Part I of the 'Staying Virtually Up-to-date' Series delivered by 3PB's Commercial Team

UPDATES TO INSOLVENCY LAW AND PRACTICE IN LIGHT OF COV-19

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THIS GUIDE

This guide is intended to act as an aide-memoire to Part I of the 'Staying Virtually Up-to-Date' Series delivered by 3PB's Commercial Team on 27th April 2020. Thank you for joining us!

Whilst every effort has been taken to ensure the accuracy of the contents of this guide, Parliament resumed last week and the position in relation to Covid-19 is rapidly changing. This document should not be used as a substitute for obtaining legal advice.

Likewise, as explained in the webinar, the discussion related to companies whose relevant COMI was in England and Wales. Therefore, this guide does not detail any jurisdictional issues which may arise in the wider context of insolvency disputes concerning companies present in multiple jurisdictions.

If you have a particular query, please contact David Fielder (Email - david.fielder@3pb.co.uk), who will be happy to direct your enquiry to the relevant person.

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UPDATES TO COURT PRACTICE

1. In the days preceding Public Health England's Guidance to social distance and ever since, the courts have issued various updates concerning the way in which forthcoming litigation is to be conducted.
2. The box below summarises some key updates for insolvency practitioners:

Update	Court/ Information
Protocol for Insolvency and Company Work at Central London	This provides guidance on bankruptcy petitions; applications in bankruptcy; public examinations; claims for extensions of time to register company charges; claims for the restoration of companies to the register proceeding in Central London County Court at this time.
Priority Courts	This outlines the network of priority courts which remain open during the coronavirus pandemic.
County Court Priority Listings	County Court Listings are falling into two categories: a. Priority 1 work – work that must be done b. Priority 2 work – work that could be done
Temporary Insolvency Practice Direction	The Temporary Practice Direction applies to all insolvency proceedings throughout the Business and Property Courts subject to any variations outside of London, it remains in force until 1st October 2020 unless amended or revoked.
Temporary Insolvency Practice Direction, North Guidance	The North Guidance deals with variation and guidance for the conduct of insolvency proceedings on the North and North Eastern Circuits
Temporary Insolvency Practice Direction, Variation and Guidance for the Midland, Western and Wales Circuit	The Midland, Western and Wales Guidance deals with variation and guidance for the conduct of insolvency proceedings on the Midland, Western and Wales Circuit
Listing Guide for a hearing before an ICCJ in London	The Guidance runs concurrently with the Temporary Insolvency Practice Direction.

3. 3PB's commercial team have also produced a guide to the Temporary Insolvency Practice Direction.

RE CARLUCCIO'S LTD AND THE RISE OF ADMINISTRATION

What is administration?

1. Generally, over the last few years, there has been an increase in companies going into administration as opposed to other forms of company rescue (such as entering into a company voluntary arrangement ("CVA")). The benefit of administration is that it provides a statutory moratorium freezing other creditors' actions, giving the company breathing space and the appointed administrator a stronger position to preserve the value of the business and goodwill. The decision in *Re Carluccio's Ltd* concerned the struggling causal dining High Street chain, Carluccio's, which was the latest in a long line of other High Street retail companies entering into administration recently (in light of the Government's Covid-19 lockdown).

2. It goes beyond the scope of this note to detail all forms of administration for all bodies and their respective legislative origins. For example, there is a specific statutory regime applicable to building societies and some public-utility companies. In circumstances where administration is considered, tailored advice is necessary for each entity in question.

3. However, under Schedule B1 of the Insolvency Act 1986 ("the Act") a company is placed into 'administration' when a person is appointed under Schedule B1 to manage the Company's affairs, business and property (see Paragraph 1, Schedule B1 of the Act).

4. A person may be appointed in three potential ways under Schedule B1, either by way of court order or using the 'self-certifying' route:

Order of the court	See paragraph 10, Schedule B1 of the Act for further details
By the holder of a floating charge	See paragraph 14, Schedule B1 of the Act for further details
By the company or its directors	See paragraph 22, Schedule B1 of the Act for further details

5. Upon a company entering into administration a moratorium is imposed on certain insolvency proceedings under Paragraph 42, Schedule B1 of the Act.

6. When appointed, the administrators must act pursuant to the following objectives:
    a. to rescue the company as a going concern; or

    b. to achieve a better result for the company's creditors than would have been achieved if the company was wound up (without first being in administration); or

    c. to realise property in order to make or distribute to one or more secured or preferential creditors (See Paragraph 3(1), Schedule B1 of the Act).

7. The administrators should pursue the objectives in the order set out above (see paragraph 3(3), Schedule B1 of the Act).

8. In terms of making payments, it also goes beyond the scope of this note to summarise how the priority of asset distribution works in insolvency law. Nevertheless, for these purposes it is simply highlighted that administrators are able to make distributions to relevant creditors. Distribution in administration works in the same way as in a winding up scenario (see Paragraph 65, Schedule B1 of the Act). In brief the administrator may make a payment to a creditor of a company in the following order (if there are sufficient assets to make payment to all classes of debt in full):
    a. Preferential debts should be paid in priority to all other debts. Preferential debts may include, for example, contributions to occupational pension schemes;

    b. The expenses of the administration should be paid in full next;

    c. Ordinary preferential debts should be paid next; and

    d. Secondary preferential debts after that (See Section 175 of the Act for further details)

9. There are two relevant exceptions to the above:

a. Firstly, Paragraph 66, Schedule B1 of the Act provides that the administrator may make payment otherwise than in accordance with Paragraph 65 or Paragraph 13 of Schedule 1 of the Act, if he or she thinks it is likely to assist in the achievement of the purpose of administration.

b. Secondly, Paragraph 99, Schedule B1 of the Act provides when an administrator vacates office, if he or she has adopted any contracts of employment, such wages or salary arising out of the employment contracts are payable out of assets held by the administrator in priority to the administrator's expenses, which themselves have priority over claims of floating charge creditors and unsecured creditors [see *Re Carluccio's Limited* [2020] EWHC 886 (Ch) paragraphs 38 – 39]. Employees whose contracts of employment are adopted by the administrators '*gain the benefit of super-priority'* under Paragraph 99(5) [41].

10. It is noted under Paragraph 99(5)(a) no action taken within the first 14 days of the administration can constitute or contribute to the administrators' '*adoption*' of the contract. The 14 day period is therefore known as the 'safe period'.

11. In respect of Paragraph 99(5)(c) liabilities for wages or salary includes holiday pay and contributions to an occupational pension scheme but does not extend to all liabilities under an employment contract. For example, it does not encompass redundancy payments; unfair dismissal payments; payments in lieu of notice or protective awards concerning employees whose employment has been terminated.

What is a CVA?

12. A Company Voluntary Agreement is a procedure available to directors of a company struggling to perform. It is also available to administrators if a company is in administration and liquidators if a company is in liquidation. The procedure is slightly different for liquidators and administrators, so you are invited to consult Part I of the Act.

13. In brief, a CVA is a deal between the Company and its creditors which generally provides that the creditors will accept less than the monies otherwise owed to them.

14. The directors of a company drafts proposals under the Act (see Section I of the Act). An Insolvency Practitioner ("the Nominee") is nominated as supervisor of the proposal (See Section 1(2) of the Act). The Nominee is provided with the proposal and the company's statement of affairs. The Nominee has to determine whether to put proposals to creditors and members (see Section 2 of the Act). If it decides to do so, the Nominee conducts the decision procedure to obtain creditors' approval (see Section 3 of the Act). The creditors are subsequently able to review the proposal and vote whether to approve the compromise (see Section 4 of the Act). Unless secured or preferential creditors agree to the proposal, it does not bind them (see Section 4(3) and (4) of the Act). In order for the proposal to be approved, it requires creditors with over 75% of the value of the Company's debts to vote in favour of the proposal.

15. Unlike administration, there is a process directors must follow to obtain a moratorium and it is not available to all companies (see Schedule A1 of the Act for further details).

Why is it likely administrations will increase and CVAs will decrease during Covid-19?

16. According to Sealey & Milman: Annotated Guide to the Insolvency Legislation 2019, from the latest estimated figures available for 2018, there were 1,464 administrations compared with only 356 CVAs.

17. The disparity between the popularity of the two procedures is likely to be exacerbated in the forthcoming months, not least because:

    a. Companies entering into administration have no real prospect of recovery (they may have considerable assets but their long term prospects are weak as debts increase over time);
    b. Uncertainties in the market are such that it is difficult for IPs, when drawing up proposals, to say with any certainty what the rates of return will be in a CVA; and
    c. Creditors are becoming more hostile due to general uncertainties in the market, certainly not helped by the current lockdown and therefore, they are likely to vote down CVA proposals.

18. In comparison, administration is far more flexible and allows an Insolvency Practitioner to evaluate the company's position and put a statement of proposals to the creditors. Furthermore, in administration, only creditors with debts amounting to more than 50% of the Company's debts need to vote in favour of the proposals made during an administration.

What is 'light touch'/ 'rescue' administration?

19. Generally where a company enters into administration officers of a company are prevented from exercising the management powers of the company in absence of consent from the administrator (see Paragraph 64, Schedule B1 of the Act).

20. A consent protocol has been developed which allows the administrator to provide its consent for company officers to exercise certain powers and respond to the difficulties created by the pandemic[1] provided the administrators continue to act in pursuit of the statutory objective(s). The aim of the protocol is therefore to provide directors with an ability to manage the day-to-day affairs of the company and potentially save costs.

21. If the consent protocol is adopted by administrators, it should be kept under review in order to protect their position.

Re Carluccio's Ltd: the issues and the decision

22. Administrators were appointed in late March 2020 over the well-known restaurant chain, Carluccio's ("the Company"). This was shortly after the government announced the Corona Virus Job Retention Scheme ("the Scheme"). The Administrators planned to 'mothball' the company in tandem with seeking to sell the Company.

23. In order to take advantage of the Scheme, following their appointment, the Administrators wrote to the employees of the Company. In their letter ("the Variation Letter") the Administrators:

[1] https://www.ilauk.com/news-events/news-view/saving-livelihoods-update-and-consent-protocol-leaving-certain-management-powers-with-the-directors

a. indicated that they intended to place the Employees on Furlough Leave;

b. noted that under the scheme the Company understood that the employees would be provided with 80% of their regular wages up to a maximum of £2,500.00;

c. stated it was the Company's intention to claim for every eligible employee in full; and

d. invited the employees to consent to the employment contract variation(s) which included an agreement to be placed on furlough leave; acceptance that wages would be reduced and recognition that payment would only be made to the relevant employee once the Company received the relevant grant from the Government.

24. The employees subsequently fell into three categories:

a. Consenting Employees;

b. Objecting Employees; and

c. Non-Responding Employees

25. In light of the uncertainty surrounding how the Retention Scheme would operate and the potential need to make the entire and/or some of the workforce redundant to avoid the adoption of employment contracts after the 'safe period', the Administrators sought directions from the court.

26. In summary[2], the first issue the court had to determine was whether the existing contracts had been validly varied. For the Consenting Employees, their employment contracts had been varied in line with the Variation Letter. For Non-Responding Employees, there was no conduct from which consent to the variation could be inferred.

[2] See https://www.3pb.co.uk/3pbs-daniel-brown-and-rebecca-farrell-review-court-decision-on-carluccios/ for a detailed summary of this case produced by Daniel Brown and Rebecca Farrell.

27. Subsequently, the court determined Paragraph 99, Schedule B1 of the Insolvency Act 1986 ("the Act") was the relevant mechanism under which the payment of wages could be made to employees over other claims in the administration. However, this section could only provide employees with the benefit of 'super priority' for wages if the Administrators had 'adopted' the employment contracts under Paragraph 99, Schedule B1 of the Act.

28. Ultimately, the court determined that adoption was an act whereby the administrator demonstrated that it elected to treat the varied contract as giving rise to liabilities which qualify for super-priority. Whilst the Administrators were concerned that this situation arose automatically if the relevant contracts were not terminated after the 'safe period', in reality adoption in respect of the Consenting Employees would only occur where:
    a. the administrators made an application under the Scheme; or

    b. made payment under the Scheme / varied contracts.

29. For the objecting employees, their contract were terminated and they were now redundant.

30. For non-responding employees who did not subsequently accept the variation letter, they would remain employed by the Company on the terms of their unvaried contract until termination. However, in light of the court's guidance the Administrators were no longer under pressure to decide whether to terminate the contract before the end of the safe period.

Stakeholders in an administration

31. There are a number of stakeholders who are likely to need advice if administration is contemplated. Tailored advice will always be necessary for each company in question.

32. Some issues to consider are as follows:
    a. For employees who are invited to consent to variations to their contract of employment, it will be necessary to consider whether to accept such variations. In *Carluccio's* the employees who responded to the variation

letters will benefit from the insolvency mechanism under Paragraph 99, Schedule B1 of the Act when the Company receives payment under the Scheme.

b. For directors, the decision to enter into administration is likely to be a daunting one. Owing to the Administrators' powers, directors should consider if there are any transactions which require explanation and monies which should be returned to the company.

c. For creditors, generally it will be necessary to seek advice regarding whether to support proposals for administration or wind up the company. Likewise, If you have supported the proposals but are unhappy with the administrators' progress or wish to challenge the administrators' actions, you have powers to do so and you should seek advice in this regard. An example would be, if you feel that the administrators should be taking advantage of a statutory scheme made available by the Government in the lockdown but they refuse to do so, you could apply to the court compelling the administrator to apply under the scheme.

d. For landlords who are creditors, if you have a commercial lease which largely follows the Law Society's model commercial lease, your tenant going into administration will normally be a termination event such that it entitles you to terminate the lease. As a landlord, you should then consider whether you want to terminate. In the current climate, it will be difficult to find an alternative tenant and even if you do find an alternative tenant, whether they will agree a lease on favourable terms. There are obviously pragmatic considerations here as well, a new tenant who is solvent but paying a lower rent is clearly more favourable than insisting on the rent payments from an existing tenant who is in administration and the inherent unlikelihood of recovering those sums after the administration. Again, this is all factually sensitive and you should seek specialist advice on your particular circumstances.

e. As per the latest edition of 'Changing the Locks during Lockdown' produced by Charles Irvine and Rebecca Farrell, the government announced on 23rd April 2020, 'new measures to protect UK high street from aggressive rent collection and closure'. The press release set out where a company cannot

pay its bills due to Covid-19, the Corporate Insolvency and Governance Bill would temporarily ban the use of:

I. statutory demands made between 1st March 2020 and 30th June 2020; and

II. winding up petitions presented from 27th April 2020 to 30th June 2020.

Secondary legislation which would prevent Landlords from using the Commercial Rent Arrears Recovery (CRAR) unless they are owed 90 days of unpaid rent is also intended.

The aim of the legislative proposals is to protect High Street retailers and other companies under pressure from debt recovery action. However, within the press release tenants, were also encouraged to pay what they can afford "*in recognition of the strains felt by commercial landlords too"*.

Whilst it is noted "*under these measures, any winding-up petition that claims that the company is unable to pay its debts must be first reviewed by the court to determine why"*, it is unclear how the court will make such a determination in practice.

SUSPENSION OF THE WRONGFUL TRADING PROVISIONS DURING THE LOCKDOWN

33. A comprehensive analysis of the suspension of wrongful trading provisions prepared by Cheryl Jones is available here. The below summarises the wrongful trading provisions, sets out the current position during the suspension and summarises areas where practitioners may consider future litigation lies.

Wrongful trading: an overview

34. Wrongful trading takes place when one or more directors knows or ought to have known that the Company had no reasonable prospect of avoiding going into administration or insolvent liquidation but continues to trade anyway, with the Company subsequently entering administration or insolvent liquidation [S214(2) & 246ZB Insolvency Act 1986]. The consequences for the director can be swingeing,

with orders against them personally to pay contributions reflecting the increase in insolvency during the period of wrongful trading, together with the never inconsiderable costs of the Insolvency Practitioner who brings the claim. The consequence of such orders is often the bankruptcy of the director(s).

35. The Court will not make the order if, at the point when the director knew (or ought to have known) that administration/insolvent liquidation was unavoidable, they took steps to minimise the potential losses to the creditors. That usually means they should seek advice from an Insolvency Practitioner about going into administration/liquidation. Directors also have the benefit of section 1157 of the Companies Act 2006 whereby a director (or other officer of a company) facing proceedings for negligence, default, breach of duty or breach of trust may be relieved from liability if (s)he *"acted honestly and reasonably, and having regard to all the circumstances in the case […] (s)he ought to be excused"*.

36. In practice, a claim for wrongful trading is often brought in conjunction with other allegations of misfeasance etc against a director. However, such claims have been on the receiving end of justifiable criticism because, in the end, it is a question of judgment as to when a Company has no reasonable prospect of avoiding entering administration/insolvent liquidation, with that judgment being far easier for an Insolvency Practitioner making a retrospective analysis than for a Director in a fastmoving situation where the hope of rescue burns bright. Information presented and analysed in a dry and calculated manner at leisure after the event is very different from the piecemeal information tumbling through in no particular order to the pressurised director(s) of a Company which is clearly in trouble but for which there may be a prospect of a contract or payment which will turn things around, or a genuine hope of a sale or a white knight.

The proposed suspension of wrongful trading provisions

37. Given the Covid-19 lockdown, many Companies are being driven into a position whereby they cannot, in the short term, reasonably avoid administration or liquidation although they might be able to trade out of difficulties if they can weather the present storm. Even relatively strong Companies in some sectors (restaurants, for example) are likely to struggle with lack of cashflow whilst overheads remain relatively high. There are also, and in particular, difficulties for them in seeking and obtaining loans which, at present, they have little prospect of being able to repay. As things stand,

the directors of those Companies are personally at risk if they do not take the appropriate steps, despite the distant possibility or even probability of a brighter future. Therefore, the Government has proposed suspending the wrongful trading provisions to avoid directors' anxiety over personal insolvency whilst they are trying to keep Companies going without hope of any income in the near future.

38. Some may consider that legislation is unnecessary as the courts, in any event, may be reluctant to make findings of wrongful trading in the current circumstances. However, there is a risk that without the comfort of legislation, a large number of Companies who have a prospect of trading through insolvency on the lifting of the lockdown, but who on present information are insolvent, will be placed into administration or liquidation.

39. The Government has proposed that s214 & s246ZB should be suspended for a period of three months, backdated to 1st March 2020 but with the possibility of an extension beyond 31st May 2020 if considered necessary. During the operational period it is intended that, in the event that a Company enters administration or insolvent liquidation, a Director will not be held personally liable for failing to take steps to minimise potential losses or for taking Government-backed loans. There is also discussion of a separate stand-alone option of a moratorium during which no insolvency proceedings can be brought, to try to give time to trade out of temporary difficulties. There are no real details available of this option yet, but it is likely to resemble the Chapter 11 process in the United States. A discussion of the Government's proposals is contained in latest edition of 'Changing the Locks during Lockdown' produced by Charles Irvine and Rebecca Farrell.

The proposal's current effect

40. Until the Government's proposals have statutory force, the Insolvency Act 1986 is primary legislation and any change or suspension can only be dealt with by way of an Act of Parliament. Parliament has only just returned sitting and there is never any guarantee that a government can pass its intended legislation, although in these strange times it is unlikely that the relevant legislation would fail. Directors who are continuing to trade insolvently are hanging their hats on the intentions of the Government, which does not tend to have a great deal of force in the courts. Plain

fact is that they are subject to s214 or 246ZB until and unless the legislation is enacted and the proposed backdating becomes law.

41. Secondly, the proposed legislation appears to be something of a blanket provision, attaching to any Company and director for the relevant period, irrespective of whether or not the reason for the insolvency of the Company is linked to Covid-19, is pre-existing or arises for completely unrelated reasons after 1st March 2020. It would be foolish for Directors of a Company already in trouble simply to assume that they will get a free pass because of the suspension from 1st March 2020. If the Company was obviously and objectively insolvent before 1st March 2020, then there is nothing to stop a claim being brought for a contribution relating to the period prior to 1st March 2020. In addition, it is possible, depending on the wording of the legislation, that if directors were trading wrongfully before 1st March 2020 they may be unable to claim the benefit of the suspension after 1st March 2020. One can certainly anticipate a certain amount of finetooth combing of the legislation to see if additional claims are a possibility. It would seem contradictory for a director to be liable on 29th February 2020 on the grounds that the Company should already be in administration or liquidation, and then be relieved of responsibility for the next three months. 1

42. Any unrelated insolvency becoming apparent after 1st March 2020 is likely to be bleached out by the proposed legislation. To be fair, it would be extremely difficult to ascertain whether a Company has become insolvent because of Covid-19 or for unrelated reasons, because the whole economic landscape is so tainted by the pandemic. There seems little likelihood that any Insolvency Practitioner would take the financial risk of trying to get around the suspension where a Company was viable on 1st March 2020, even if the wording of the legislation was sufficiently loose to allow for the possibility, because of the obvious difficulty of proving in the current climate that a Company became insolvent for any other reason.

43. Thirdly, the only provision which is suspended is wrongful trading. Claims in misfeasance [s212], preferences [s239] and transactions at an undervalue [s238] remain in force so that, for example, a Director who sells a property at a low price in order to keep paying important suppliers might be faced with a claim under s238 or s239; or a Director who pays herself dividends to keep afloat, or increases her Director's loan, may face misfeasance claims.

44. In addition, fraudulent trading remains in place [s213] with its wider compass. It may be that this section could be used where it was clear before 1st March 2020 that a Company was unlikely to avoid administration or insolvent liquidation, but the Directors kept it trading after 1st March 2020 on the basis that they could take advantage of the suspension of s214/s246ZB.

45. In conclusion, therefore, whilst the suspension of s214/s246ZB is a welcome assistance to directors struggling to keep Companies afloat in the expectation, or even mere hope, that things will turn around in the summer, it cannot and must not be treated as a "Get out of Jail Free" card. There are still a number of claims which can be brought in cases where Insolvency Practitioners take the view that a Director has fallen foul of the remaining parts of the Insolvency Act 1986.

46. Practitioners should be thinking about whether, like the administrators in *Carluccio's,* a director should be seeking declaratory relief from the court whilst awaiting the Government's proposed legislation. Practitioners should also consider the timing of when a director of a Company knows or ought to know that the Company had no reasonable prospect of avoiding going into administration or insolvent liquidation but continues to trade anyway. For example, the director of a Company who ought to know that the Company was going into administration or insolvent liquidation before or after the period of the suspension would not receive the comfort of any proposed legislation, which would be an issue for those Companies trading with suppliers up or downstream who are making use of the suspension.

PART II AND III OF THE 'STAYING VIRTUALLY UP-TO-DATE' SERIES

Please join us for the next two webinars in this series.

On 5th May 2020, David Parratt QC and Richard Owen-Thomas will present a webinar on 'Force Majeure and other remedies available to business in this current climate'. We hope the trailer has had the desired effect!

On 12th May 2020, Oliver Ingham and Alexander Whatley will deliver a webinar on 'applications; injunctions and other urgent business' with Rebecca Farrell moderating.

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