Pro-Commerce Outlooks: The Bane of English Corporate Insolvency Law?

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Abstract

This article cursorily examines strands of English corporate insolvency law that highlight an overarching pro-commerce approach in marshalling competing rights of stakeholders in the insolvency matrix as well as in resolving insolvency proceedings. In particular, it uses case law (*Belmont Park Investment Pty Ltd v BNY Corporate Trustee Services Ltd*[1]) and legislation (Corporate Insolvency and Governance Act 2020[2]) as selected – and decidedly limited – paradigms of this approach. In so doing, this article suggests that while there is typically a wide benefit to this approach in commercial life, it also has the propensity to disrupt the insolvency polity by introducing elements of subjectivity and, *pro tanto*, uncertainty. Of more concern, however, is that the approach could also inhibit the "creative-destruction" role that insolvency proceedings ought to play in a well-functioning economy.

1. Background

A high-level examination of English corporate insolvency law will reveal certain 'truths'. First, English insolvency law is, predominantly, a creditor-friendly regime [3] Further, this conventionally creditor-friendly regime is now fixated on the rescue ideology as is evidenced by the number of rescue regimes in insolvency legislation that are available to distressed

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[1] [2011] UKSC 38, [2012] 1 AC 383.
[2] In particular, as amended by the Corporate Insolvency and Governance Act 2020 (Coronavirus) (Extension of the Relevant Period) (No 2) Regulations 2020, SI 2020/1483.
[3] A classic demonstration of this point is in the fact that predominant insolvency procedures like Administration and Liquidation are typically 'management displacing' procedures and the recognition of private contracts for the creditors to obtain security over company assets. As Lord Macnaghten said in *Salomon v Salomon* [1897] AC 22 at 52: "Every creditor is entitled to get and to hold the best security the law allows [them] to take."

business.[4] Third, the probable impact of embracing the rescue ideology on an otherwise creditor-centric regime is a progressive transmutation to a more debtor-friendly regime. The verity of this proposition lies in the number of 'debtor-in-possession' procedures that are now available in English insolvency law – the standalone moratorium, company voluntary arrangements (CVAs) and light touch administrations.[5] Fourth, the regime tries to manage the varied interests of relevant stakeholders when business failure occurs or is likely to occur. Fifth, English insolvency law, typically (though not exclusively) by legislation, proactively tries to minimise the negative impact that corporate failures may have on the economy. Sixth, when it comes to the treatment of creditors, the regime may engender inefficient practices or outcomes in certain contexts.[6] Finally, and notwithstanding the sixth truth, many of the preceding truths are a testament to the adaptability of English law to unpredictable and often complex commercial realities.

This article examines these points by focusing on the fourth and fifth truths. It does so in order to reveal the pro-commerce underpinnings of English insolvency law's attitude to the management of a financially distressed company's estate as well as the competing interests of its stakeholders on one hand, and the drive to preclude undesirable impacts of business failures on an economy that is acutely dependent on companies.[7] It does this by examining the Supreme Court's clarification of the anti-deprivation rule in *Belmont Park Investment Pty Ltd v BNY Corporate Trustee Services Ltd*[8] and the government's latest decision to extend the temporary

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[4] Insolvency Act 1986, part A1 ('Standalone' Moratorium), part 1 (Company Voluntary Arrangements), and sch B1 (Administration). These, of course, do not discount the value of other rescue-driving regimes like Schemes of Arrangement and the new Restructuring Plan (Companies Act 2006, parts 26 and 26A) as well as Administrative receivership in the business rescue context (Insolvency Act 1986, part III). For contemporary analysis of the utility of receivership in corporate law, see K Akintola and D Milman, 'The rise, fall and potential for a rebirth of receivership in UK Corporate Law' (2020) 20 JCLS 99.

[5] Pursuant to Insolvency Act 1986, sch B1, para 64(1). See also C Shuffrey, 'Crisis Management and Insolvency' (2020) 170 NLJ 15.

[6] Particularly in the context of the treatment of unsecured creditors under the prescribed part fund prior to the recent increase to the limit of the fund. See K Akintola, 'The Prescribed Part for Unsecured Creditors: A Pithy Review' (2017) 3 Insolvency Intelligence 54 and K Akintola, 'The Prescribed Part for Unsecured Creditors: A Further Review' (2019) 32 Insolvency Intelligence 67.

[7] For the verity that companies are the principal unit of commercial life, see *Prest v Petrodel Resources Ltd & Ors* [2013] UKSC 34, [2013] 2 AC 415 [8] (Lord Sumption).

[8] [2011] UKSC 38.

restrictions on statutory demands and winding up petitions from 31 December 2020 to 31 March 2021.[9]

At first blush, it would appear that there is something disingenuous in juxtaposing a common law rule and a legislative policy that are ostensibly aimed at different mischiefs. However, a closer examination of the two policies will betray a congruent desire to position the English insolvency regime as commercially indulgent. This, as we will see, ought not be seen in a pejorative light in so far as a balanced approach is adopted to avoid pitfalls associated with this pro-commerce outlook. There is also another overlap between the two policies considered in this article – the case of *Belmont* as well as the government's decision to extend the restriction on statutory demands and winding up petitions came on the back of economic downturns of relative unprecedented proportions. We should not gloss over this significant commercial wrinkle.

The rest of this article in divided into two sections. Section 2 discusses the role of the *Belmont* decision in fostering a pro-commerce approach in English insolvency law. It also examines the impact of the government's decision on insolvency proceedings and the wider economy. Section 3 provides some concluding thoughts.

2. Contemporary Pro-Commerce Outlooks in Case Law and Legislation.

We commence this section by looking at the scope of the anti-deprivation rule as refined in *Belmont*. This author has elsewhere branded the rule as a *rule of preservation* of corporate assets in insolvency. This is in contradistinction to its counterpart *pari passu* rule, which may be described as a *rule of distribution* of corporate assets in insolvency.[10] Both rules are components of the general principle that parties cannot contract out of the insolvency

[9] Corporate Insolvency and Governance Act 2020, sch 10, paras 1(3)(b) and 21(1)(b) as amended by the Corporate Insolvency and Governance Act 2020 (Coronavirus) (Extension of the Relevant Period) (No 2) Regulations 2020, SI 2020/1483, reg 2.
[10] See K Akintola, *Creditor Treatment in Corporate Insolvency Law* (Edward Elgar 2020), paras 3.38 *et seq*.

legislation.[11] The anti-deprivation rule operates to render void a contractual provision that deprives the company of an asset in insolvency where typically – but not necessarily – [12] the deprivation is triggered by the company's insolvency. Put differently, the rule prohibits withdrawal of assets from the company's beneficial ownership on its insolvency.[13] It does this in order to preserve value in the insolvent company's estate for the benefit of the general body of creditors.

The anti-deprivation rule may be seen as contrary in a commercial sense. On the one hand, it is an exception to the well-established principle that the insolvency office-holder takes the company's assets as he finds them – warts and all.[14] On the other hand, this common law inroad into parties' freedom of contract is a policy that was designed to preserve the commercial expectations of creditors in their debtor's insolvency.[15] This inroad deprives commercial parties of the ability to derive benefit from a contract that, in effect, is a fraud on bankruptcy or insolvency law.[16] The fraud is the circumvention of the policy of holding all the property of the insolvent company on a statutory trust for the purpose of a collective and rateable distribution to its creditors.[17] The policy is not too dissimilar to the vesting of the legal title to a bankrupt's assets in a trustee in bankruptcy (or assignee) for the purpose of enforcing the statutory scheme of distribution.[18]

The Supreme Court's decision in *Belmont* provides a useful exposition of the applicability of the rule in commercial transactions. The appeal came on the back of the collapse of the Lehman Brothers group – at the time the fourth largest investment bank in the

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[11] *Belmont Park Investment Pty Ltd v BNY Corporate Trustee Services Ltd* [2011] UKSC 38 [1] (Lord Collins).

[12] As we shall see in the discussion of *Belmont,* the effect of an insolvency triggered divestment may depend on whether it intentionally or inevitably evades the policy that the corporate debtor's property is for the benefit of all creditors. See [2011] UKSC 38 [105]-[106].

[13] See also *Skandinaviska Enskilda Banken AB (Publ) v Conway and another* [2019] 3 WLR 493 [101].

[14] It is often said that as a general principle, insolvency law does not disturb properly acquired pre-insolvency interests – see K Van Zwieten, *Goode on Principles of Corporate Insolvency Law* (5th edn, Sweet & Maxwell, London 2018), 3-01-305.

[15] Some early judicial descriptors of the rule talk about the divested property " … pass[ing] to another and not to his creditors." or being " … taken away from [the company's] creditors …." See generally *Whitmore v Mason* (1861) 2 J & H 204 at 212; *Re Harrison, Ex parte Jay* (1880) 14 Ch D 19 at 25; *Borland's Trustee v Steel Bros & Co Ltd* [1901] 1 Ch 279 at 290 (quoting *ex parte Jay*).

[16] See *Higginbotham v Holme* 19 Ves 88.

[17] For the notion of the statutory trust, see *Re Oriental Inland Steam Company* (1873-74) LR 9 Ch App 557; *Re Yagerphone, Limited* [1935] Ch 392, 395 (Bennet J); *Ayerst (Inspector of Taxes) v C&K (Construction) Ltd* [1976] AC 167.

[18] See Insolvency Act 1986, s 306. Although a liquidator is duty-bound to take custody of corporate assets, s/he is not automatically vested with the legal title to such assets until and unless the court grants an application for a vesting order. See Insolvency Act 1986, ss 144-145.

United States (US) – in September 2008 and the ensuing global financial crisis. The underlying facts that formed the background to the appeal involved a complex series of credit swap transactions and will not be set out here in detail.[19] Suffice to say that the principal issue was the validity of the clause that provided that Lehman Brothers Special Financing Inc (LBSF)'s priority to the collateral held by a trustee in furtherance of the credit swap transactions would flip in favour of noteholders like Belmont who, along with LBSF, had subscribed to notes issued by a special purpose vehicle (SPV/"the issuer"). Such flip in priority would occur on certain defined events of default, including the insolvency of LBSF or its parent. Commercially, the practical implication of the flip in priority was that the collateral would be exhausted in repayment of the notes rather than, should the priority not take place, giving LBSF recourse to the collateral in order to satisfy substantial "unwind costs" that would be due to LBSF as a result of credit events that were likely to arise in the wake of the financial crisis.[20]

The Supreme Court held that the clause was valid and did not contravene the anti-deprivation rule. It held that subject to limited exceptions, the courts should not use the rule to disturb *bona fide* commercial transactions which do not have as their predominant purpose, or as one of their main purposes, the deprivation of the property of one of the parties on insolvency.[21] Thus, the rule will invalidate a commercial agreement that *intentionally* or *inevitably* evades the policy that the debtor's property is part of the insolvent estate for the benefit of its creditors.[22] This analysis, perforce, applies in the context of complex financial instruments.[23]

The commercial appeal of this decision is obvious and significant. On the particular facts of the case, the financial protection afforded to the parties by the treatment of the collateral under the "Swap Counterparty Priority" and "Noteholder Priority" in the swap agreement were

[19] A summary of the events will be found in Lord Collins' judgment in [2011] UKSC 38 [18]-[48].
[20] [2011] UKSC 38 [23]-[24].
[21] *ibid* [104].
[22] *ibid* [105]-[106].
[23] [2011] UKSC 38 [103]. See also *Lomas v JFB Firth Rixson Inc* [2012] EWCA Civ 419.

not trivial, particularly in light of the credit events that were expected to occur because of the financial crisis. One could expect similar credit events to occur in similar contracts in the current COVID (CV-19) impacted business climate. More widely, the decision could represent a broad protection of party autonomy and commercial expectations in English commercial law.[24] For the insolvency polity, however, some caution ought to be exercised in the application of this pro-commerce outlook. For example, outside of the avoidance provisions in insolvency legislation,[25] it is not necessarily easy to discern commercial transactions that are *bona fide* without the purpose of stripping corporate property in insolvency for the purpose of applying the rule . Those avoidance provisions provide a method of invalidating commercial transactions in insolvency by reference to, for example, the timing of the transaction or the motive behind the transaction,[26] which unjustly enrich a creditor in insolvency at the expense of other creditors. These indicia (save where timing relates to an insolvency event) are ostensibly absent in the context of the anti-deprivation rule. In any event, while they may be relevant in appraising the applicability of the rule to commercial agreements, they are clearly not a determinative.

Further, on the point of the commercial transactions having “ … as their predominant purpose, or one of their main purposes, the deprivation of the property of one of the parties on bankruptcy …”,[27] there is an element of uncertainty since the fact that the flaw in the relevant assets is triggered by insolvency is not determinative on the applicability of the rule.[28] Where the inclusion of such insolvency-triggered deprivation is inescapable, parties drafting commercial agreements should be careful to indicate an additional commercial purpose such as the protection of a legitimate contractual interest.[29] This state of mind may illustrate the good

[24] See for example, the Supreme Court’s decision on the rule against penalties in contracts in *Cavendish Square Holdings B.V. v El Makdessi* and *ParkingEye Ltd v Beavis* [2015] UKSC 67.
[25] For example, Insolvency Act 1986, ss 238, 239 245 and 423.
[26] *Re M.C. Bacon Ltd.* [1990] BCC 78; *Re Stealth Construction Ltd* [2012] 1 BCLC 297; *Re Cosy Seal Insulation Ltd (In Administration)* [2016] 2 BCLC 319.
[27] [2011] UKSC 38 [104].
[28] *ibid* [177]. It is clear that the rule does not apply if the deprivation takes place for reasons other than bankruptcy/insolvency – see [80]-[83].
[29] *ibid* [179].

faith that the court will assess *objectively* in determining the applicability of the rule.[30] However, one could also argue that the fact that the parties' state of mind matters introduces an unwelcome element of *subjectivity* to this rule; this element is absent in the counterpart *pari passu* rule that catches the effect of commercial agreements.[31] Finally on this case, the differentiation between commercial agreements involving "complex financial instruments" and, let us say, 'ordinary commercial agreements' creates further uncertainty as it is not clear that an ordinary agreement with an insolvency-triggered deprivation clause will be valid (due to commercial sense and absence of intention to evade insolvency laws, rather than being struck down as a blatant attempt to divest property in insolvency) based on the principle of party autonomy that is prevalent in English commercial law.[32]

We now turn to the government's latest decision to extend the temporary restrictions on statutory demands and winding up petitions from 31 December 2020 to 31 March 2021.[33] This restriction applies to companies across all sectors but operates alongside provisions to protect corporate tenants from business evictions and the Commercial Rent Arrears Recovery tool.[34] Keen observers of the CV-19 sphere would note that is the second extension to these insolvency restrictions following their respective introductions on 1 March 2020 (statutory demand) and 27 April 2020 (winding up petitions).[35]

The rationale for this pro-commerce decision is logical, if not justified, in the face of the continuing impact of CV-19 on the general public and the significant level of economic depression. It sits within the laudable objectives of our corporate insolvency regime identified in section 1 above – the fourth and fifth 'truths' – of managing varied interests of relevant stakeholders when business failure occurs or is likely to occur, and minimising the negative

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[30] *ibid* [79], [151].
[31] See *Carreras Rothmans Ltd v Freeman Mathews Treasure Ltd (in liq.)* [1985] Ch. 207 at 226.
[32] [2011] UKSC 38 [103]-[104]; Akintola, *Creditor Treatment in Corporate Insolvency Law*, para 3.46.
[33] Corporate Insolvency and Governance Act 2020, sch 10, paras 1(3)(b) and 21(1)(b) as amended by the Corporate Insolvency and Governance Act 2020 (Coronavirus) (Extension of the Relevant Period) (No 2) Regulations 2020 (SI 2020/1483), reg 2.
[34] See for example, Coronavirus Act 2020, s 82 (on forfeiture of commercial leases) and The Taking Control of Goods and Certification of Enforcement Agents (Amendment) (Coronavirus) Regulations 2020 (SI 2020/451).
[35] The Corporate Insolvency and Governance Act 2020 (Coronavirus) (Extension of the Relevant Period) Regulations 2020 (SI 2020/1031).

impact that corporate failures may have on the economy. A less obvious point is that the decision furthers the rescue ideology; although it is doubtful that many of the companies that are being drip-fed by these measures have viable and competitive business structures that make them eligible for rescue. Thus, a key question for insolvency stakeholders when these measures are lifted is whether precluding insolvency proceedings has had a positive impact on the economy? Put differently, would the economy have been better off by restructuring or eliminating inefficient companies?

These are apt enquiries given that this decision, along with other government measures designed to provide financial support to companies during the pandemic, seem to be steering a significant suppression of insolvencies. Indeed, insolvency statistics for the last three months show a decrease of 41% (November 2020), 42% (October 2020) and 39% (September 2020) when compared to the same months last year.[36] The data shows that this decline is primarily driven by a decrease in creditor voluntary and compulsory liquidations. The concern here is a distortion of the principle that business failures could contribute to economic growth.[37] The distortion lies in the fact that the measures may be preserving anaemic or "zombie" corporations.[38]

For a number of reasons, this may not bode well for the economy and insolvency stakeholders in the long term. First, such businesses typically lack the depth in liquidity that is required to trade at an optimal level and, for this reason, cannot be a contributory to economic growth. Further, their continued existence necessitates certain recurring overhead expenditures such as rents and employee wages. Despite the CV-19 relief measures, such costs, when

[36] A summary of the data reported by The Insolvency Service will be found in *The Gazette* <https://www.thegazette.co.uk/insolvency/news> accessed 20 December 2020.
[37] See generally, JA Schumpeter, *Capitalism, Socialism and Democracy* (Harper & Brothers 1942), ch.VII, pp.81-86; CW Frost, 'Bankruptcy Redistributive Policies and the Limits of the Judicial Process' (1995) 74 NCLR 75-139.
[38] One of the first reports on Zombie Companies was released in 2012 by the Association of Business Recovery Professionals (R3) which documented the impact of the forbearance of principal creditors on keeping ailing businesses afloat. See R3, '146,000 "Zombie Businesses" teetering on the Edge' <http://www.r3.org.uk/index.cfm?page=1114&element=16971>. R3 provided an update in 2014 - The 'zombie businesses' phenomenon: An update <https://www.r3.org.uk/media/documents/policy/research_reports/special_reports/R3_Zombie_Report_Jan_2014.pdf>.

bundled with their inefficient trade and unpredictable economic climates, suggest that zombie companies are just a foot from falling into insolvency. Thirdly, the consequences of such companies existing and doing business in such a feeble state may not be trivial for their directors. While English law does not attach any sanction to putting a company into an insolvency procedure precipitously,[39] there are duties relating to and repercussions for transacting within the "zone of insolvency." The temporary suspension of wrongful trading provisions[40] does not alter this proposition due to the common law rule in *Liquidator v West Mercia Safetywear Ltd v Dodd* that imposes a duty on directors to prioritise the interest of company creditors with respect to the available assets whenever the company is actually or prospectively insolvent.[41] Moreover, where a breach of duty cannot be established, there is still the possibility of the director's conduct falling within the compensation regime of the Company Directors Disqualification Act 1986 for loss caused to creditors.[42] Finally, the temporary ban on liquidations frustrates the ability of unsecured creditors to pursue a remedy that is almost tailor-made for them – compulsory liquidations. Due to the reinstatement of the Crown's preferential status, the remaining constituents of the unsecured creditor class will typically be financially vulnerable. Therefore, we should not overlook the impact of this decision on the investment chain.

3. Concluding Thoughts

The pro-commerce outlook of English corporate insolvency law is not trivial. Respect for private agreements (party autonomy), non-interference with commercial decisions and pro-business policies are all badges of this outlook. In most instances, they enable Parliament and

[39] However, a director has a duty to promote the success of the company - Companies Act 2006, s 172.
[40] Corporate Insolvency and Governance Act 2020 (Coronavirus) (Suspension of Liability for Wrongful Trading and Extension of the Relevant Period) Regulations 2020 (SI 2020/1349).
[41] (1988) 4 BCC 30. See also Companies Act 2006, s 172(3).
[42] s 15A; *Re Noble Vintners Ltd* [2020] BCC 198.

the judiciary to provide a dynamic, timely and sensible response to recondite commercial events. But this article has also shed light on some pitfalls associated with that outlook that stakeholders ought to consider. The final thought speculates on what would happen when the government's restrictions are lifted and, as expected, a return to normal or greater insolvency levels occur. The key message in this article on that point is not that the economy will thrive if viable businesses fail on a large scale; rather the proposition is that there is a need to either allow distressed companies to go through an orderly insolvency procedure with sensible outcomes, or robustly address the pecuniary challenges they face. This would require a nuanced approach that provides measured fiscal support where, for example, there is a reasonable prospect of rescuing (outside or within formal insolvency proceedings) the company or parts of it. On the other hand zombie companies, for the benefit of other commercial stakeholders and the economy, have to go.