Feature

KEY POINTS

- At the heart of the new Pt 26A "compromise or arrangement" process is the requirement that the debtor company has or is likely to encounter "financial difficulties" affecting "its ability to carry on business as a going concern". Unfortunately, this requirement is thoroughly confused.
- In fact, financial difficulties may be exacerbated rather than mitigated by the carrying on of the business as a going concern.
- Further, even if the business ought to continue as a going concern, the company may best address its financial difficulties by disposing of instead of carrying on that business.
- Worst, a company may burn cash for a significant time, thereby sinking ever deeper into balance sheet insolvency, without encountering financial difficulties which would affect its ability to carry on business as a going concern.

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The difficulties with "financial difficulties": the threshold conditions for the new Pt 26A process

The new arrangements and reconstructions mechanism inserted in the Companies Act 2006 as Pt 26A by the Corporate Insolvency and Governance Act 2020 is a welcome addition to the restructuring toolkit available in this jurisdiction. On any view, it will add powerfully to the ability of restructuring professionals to assist distressed debtors and their stakeholders. Unfortunately, the threshold requirements that the debtor company be in "financial difficulties" affecting "its ability to carry on business as a going concern", and that the plan it proposes should address these difficulties or their effect are deeply confused and themselves likely to create difficulties. This article highlights the key problems and shows how they arise, why they are unnecessary, and how they might be fixed.

The Corporate Insolvency and Governance Act 2020 is greatly welcome for providing a set of powerful tools which together can be expected very significantly to benefit UK businesses and the full range of their stakeholders, during and well beyond the COVID pandemic. In particular, the government and its advisors are to be commended for the new arrangements and reconstructions process now found in Pt 26A of the Companies Act 2006, which looks set to broaden and deepen the already formidable restructuring capacity available in this jurisdiction.

Instead of commenting on any of the numerous excellent features of the Pt 26A process, I will focus on one of its key weaknesses: the threshold conditions in s 901A of the 2006 Act which determine whether a company may make use of the Pt 26A process by proposing a compromise or arrangement (which I will refer to together as a "plan").

THE THRESHOLD CONDITIONS

A Pt 26A plan may only be proposed if two threshold conditions are met (ss 901A(2) and (3)). First, by what the legislation labels "Condition A", the company must have encountered or must be likely to encounter "financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern". And second, the purpose of the plan it proposes "must be to eliminate, reduce or prevent, or mitigate the effect of, any of [those] financial difficulties" (Condition B). Note that "financial difficulties", a term forming part of the definition of each Condition, is not defined, and presumably takes its meaning from the Condition A modifier "affecting [etc] the company's ability to carry on business as a going concern". (Consistently with this, Mr Justice Trower appears in the convening hearing in *Re Virgin Atlantic Airways Limited* [2020] EWHC 2191 (Ch), [37], to have read "its ability to carry on business as a going concern" as part of the definition of "financial difficulties".)

Conceptually, these threshold conditions are a mess. They require the parties and the court to ride roughshod over several distinct policy-relevant issues. Let me make four points to assist the subsequent analysis.

SOLVENCY, DISTRESS, AND THE GOING CONCERN

Bear in mind the distinction between the legal entity which is the *company* (say, X Ltd) and the productive assets – traditionally categorised as land, labour, capital, and entrepreneurship – which together constitute its *business*. Consider, first, the question whether the law should facilitate the survival of the business as a going concern. This is a matter of whether the business as a going concern is more valuable than are its constituent assets if split up and disposed of piecemeal. If a piecemeal disposal is likely to realise greater value, then that is what the law should facilitate, since, by hypothesis, value is being lost each day that those assets remain harnessed to their current use, to the detriment of all of X's stakeholders considered as a group. In the economics jargon, X is *economically distressed*: the business proposition on which it is based (say, operating a bricks-and-mortar travel agency franchise) is dead (the franchisor and its competitors are increasingly taking operations inhouse and online), such that the socially desirable response is to encourage redeployment of the business's constituent assets to more promising uses. By contrast, the law should facilitate the preservation of the going concern if (and to the extent that) it is more valuable than the assets considered piecemeal.

This leads to the second issue. Suppose X is not economically distressed, so that its going concern should be preserved. Nevertheless, its stakeholders as a group presumably wish to maximise its value to them. Broadly, this may be done in one of two ways: the business may be retained in X's ownership, or it might be sold to (say) Y Ltd as a going concern. Which of these courses was chosen would characteristically depend on whether X's or Y's stakeholders placed a greater value on X's going concern.

Third and critically, notice that I have said nothing so far about X's debts and liabilities, nor about whether X is solvent or insolvent. The reason is obvious: each of the two points made above holds irrespective of X's solvency. X's decision-makers – if rational and acting scrupulously in the interests of X's (relevant) stakeholders as a group – would decide whether to preserve its going concern in the way outlined above, ie by comparing the value it generates in X's hands with the value that would be realised from the piecemeal disposal of its assets. And they would choose whether to retain the going concern in X's hands or to sell it to (in our example) Y by comparing which of these options would bring in better returns. None of this reasoning is affected by whether or not X is in financial difficulties or even insolvent, nor by whether its decision-makers are acting primarily on behalf of its members as a group or on behalf of its creditors as a group.

(If X were insolvent, the value of its going concern may be realised either through a going concern sale to a third party like Y, or else by effectively "selling" the going concern to creditors, who "pay" for it by agreeing to variations in existing rights against X, such as through debt repayment holidays, maturity extensions, interest write-offs, principal write-downs, debt for equity swaps, and so on. It is a key function of a restructuring plan to bring about such asset sales and rights variations.)

Fourth, then, let us introduce the concept that economists call *financial distress* and insolvency lawyers know better as *cashflow insolvency*: the inability of a debtor to pay its debts as they fall due. This does require comparing the cashflow being generated by X's business with X's liabilities. However, and as should be clear by now, there is no necessary connexion between financial and economic distress, between X's (in)ability to meet its liabilities as they fall due and the question whether X's assets are currently deployed in their optimal use (ie as a going concern and, indeed, in X's ownership).

THE TRIPLY CONFUSED CONDITION A

This highlights the triple confusion inherent in Condition A, which, as noted, appears to tie the very existence of (in our example) X's financial difficulties – apparently as a matter of the definition of "financial difficulties" – to X's ability to: (i) continue its business; and (ii) as a going concern.

First, whether X is suffering financial difficulties is presumably a function of its ability to meet its financial obligations. It is in financial difficulties if and to the extent that it is struggling or may in the future struggle to do so. If X were beset with financial difficulties, its decisionmakers (again, if rational and acting properly) would seek to determine how to maximise the value generated by X's assets. The greater that value, the higher the proportion of its indebtedness that X would likely be able to repay and the lower the level of its financial difficulties. As noted, however, preservation of X's going concern may *or may not* maximise the value of X's assets, depending on whether X *is* economically distressed. If X is economically distressed, preservation of its going concern may *exacerbate* rather than mitigate its financial difficulties. So (ii) – which appears to overlook the quite ordinary possibility that continuation of a company's business as a going concern may hinder rather than help resolution of the company's financial difficulties – is misguided.

Second and even if X is not economically distressed, the optimal way of reducing its financial difficulties might be to cause a going concern sale of its business to Y, leaving X with no business but a pile of cash with which to pay down its debts. It follows that (i) – which appears to overlook the commonplace possibility that a company may best address its financial difficulties by disposing of rather than continuing its business – is also misguided.

Third and perhaps most strikingly, note the gap concerning *balance sheet insolvency*, the state in which the quantum of X's liabilities exceeds the value of its assets. X may not encounter financial difficulties affecting its ability to carry on business as a going concern for a significant time, effectively by burning cash and sinking ever deeper into balance sheet insolvency. All this time, it would remain ineligible for a Pt 26A plan under Condition A.

CONDITION B AND THE PERMITTED PURPOSES OF THE PLAN

This takes us to Condition B, which requires the plan to have as its purpose (iii) the elimination, reduction, or prevention of any of the financial difficulties referred to in Condition A or (iv) the mitigation of their effect.

Note that (iv) appears as an undifferentiated appendage of (iii). This suggests that the legislator may not have noticed that (iii) and (iv) envisage what in practice would be dramatically different outcomes. Since the financial difficulties referred to in Condition A are apparently those which (do, will, or may) affect X's ability to carry on its business as a going concern, and since (iii) requires the prevention, elimination, or reduction of those difficulties, it follows that (iii) envisages a plan whose purpose is to enable or at least make it more likely for X to retain its business as a going concern. By contrast, (iv) is perhaps best read, avoiding redundancy, as governing situations in which X cannot retain its business as a going concern, which results in some undesirable "effect" – on which more below – which the plan is intended to mitigate.

Further, juxtaposing the points made about (i) and (ii) with those about (iii) suggests that a plan under (iii) would not be available in a range of scenarios in which Pt 26 schemes have frequently been deployed. For example, any plan envisaging (among other things) a going concern sale – ie any

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variant of the so-called "*Tea Corporation* scheme", named after *Re Tea Corp Ltd* [1904] 1 Ch 12 (CA) – may not be proposed under (iii). This is because such a plan would not eliminate (etc) X's financial difficulties so as to enable it to carry on business as a going concern but instead would leave X without any business. For similar reasons, a plan proposed by X's administrators or one which envisaged X entering into administration followed by a transfer of X's business to Y – such as that proposed in *Re McCarthy & Stone plc* [2009] EWHC 712 (Ch) – cannot be addressed under (iii). Other common Pt 26 scheme structures, such as those involving substantial collateral sales by or on behalf of secured creditors, would also fall outwith (iii). All such plans may only be proposed under (iv). These limitations on the ambit of (iii) seem unnecessary and the result not of design but rather of the accident that is the misguided conceptualisation of "financial difficulties".

Turning to (iv), while the purpose of the plan must be to mitigate the effect of any of the Condition A financial difficulties, it is not clear who may benefit from such mitigation. Suppose X's financial difficulties have adverse effects on X itself (say, because its suppliers are refusing to give it discounts and trade credit and its customers are discounting its warranties) and also, upon further analysis, on its creditors (who have or look set to suffer defaults) and its members (whose equity appears worth little if anything at all). Does (iv) permit a plan which would disproportionately, or even exclusively, mitigate the effect on members as a class? Or on creditors, considered as a group? Or on only certain classes of creditor? Or directly on X itself in aid of its ability to continue its business as a going concern, say, by proposing severe write-downs to creditors' claims but full payment upon delivery to critical suppliers? In principle and since the nature of the financial difficulties that might beset X and how they might optimally be addressed is difficult to predict in advance, it would seem counterproductive to rule out any of these plans by definitional fiat. All should be admitted and then stand or fall by the operative requirements of the Pt 26A process. (Again, this approach seems consistent with that accepted by Mr Justice Trower in *Virgin Atlantic* [2020] EWHC 2191 (Ch), [39].)

POINTLESS, AND POINTLESSLY RESTRICTED

This does, however, create something of an asymmetry between the two Conditions. A plan may *only* be proposed in relation to X on the basis that it suffers financial difficulties affecting its ability to operate as a going concern. The plan *need not*, however, seek to restore that ability but only to mitigate the effect of those difficulties upon an unspecified someone, be it some or all creditors or members or even X itself. Pt 26A's very own Duke of York, the two Conditions look set to march ten thousand Xs to the top of the going concern hill, only to march them down again. Why not avoid this pointless detour by permitting X access to Pt 26A simply on the basis of financial difficulties (but see below) regardless of any threat to its going concern?

Equally unfortunate is the symmetry between the two Conditions: for the same reason that X would not meet Condition A "merely" because of balance sheet insolvency, a plan whose purpose was "merely" to eliminate, reduce, or prevent balance sheet insolvency or to mitigate its effect would not meet Condition B. It is particularly implausible that the legislature intended for a Pt 26A plan not to be able to address balance sheet insolvency as such. This would seem to be the clearest indication amongst the several adverted to above that the definition of "financial difficulties" has gone badly awry.

BETTER ALTERNATIVES

It would have been far preferable for Pt 26A to track Pt 26 in not having any financial entry requirement at all. This is what the government had originally proposed, and none of the other differences between the two regimes – which Mr Justice Snowden identified in the sanction hearing in *Virgin Atlantic* [2020] EWHC 2376 (Ch), [41]-[43] as the express provision for those who must be permitted to participate in a class meeting, the absence of a numerosity requirement, and the availability of a cross-class cram down mechanism – justifies a different approach. In particular, there is no financial entry requirement for Chapter 11 of the US Bankruptcy Code, which provides the inspiration for the cross-class cram down.

And if the government had been persuaded – in my view misguidedly – that an entry requirement was necessary, it should have eschewed vague and untested formulae such as "financial difficulties" in favour of the "is or is likely to become unable to pay its debts" precondition for the court to make an administration order (para 11(a) of Sch B1 to the Insolvency Act 1986). This requirement at least has a rational and well-understood connexion with the rationale for a distressed restructuring. It is also broadly consistent with the "present or imminent inability of the debtor to service [its] debt" criterion identified by the UNCITRAL Legislative Guide on Insolvency Law (at p 22) as appropriate to voluntary restructuring negotiations.

CONCLUSION

Virgin Atlantic, the only Pt 26A restructuring at the date of writing, was in the end a simple case which did not implicate any of the issues raised above. For that reason, Mr Justice Trower was able, with respect quite correctly, to find that each of the two Conditions was met ([2020] EWHC 2191 (Ch), [37]-[39]). Not all future restructurings may prove so straightforward. The problems with the threshold conditions are deep seated and endemic and can be expected to raise difficulties in at least some cases. They are also entirely unnecessary and, happily, readily remediable. ■

Further Reading:

- Corporate Insolvency and Governance Act 2020: a balancing act (2020) 9 JIBFL 629.
- UK Corporate Insolvency and Governance Act: effects on *ipso facto* clauses (2020) 8 JIBFL 550.
- LexisPSL: Banking & Finance: Practice Note: Corporate Insolvency and Governance Act 2020 – restructuring plan provisions.