CORPORATE INSOLVENCY LAW UPDATE

Milestone cases shaping the future of Insolvency Law for 2009

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Introduction

1. "Rushing past them at speeds undreamt of by the people who erected them, we pass these silent sentinels of earlier ages without much thought. We retain a fondness for these early markers by declaring any definitive waypoint as a "milestone…....''[1]

2. It is little wonder, in these topsy-turvey times, as the excesses of laissez-faire appear to have landed us in the most serious financial crisis since the Depression, that more Governmental Regulation should be on its way, not just in the shape of the Banking Act 2009, but in the form of another layer of reform of the insolvency legislation itself.

3. The Budget Report on 22 April 2009 included a statement that the Insolvency Service would be consulting on the concept of super-priority funding and extending the moratorium provisions currently applicable to smaller companies to medium and large companies. These two reforms reflect some of the arguments put forward for a more US style "debtor in possession" type proceeding.

4. In addition and to ensure that the recently introduced regulation of the pre-pack procedure is working to plan, the Insolvency Service is to publish a report in June 09 following the first six months of SIP 16 and plans to publish further follow up reports on an annual basis.

5. None of this comes as a surprise, although a question for another forum to debate is whether additional regulation will do any good, given the propensity of financial professionals to innovate and expand, combined with the fact that such professionals are more financially motivated to act than the regulators are to respond.

6. It is unsurprising that insolvency lawyers too are reaching back to first principles to steady their nerves with the rapidity of the collapse of the financial world and the huge uncertainty over its impact on the broader economy[2]. Who better to turn to than to Professor Goode's Principles of Corporate Insolvency Law[3] for a statement of the ten fundamental principles underpinning insolvency legislation[4].

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[1] MilestonesWeb V: 1.1 Counting down the miles in a survey of milestones in Great Britain.
[2] See Davies and Frith: "Clearing up the Mess" delivered at the R3 19th Annual Conference on 19 February 2009
[3] Third Edition
[4] He uses liquidation as the paradigm. The principles are worth restating:

> " First Principle: corporate insolvency law recognises rights accrued under the general law prior to liquidation. Second Principle: only the assets of the debtor company are available for its creditors. Third Principle: security interests and other real rights created prior to the insolvency proceeding are unaffected by the winding up. Fourth Principle: the liquidator takes the assets subject to all limitations and defences. Fifth Principle: the pursuit of personal rights against the company is converted into a right to prove for a dividend in the liquidation. Sixth Principle: on liquidation the company ceases to be the beneficial owner of its assets. Seventh Principle: no creditor has any interest in specie in the company's assets or realisations. Eighth Principle: liquidation accelerates creditors' rights to payment. Ninth Principle: unsecured creditors rank pari passu. Tenth Principle: members of a company are not as such liable for its debts."

7. Against this background we propose, in the time available to us to look briefly at five of the many significant cases which have been decided in the course of the last year.

SIGNIFICANT RECENT CASES

Stones and Rolls v Moore Stephens 2008 EWCA Civ 644, House of Lords hearing 10/2/09, awaiting judgement.

8. This is an example of Professor Goode's Fourth Principle in operation. The liquidator takes the assets subject to all limitations and defences. He is in no better position than the company itself: He takes the assets as they stand, warts and all. A liquidator takes subject to another party's contractual rights under a contract with the company; and subject to another party's equitable rights to impeach or qualify a transaction, which rights survive the company's liquidation. Conversely the liquidator may by statute be able to assert defences which the company could not have raised prior to liquidation.

9. The company in that case was a one man company owned and controlled by S who procured the company to defraud a bank. The proceeds were then diverted in favour of S and others who were party to the fraud. The bank sued the company and S in deceit and was awarded substantial damages against both. The company was unable to pay and went into liquidation. By its liquidators the company then issued proceedings for damages against its former auditors alleging negligent failure to detect the dishonest behaviour of S its sole directing mind and will.

10. M denied negligence and applied to strike out the claim or for summary judgement contending that the company was seeking an indemnity against liabilities it had incurred by its own fraud and that such a claim was barred by the public policy principle ex turpi causa non oritur actio ("the Own Fraud rule").The judge refused the application to strike out and the auditors appealed.

11. In the CA two issues were identified, namely whether the Own Fraud rule (a) prevented the company from suing for recovery in respect of its own losses caused by the individual who was its directing mind and will in relation to the frauds – i.e. had the Company itself been a victim of the frauds which should not therefore have any knowledge of them attributed to it; and (b) in any event provided no defence to the auditors when the detection of dishonesty in the operation of the affairs of the company was the "very thing" that the auditors had been retained to do.

12. The CA referred to the well known exception to the Own Fraud rule to the effect that an agent's knowledge of a fraud is not imputed to his principle if the agent is acting in fraud of his principal and the matter of which he has notice is relevant to the fraud. The critical question was whether the Court should regard the company as the villain or the victim of the fraudulent activity of S: (a) if it was to be regarded as the victim of S's dishonesty, his dishonesty would not be attributed to it such that it would be entitled to bring its claim. (b) If however it should properly be treated as itself carrying out the frauds (such that its claim to be a victim was based on no more than the liabilities it incurred as an inevitable consequence of those frauds) the Company must be regarded as the villain.

13. The CA concluded that the Own Fraud rule applied on the grounds that the Company was not the target or the victim of S's fraud but should be treated as the fraudster itself. It was the company which dealt with the banks and the principle of attribution required S's dishonesty to

be imputed to the company. It made no difference that the fraud was likely, when found out, to result in the incurring of liabilities by the company itself.

14. The liquidator's second argument was that the public policy behind the Own Fraud rule was not engaged where the prevention of fraud was the very thing the auditors were tasked to do. The CA concluded following a careful review of the authorities that once the Own Fraud rule applied, the Court was left with no discretion in the matter and the claim had to be stopped. The appeal was allowed and the claim against the auditors was struck out.

15. The CA was unimpressed by the fact that the proceedings were pursued by independent liquidators for the benefit of the company's creditors including the bank. Pre liquidation S could not credibly have caused the company to sue the former auditors for damages for failure to detect the frauds of S himself. As Mummery LJ observed:

> *"116. What difference does the liquidation of the company make? None. The fact that the company is in insolvent liquidation is irrelevant to the company's cause of action against the firm. It is also irrelevant that, if successful, the claim could benefit the victim bank.The company in liquidation is asserting the same cause of action that was vested in it prior to liquidation. Liquidation of the company did not alter the existing cause of action or create a new cause of action. Prior to liquidation, the cause of action against the firm, could, if successful, benefit the fraudulent company. The same is true post-liquidation and is a reason for striking the claim out."*

16. This is a manifestation of the principle that the company inherits the claim warts and all.

17. The hearing of the liquidators' appeal against the striking out in the House of Lords took place on the 10 February 2009 and judgement is expected before the seminar date.

Sunberry Properties Limited v Innovate Logistics Ltd (in administration) 2008 EWCA Civ 1321

18. Rent is not an administration expense.

19. It is a provable debt.

20. Payments falling due under a lease after the date of administration arise by virtue of a liability entered into before the commencement of the administration (the lease).

21. Landlords are not automatically entitled to receive rent from tenants in administration.

22. However, rent can be paid *as if* it were an administration expense.

23. What does that mean? In *Sunberry v Innovate* it meant that when Innovate went into administration and breached the terms of its lease by permitting the purchaser of its business into occupation, agreeing with the landlord to pay the landlord the rent reserved by the lease on a monthly basis (as opposed to quarterly in advance, as reserved by the lease) there was little the landlord could do about it.

24. Innovate leased more than 8 acres of cold storage facilities from Sunberry at an annual rent of £1.2m. The premises were used to store frozen food pending distribution. In June 2008, shortly before the next quarter's rent fell due, it went into administration. The administrators completed a pre-packaged sale of the business to YHL, the UK's largest operators of cold

storage facilities. The sale included the grant to YHL of a six month licence of the premises to YHL, on the basis that YHL would make payments equal to each month's passing rent. The licence would be determined on forfeiture of the lease by the landlord or upon earlier notice to terminate given by YHL or the company in administration.

25. The granting of the licence was a clear breach of the terms of the lease. The Sunberry, as landlord, asked the administrators to terminate it. They refused to do so. Sunberry further sought the administrators' permission to commence proceedings against the company in administration for an injunction for the immediate termination of the licence. Again, the administrators refused.

26. The landlord applied, successfully at first instance, for the court's permission to commence proceedings. However, when the matter came before the Court of Appeal, the decision was overturned.

27. The Court of Appeal concluded that relevant evidence was not before the court at the first hearing and as a result, the judge had drawn incorrect inferences about the administrators' conduct. Furthermore, the judge at first instance had incorrectly concluded that the purpose of the administration had been achieved as soon as the sale to YHL had been concluded. Having done so, he was of the view that it would not be appropriate for him to undertake the balancing exercise expounded in *Re Atlantic Computers* which the court would usually apply when asked to consider whether to grant permission for a creditor to bring proceedings against a company in administration. That view was wrong.

28. The purpose of this administration was to achieve a better result for the company's creditors as a whole than would be likely if the company were wound up without first being in administration. In seeking to give effect to the statutory purpose of administration, the court had to conduct a balancing exercise between the legitimate interests of the landlord and the legitimate interests of the other creditors of the company. In this case, although the company's business was sold immediately after the appointment of the administrators, in order for the purpose of this administration to be achieved, YHL would need to continue to use the premises for a short while, to ensure that customers received their goods and the insolvent business received the full benefit of its outstanding book debts.

29. The court would need to compare the financial loss suffered by the landlord, if permission to commence proceedings were to be refused, with the loss suffered by the company's other creditors, if permission were to be granted.

30. In this case, the landlord was notably not seeking permission to commence proceedings to forfeit the lease. It was clear that he did not want to recover possession of the premises. Sunberry's motive, it appears, was to seek to bring pressure to bear upon YHL to take a formal assignment of the lease and be committed to performing the tenant's covenants, including payment of the not insubstantial rent which, by then, probably exceeded market rates. Counsel for Sunberry argued that the administration moratorium was not being used to achieve a better result for the company's creditors as a whole but to benefit YHL and give it an unfair bargaining position in its discussions with the landlord.

31. He submitted that Sunberry's intended proceedings would not deprive the administrators of possession of the property - the company in administration no longer required the property. The proceedings were directed against a third party, unlawful occupier and the ability of the company in administration to grant an unlawful licence to a third party was not "property of the company" which was protected by the statutory moratorium.

32. However, whilst noting that the thrust of Sunberry's submissions referred to the detriment which the administrators actions had imposed upon the landlord's bargaining position with YHL the Court of Appeal concluded that the judge at first instance ought to have asked himself whether Sunberry had shown that it was inequitable to prevent it from commencing the proceedings for a mandatory injunction. Instead, he relied upon a range of inadequate reasons for not carrying out the *Atlantic Computers* balancing exercise.

33. When the Court of Appeal now performed that exercise, it concluded that when weighing the loss to Sunberry compared with the loss to the company's creditors if the collection of book debts were to be impeded by Sunberry succeeding in its application, Sunberry's application should have been refused.

34. In reaching its judgment, the Court noted that it had been accepted that Sunberry had no automatic right to be paid the contractual amounts during the occupation of the company in administration.

> *"Sunberry does not have an absolute legal entitlement to be paid contractual rent and interest as an administration expense. On this point the court has a wide discretion exercisable according to the circumstances of the case."*

> *"In my judgment, Sunberry should be in no better position as regards rent and interest than it would have been in had it wished to forfeit the Lease. As regards rent falling due after the the administration order Sunberry is an unsecured creditor of the Company, and will benefit from the collection of the company's book debts."*

35. The Court declined to order that the company in administration should pay anything more than the passing rent on a monthly basis, despite Sunberry's attempts to require payments in advance on the usual quarter days.

Lehman Brothers International(Europe) (in Administration) *("**LBIE**")*
2008 EWHC 2335; 2009 1 BCLC 161;

36. If the "Golden Milestone" defined the centre of Imperial Rome, the Lehman insolvency defines the epicentre of the present economic collapse and the insolvency culture emanating there-from. To gain a small insight into the complexity of the issues raised from an insolvency angle, a scan through the Joint Administrators' Progress Report dated 14 April 2009[5] for the period from 15 September 2008 to 14 March 2009 is an interesting experience.[6]

37. From the outset of the administration, which of course happened with little notice to anybody concerned, there has been very considerable focus on the return of property to which third parties assert a proprietary claim[7].

38. This trust property included securities in the Company's possession as at the 15 September 2008 (called "Client Assets" in the Report) and cash balances managed by LBIE pursuant to the UK Financial services authority's Client Money Rules at 15 September 2008 ("Client Money") and jointly referred to as Trust Property.

[5] On the PWC website
[6] This applies not least to the Operating Model applied to the case: see Section 4 of the Progress Report
[7] And illustrates Professor Goode's Second and Third Principles in play.

Proposed Scheme of Arrangement

39. The objectives in relation to Trust Property are set out at Section 5 of the Report[8] which includes the identification, protection and return of Client Assets. There is in place a process[9] for the return of assets under a "risk mitigating indemnity framework", although it appears that over US$15 billion of the estimated $US26.1 billion of clients' assets and over $2billion in Clients' Money is still caught up in the administration. This process is dependent on bi-lateral negotiations with the individual clients, is proving to be lengthy and onerous and failing to bring finality between the administrators and the clients. One of the difficulties concerns the identification and determination of the pool of Claimants. There are competing claims, clients who are not playing ball in terms of providing adequate documentary evidence, and set-off issues all getting in the way of determining the pool of claimants . There are also valuation issues. In addition, some clients have not terminated their agreements with the company and the effects of termination are not legally clear. It is predicted therefore that the current bilateral approach to distributing the clients' assets will take years.

40. In addition the Administrators have shown themselves, not surprisingly given the sums of money involved, to be somewhat risk averse and do not want to return assets to a client unless they are certain that the client is unequivocally entitled to the assets. Recovery in the current climate and in any event may be difficult should it turn out that someone else has a better claim to a particular asset. As a result it is understood that the approach taken by the Administrators to a request for the return of assets typically includes:
    - a payment by the former client of at least $50,000 USD as a "contribution to the cost of dealing with the request on a priority basis
    - a retention of up to 1.25% to cover the costs of dealing with the assets and
    - an undertaking by the client to return the assets if the Administrators decide in good faith that the assets should not have been transferred together with security to support that obligation to return.

41. To reduce the delay attendant on resolving the issues identified, and given the disinclination to sign up to the Administrators' terms for bilateral return, the administrators have proposed that the return of clients' assets is best facilitated through a Scheme of Arrangement pursuant to section 895 of the Companies Act 2006[10] and to that end an application was made to the Court on 16 March 2009 for approval to call creditors meetings. This is the first stage of a three stage process the other two stages being the calling of creditors/members meetings and the sanction by the Court of the scheme approved at the meetings. If the creditors voting on the scheme support it by majorities of 50% in number and 75% in value, and the court approves the scheme then it becomes binding on all creditors.

42. However the scheme does not itself provide for the distribution of assets to clients but is designed principally to impose a bar date for submitting final claims. The Administrators say that it should provide the following benefits to clients:
    - achieving finality of the population of Client Assets claims allowing Client Assets to be distributed without the need for indemnity
    - ensuring no future claim arises against the company for assets distributed under the Scheme

[8] Section 5.3 of the Report.
[9] Following an application to the Court by the Administrators for directions on 7 October 2008.
[10] Section 5.3.1 of the Progress Report

- addressing the issue of competing claims and defines rules for dealing with asset shortfalls
- providing finality of dealings with Client Assets claimants
- allowing controlled termination of open positions and
- applying a consistent set of rules for a number of issues including valuation methodology, allocation of costs and dispute resolution.

43. The Administrators describe the nature and scope of the scheme as being "novel and ambitious" and that it is likely to require compromise by clients and the Company if it is to be effective. Although it is thought that the scale and complexity of this insolvency is unlikely to be seen again in this economic cycle, the approach being taken is instructive when faced with insolvencies involving substantial third party assets with significant obstacles in the way of straightforward return through bilateral negotiation or through seeking directions from the Court within the administration.

Third Party Applications to Court

44. There have been two applications to the Court by Third Parties keen to extract their assets from the administration. They both demonstrate that the courts will not readily give permission for the decisions of the administrators to be overridden and implicitly acknowledge that the business of an insolvency appointment calls for a high degree of specialist knowledge and experience and the Court will not intervene routinely.

45. The first was *RAB Capital plc and RAB Master Fund v LBIE* 2008 EWHC 2335 (ch) in which Morgan J considered on 22 September 2008 whether a proprietary claim against the company under a prime brokerage agreement could be expedited following the administration . It submitted that bills held by the company for its Market (Master) Fund under a prime brokerage agreement represented the vast majority of the Fund's assets and that the Fund would have to be put into suspense if its proprietary right was not established as a matter of urgency. The company submitted that the Applicant should not be allowed to circumvent the effects of the moratorium in this way as this would force the administrator to focus disproportionately on one particular counter-party and would potentially open the floodgates.

46. The Judge said that the Claimants appeared to have a strong case on the merits and had his sympathies but he felt he had to refuse to have the claim dealt with as a matter of urgency because this was a case of administering an application for the return of assets and this was primarily a matter for the Administrators[11]. If he were to intervene the Court would be inundated with applications from others. In any event it appeared that the company had entered into a sub-custodian arrangement with another Lehman company in respect of the bills in question and all the company could do was to demand the return of the bills from that company.

47. Following the Court's order at a later hearing on the 7 October 2008 in which the Administrators sought directions from the Court regarding their approach to the return of third party property, the administrators set up a "hardship and prioritisation" committee to address special claims that meet specific criteria for accelerated return while ensuring that the overriding objective of treating all counterparties fairly is not prejudicial to the interests of any minority of the creditors.

[11] The caselaw in this area is already substantial, and the principles formulated in *Atlantic Computers Systems plc* 1990 BCC 439 are well known. For a sensible application of the principles governing the Court's discretion see *Re David Meek Access Limited, Re David Meek Plant Limited* 1993 BCC 175.

48. In *Four Private Investment Funds v LBIE* 2009 1 BCLC 161, involving similar facts, the Court refused an application for an order that the administrators provide additional information about securities that the Company held for the Applicants. The Court held that to make such an order would be an unjustified interference with the day to day running of the administration.

49. This application was made inter alia under paragraph 74 of Schedule B1 IA 1986 which highlights the rights of creditors to scrutinise the conduct of the administrators under the "unfair harm" provisions. The Judge did not conclude that the cases should not be prioritised as hardship cases under the Court-approved protocol and was prepared to assume that harm was being caused and then considered what constituted "unfairness" within the paragraph. Given that there was no allegation of misconduct against the administrators and that they were operating in good faith in accordance with their statutory duty, it was difficult to see how their refusal to assign resources to dealing with specific enquiries of individual creditors could be said to be unfair. The Court referred to the directions hearing at which the strategy proposed by the administrators had been the subject of directions given by the Court and creditors had approved proposals. The administrators were to be allowed considerable latitude in performing their statutory duties directed at achieving the statutory objective.

Oakland v Wellswood

50. The Transfer of Undertakings (Protection of Employment) Regulations 2006 came into force on 6 April 2006. They superseded the earlier 1981 TUPE Regulations and constituted the UK's implementation of the EC Acquired Rights Directive, Council Directive 2001/23/EC. The Regulations sought, among other things, to mitigate the unintended but nevertheless potentially harmful effects of the 1981 TUPE Regulations on those working for insolvent employers. By providing for continuity of employment, the 1981 Regulations provided for purchasers of insolvent businesses to inherit all employees and all sums and liabilities due to them. This led to some prospective purchasers being deterred from proceeding with the purchase altogether and others, reducing the amount they were prepared to pay, thus reducing the amount available for distribution to the insolvent transferor's creditors.

51. The 2006 Regulations provide for some liabilities due to the employees of solvent transferors not to transfer to the purchaser, but instead, to be met by the NIF. They also draw a distinction between:

    a. "***relevant insolvency proceedings***" being "proceedings which have been opened in relation to the transferor ***not with a view to the liquidation of the assets of the transferor*** and which are under the supervision of an insolvency practitioner"; and

    b. "***bankruptcy of any analogous insolvency proceedings*** which have been instituted ***with a view to the liquidation of the assets of the transferor*** and are under the supervision of an insolvency practitioner".

52. On 3 May 2006, Lord Hunt of Wirral rose to move the House of Lords to revoke the Regulations:

    "Insolvency practitioners are as anxious as anyone else that as many jobs as possible should be saved when an employer becomes insolvent. However, if the regulations are to have the desired effect, they must be drafted in clear, unambiguous language. Only then will those dealing with the insolvencies and those acquiring businesses subject to insolvency proceedings know where they stand and precisely how the provision of the regulations will affect transactions.

Unfortunately, the regulations, as regards the insolvency provisions, failed to achieve that. This is because they are drafted in language that is so loose and imprecise it is not possible to discern with any clarity how they are supposed to work. Instead of bringing clarity, they bring confusion to new, unprecedented heights.

My principal concerns are that these regulations, first, fail to specify the types of UK insolvency proceedings to which they are intended to apply; secondly, fail to make clear which liabilities will pass to a purchaser and which will not; and thirdly, impose unrealistic obligations on insolvency office holders with which it would be impossible for them to comply and with penalties that will ultimately fall on creditors. The regulations transpose the vague generic language of the directive without attempting to specify how it is to apply in the context of specific UK insolvency proceedings. Only expensive and time-consuming judicial interpretation will establish the circumstances in which they are intended to apply."

53. Lord Hunt's motion failed by two votes. Lord Sainsbury of Turville, then the Parliamentary Under-Secretary of State for the DTI responded on behalf of the Government:

"In our judgment, the generic descriptions of relevant insolvency proceedings in Regulations 8(6) and 8(7) are reasonably clear. In our view, there are unlikely to be significant problems.

Let us look at the position of administrations, the main category of insolvency proceeding. Regulations 8 and 9 were drafted with the intention that where there was a transfer in a business or undertaking, and the transferor was in administration under the Insolvency Act 1986, employees engaged in that business should be transferred to the acquirer of the business or undertaking. … The key question is whether administration is analogous to bankruptcy proceedings and it would appear that it is not. The principal or main purpose of administration is not the realisation of the debtor's assets with a view to distribution among creditors. The statutory purpose to which administrators are obliged to have regard first is the rescue of the company. However, the interpretation of the regulations is ultimately a matter for the tribunal and the court".

54. Perhaps the only surprising aspect of the Employment Appeal Tribunal's decision in Oakwood and Wellswood, formally handed down on 9 January 2009 (although unintentionally released without authority in December 2008) is that it took so long for the issue to be brought before a tribunal.

55. Mr Oakland was a director and 50% shareholder in a wholesaler of fruit and vegetable. When the business ran into financial difficulties, with the assistance of insolvency practitioners, a sale of the company's assets, including the unit from which it traded, fridges, vans and five of the seven employees (including Mr Oakland) was agreed with the company's main creditor. A pre-packaged sale to NewCo took place on the date of the administrators' appointment. The administrators' proposals explained to creditors that they had concluded that it would not be possible to rescue the company as a going concern and that they would therefore be exercising their powers with the objective of achieving a better result for creditors than would be likely if the company were wound up. The administrators explained that as the company was losing money, further trading would have diminished returns to creditors. They did not therefore consider it appropriate for the business to be traded in administration in order that it could be further exposed to the market.

56. Mr Oakland was dismissed less than a year after the transfer to NewCo. He complained to a tribunal that he had been unfairly dismissed. Among its defences, NewCo sought to argue that Mr Oakland did not have the necessary continuity of employment to be able to bring a claim of unfair dismissal. NewCo contended that the Regulations did not apply to the transfer to NewCo and consequently any period of employment which Mr Oakland might have had with NewCo was irrelevant.

57. This argument succeeded before the first Employment Tribunal and also in the Employment Appeal Tribunal.

58. Judge Peter Clark concluded that where joint administrators continue to trade the business with a view to its sale as a going concern, any relevant transfer in those circumstances will attract TUPE protection for employees. However, where, as in this case, the administrators realised that it would not be possible to trade the business and sold the company's assets immediately after their appointment, in his view, the appointment of the administrators "was with a view to the eventual liquidation of the assets of Oldco, by way of a CVL."

59. The learned judge considered that his decision accorded with the rescue culture whereby a purchaser is not put off the proposed sale by the effects of TUPE, pointing out that in this case some jobs were preserved and the creditors benefited from the best available outcome.

60. An application for permission to appeal to the Court of Appeal has been heard and at the time of writing, awaited. It seems likely that permission will be granted. As reflected by the comments of Lord Sainsbury above, those involved in the years of consultation before the Regulations were introduced are of little doubt that the spirit of TUPE dictates that a transfer of a business effected by administrators should attract the protection afforded by TUPE for the employees of the business. However the Regulations were consulted upon and introduced against the backdrop of a thriving UK economy. Unemployment has risen considerably since Judge Peter Clark handed down his judgment in January this year. In early May 2006 the European Commission predicted that unemployment will rise to 11% in 2010.

61. News of the EAT decision spread like wild fire around the insolvency market. Within days of the unauthorised version of the judgment inadvertently being released on BAILII, prospective purchasers of insolvent businesses were seeking to remove provisions in sale agreements intended to ensure that notwithstanding the doubt concerning the meaning, effect and application of the Regulations, they would nevertheless treat the sale as if TUPE would apply.

62. The market now awaits the outcome of an appeal (assuming that permission will be given). It seems undeniable that in these harsh economic times, somewhat ironically, more jobs are likely to be saved if a final decision is reached to the effect that the Regulations would not apply to a pre-pack sale effected immediately after the administrators' appointment, than would be the case if the decision is overturned.

63. There is, of course, scope for the CA decision to be appealed further.

64. In the meantime, practitioners should take care to protect themselves in a number of ways:

    a. Most firms provide employees with a letter to explain the effect of the administration and business sale. They should take care to ensure that such letters could not be considered to be providing advice or making representations on the effect of the transfer on the employees' contract of employment. Such letters should prudently

advise the employees that the Government's Insolvency Service guidance has stated that the Regulations will apply to the transfer. The letter should proceed to state that the administrators and purchaser will treat the transfer on this basis but make no representation and express no view as to whether or not it is correct.

b. The Regulations require "employee liability information" to be provided to the purchaser not less than 14 days before the transfer, including the identity and age of the employee and information regarding disciplinary or grievance procedures taken with the previous two years. Where the transferor company in administration fails to provide the information, the purchaser is entitled to claim £500 per employee transferred. Despite repeated representations made by R3 to the DTI during the consultation period, it was not prepared to exclude insolvent companies from these provisions. The fact that nobody has been able to ascertain, with certainty, whether the Regulations apply to any particular sale effected by insolvency practitioners renders the requirement to provide employee information hazardous. It would amount to a breach of the data protection legislation for insolvency practitioners to provide such information without being statutorily obliged to do so. In practice, many practitioners do not, in any event, provide the required employee liability information and seek to circumvent the prohibition on contracting out of the Regulations by requiring that the purchaser agrees to indemnify the insolvent transferor company and the practitioner for any failure to comply with the employee liability information requirements - in effect ensuring that the purchaser indemnifies the IP for any claim which the purchaser may himself bring against the IP.

c. The definition of "employee" in any sale agreement should be carefully checked.

d. It is generally considered that where TUPE does not apply, the transfer of a business will automatically terminate contracts of employment. It was to prevent this hardship that TUPE was introduced in the first place. Provided this is correct, practitioners need not be concerned of the risk of Paramount claims for failing to take positive steps to terminate employee contracts.

The “Insolvency Remote” culture
Re Sigma Finance Corporation Limited 2008 EWCA Civ 1303
Re Golden Key Limited in Receivership 2009 EWHC 148 (ch)

65. SIVs are[12] investment companies that buy highly rated debt securities and fund themselves by the issue of senior debt and capital to financial institutions. Security over their asset portfolios is granted by a deed of charge to a security trustee appointed under a security trust deed for the benefit of specific categories of secured creditors. All of them have a clause dealing with priority of payments if they become insolvent, a so called waterfall which would run, typically:

(1) the costs and expenses of receivership
(2) the senior creditors
(3) the junior and senior subordinated creditors
(4) other costs
(5) the company.

[12] Most are no longer going concerns and/or are in some form of insolvency procedure

66. The triggers leading up to enforcement of rights may differ but usually they will include: the failure to pay, insolvency, a downgrading of its investments or a fall in the required levels of capital or liquidity.

67. There has been quite a bit of case law generated over the last 18 months relating to the construction of the security trust deed, in particular as to the application of realisations coming into the hands of the security trustee or receivers appointed to realise the secured assets on its behalf. The most common question to arise has been whether senior creditors should be paid on a "pay as you go" basis or a "pari passu" basis. Of course the "pari passu" rule has been the rule which every insolvency practitioner has been brought up to respect and it underpins the whole ethos of conventional insolvency law. However Professor Goode makes the valid point[13] that this principle only applies to the free assets of the company and therefore not to property held on trust or subject to the huge range of security interests now available, not to mention retention of title and other real rights and equities.

68. The documentation surrounding these structures has been drafted in such a way that the company's creditors have agreed, by way of various different contractual mechanisms, only to look to the assets secured under the documents they have signed up to for repayment of their claims, and then only within the terms of the limited recourse provisions set out in the documentation governing the company's operations. In that sense it is said to be "insolvency remote".

69. The important point to be emphasised by the Courts following a number of decisions[14] agonising on the construction of these documents, is that all of the creditors by virtue of the provisions in the contractual documentation, have agreed to limit their right of recourse against the company and its assets to their entitlement under the documentation and not to pursue any insolvency procedures against the company. Therefore the usual rights of the unsatisfied creditor to initiate insolvency proceedings are ousted in favour of the rights whether sounding in contract or trust provided by the documentation.[15] Henderson J in *Golden Key*, which is the most recent case in this area, commented that no party in that case had submitted that there was any objection from a public policy viewpoint in investors agreeing to make their investment upon such a basis. However the Courts have concluded that the consequence of the arrangement reached is that the degree to which assistance can be obtained from analogies with the general law of insolvency is limited. According to Henderson J:

> "*Since the parties have expressly agreed to oust the general law of insolvency, one should not too readily assume that the parties intended their rights to be governed or influenced by insolvency concepts, such as pari passu distribution, unless the documentation so provides*."[16]

70. *Sigma Finance*[17] raised the short question of construction of a provision in a security trust deed, which came into force after the happening of various specified events of default, and the passing of a resolution by holders of the relevant instruments to enforce the security. When that happened the security trustee had to use its reasonable endeavours to establish various pools of assets before the end of the "Realisation period" and for that purpose was obliged to realise, dispose of or otherwise deal with the assets in such a manner as, in its

[13] Surprisingly not picked up in the cases discussed below.
[14] *Cheyne Finance plc No 1* 2008 1 BCLC 732; *Cheyne Finance No 2* 2008 1 BCLC 741; *Cheyne Finance No 3* 2008 EWHC 648 (ch); *Re Whistlejacket Capital Ltd* 2008 EWHC 463 (ch) ; *Re Whistlejacket Capital Ltd* 2008 EWCA 575 ; *Bank of NY v Montana Board of Investments* 2008 EWHC 1594. *Re Sigma Finance Corp* (below); *Re Golden Key in Receivership* (below).
[15] See Henderson J in *Re Golden Key Limited in Receivership* 2009 EWHC 148(ch) at para 48
[16] Golden Key supra at para 48.
[17] The largest SIV to go into a formal insolvency procedure.

absolute discretion, it deemed appropriate. The relevant clause (clause 7.6) then concluded as follows:

> *"During the realisation Period the Security Trustee shall so far as possible discharge on the due dates therefore any Short Term Liabilities falling due for payment during such period, using cash or other realisable or maturing Assets of the Issuer".*

71. The case turned on the meaning to be attributed to the words "as far as possible". Upholding the decision of the judge at first instance, the CA decided by a majority (Lloyd LJ and Rimer LJ with Lord Neuberger dissenting) that the Security Trustee was obliged to continue paying maturing notes in full during the realisation period on a pay as you go basis , until it had no more assets with which to pay them.

72. Like all cases in this category, *Sigma* turned on the interpretation of the bargain actually made between the parties. The fact that the CA were divided shows how difficult these questions may be. At paragraph 92 Rimer LJ said:

> *"I think it likely that many lawyers may be instinctively surprised at such a conclusion, since the culture with which they will be familiar is one ordinarily providing for a pari passu sharing in an insolvency. The notion of first come first served, or pay as you go, is alien to that culture and so cannot be right. I too had an instinctive initial sympathy with the case advanced by [the creditors contending for the pari passu construction] since when the available pot is too small to pay everyone in full, a pari passu distribution has an obvious appeal. But we are not here concerned to apply any conventional insolvency regime. The STD [Security Trust Deed] reflects a commercial bargain made between or on behalf of the interested parties and our task is to interpret what that bargain was. It seems to be apparent that the STD foresaw the possibility that any enforcement might be either a solvent or an insolvent one as regards secured creditors. It is however improbable that it foresaw the possibility of the extraordinary, probably unprecedented, market events that have recently unfolded. In those extraordinary events Party A's successful argument can on one view perhaps be regarded as having achieved an unfair result. But any such assessment necessarily assumes that the parties had made some different bargain which is not being respected. This litigation is concerned with ascertaining the bargain they in fact made. I have expressed my view as to what it was, and the court's duty is to give effect to it. It is not the Court's function to re-write it."*

73. One of the main consequences of these decisions for domestic corporate insolvency is that issues similar to those dealt with in *Sigma* and *Golden Key* are likely to arise in the context of companies which are not SIVs. Many large companies have granted layers of security governed by similar provisions and their debts are subject to similar default and acceleration clauses. The SIV cases will be instructive when the factions of secured creditors of such companies contest payment of the fruits of assets realised by or on behalf of their security trustee.

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