pandemic. However, it will be in the discretion of the English

⁷² <https://www.velaw.com/insights/policy-related-complexities-in-parallel-cross-border-insolvency-and-arbitration-proceedings/>; https://www.hoganlovells.com/~media/hogan-lovells/pdf/2020-pdfs/2020_06_23_arbitrating_against_distressed_or_insolvent_party.pdf; <https://www.nortonrosefulbright.com/-/media/files/nrf/nrfweb/knowledge-pdfs/international-arbitration-report---issue-4.pdf?la=en&revision=6edf090e-2dae-4845-a812-c912f12016d0>.

courts to decide whether certain arbitration proceedings should be stayed in order to rescue viable companies.



INSOL
INTERNATIONAL

INSOL International

6-7 Queen Street

London

EC4N 1SP

Tel: +44 (0) 20 7248 3333 Fax: +44 (0) 20 7248 3384

ISBN 97 81 90776429 5