

ALTERNATIVE DISPUTE RESOLUTION & FINANCE: Insolvency and ADR



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What is "insolvency"?

Insolvency is defined both in terms of cash flow and in terms of balance sheet in section 123 of the Insolvency Act 1986 which reads in part:

123. Definition of inability to pay debts

(1) A company is deemed unable to pay its debts - [...]

(e) if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due. [This is known as cash flow insolvency.]

(2) A company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities. [This is known as balance sheet insolvency.]

Administration v Liquidation – Two main forms of corporate insolvency

Administration

In English law, the administration regime is governed by the Insolvency Act 1986. An "administrator" can be appointed without petitioning the court by the holder of a floating charge (created since 15 September 2003), by the company or by its directors. Other creditors must petition the court to appoint an administrator. The administrator must act in the interests of all the creditors and attempt to rescue the company as a going concern. If this proves impossible she or he must work to maximise the recovery of the creditors as a whole. Only then may the administrator attempt to realise property in favour of one or more secured creditor. Administration is broadly analogous to going into Chapter 11 in the United States.

Administration v Liquidation – Two main forms of corporate insolvency

Liquidation

Voluntary liquidation occurs when the members of the company resolve to voluntarily wind-up the affairs of the company and dissolve the business. Voluntary liquidation begins when the company passes the resolution, and the company will generally cease to carry on business at that time (if it has not done so already). If the company is solvent, and the members have sworn a statutory declaration of solvency, the liquidation will proceed as a members' voluntary winding-up. In such case, the general meeting will appoint the liquidator(s). If not, the liquidation will proceed as a creditor's voluntary winding-up, and a meeting of creditors will be called, to which the directors must report on the company's affairs. Where a voluntary liquidation proceeds by way of creditor's voluntary liquidation, a liquidation committee may be appointed.

Compulsory liquidation occurs when a creditor instigates court action by applying to have a company wound up. The initial liquidator will be the Official Receiver, but a private insolvency practitioner may be appointed.



Licensed Insolvency Practitioners (“IPs”)

In the United Kingdom, only an authorised or licensed insolvency practitioner (usually abbreviated to IP) may be appointed in relation to formal insolvency procedures.

Typically, IPs have an accountancy background. A few active practitioners are lawyers, but it is not necessary to be qualified as either, as since 1986 there has been a direct entry route to the profession.

IPs

IPs tend to be anti-ADR, especially mediation. They are used to doing deals all the time and feel that ‘they don’t need a mediator to help them reach a commercial solution’. As to arbitration, as we shall see there is a conflict between arbitration and insolvency. Insolvency regimes offer a route to settling all claims which is legitimately considered fair by IPs. Why should arbitration be excluded from that universal insolvency process? And what’s the point of mediation?



The Post-Insolvency Difference

Insolvency brings a new dawn. At the point of insolvency, a veil is drawn across the company's affairs. The proceeds of its assets are applied in a strict order of priority and various mandatory rules come into play. By virtue of its insolvency, an insolvent company will be in breach of contracts and other obligations.

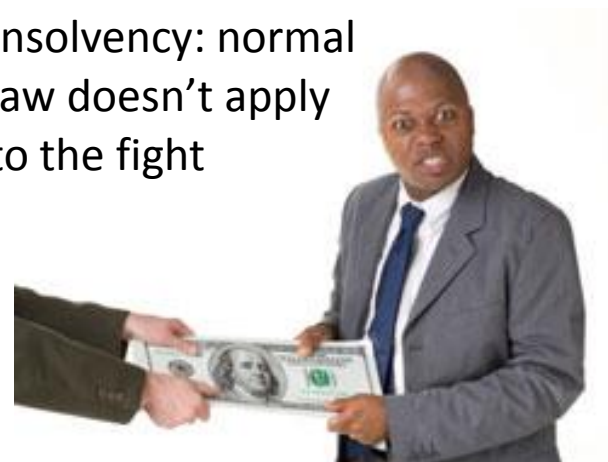
Thus by its nature, the question needs to be posed, 'what's special about ADR, especially arbitration contracts, which mean they can, or indeed should survive insolvency intact?' The question is different for any post-insolvency ADR contracts entered into by the IP. Obviously those should be honoured. The veil is drawn across and post-insolvency contracts should – and will - in the main be honoured.

Insolvency Issues for the ADR practitioner

ADR Bear Traps and ‘insolvency is different’



Insolvency: normal
law doesn't apply
to the fight



Bear Traps: arbitrators get into problems with insolvency!

ANNIE FOX AND OTHERS v. P G WELLFAIR LTD. (in liquidation)

“Arbitration - Arbitrator Misconduct - Removal - Application to set aside award or remove arbitrator for misconduct - Whether arbitrator had failed to provide applicants with fair hearing - Whether arbitrator should be removed - Whether awards should be set aside.”

Held, by ACKNER, J., that the awards would be set aside; and the arbitrator would be removed for misconduct.

On appeal by the respondents:

-Held, by C.A. that (1) on the evidence the arbitrator was an expert and not simply a legal arbitrator; (2) the fact that the claim was undefended [as the respondent had gone into liquidation] did not mean that the arbitrator was obliged to accept the claim without question nor did it mean that he was under an obligation to protect the party who was not present; his function was to hold the scales of justice as evenly as he could and act as fairly and judicially in the conduct of the hearing;...(5) in the circumstances the learned Judge was right in his conclusion that the awards would be set aside and the arbitrator removed “

Whilst Fox v Wellfair may no longer represent the law, but the bear trap uncertainty remains.

Bear Traps: mediators also get into problems with insolvency



An ADR pub story doing the rounds...

Mediation Bear Trap

We've not been able to find a reported case, nor indeed anything solid on the web, but it is accepted knowledge that a mediator has been threatened by a liquidator with a negligence action. The threat was on the basis that the liquidator believed the mediator did not take sufficient cognisance of the parlous state of the now liquidated company - perhaps a reversal of Fox v Wellfair? It is believed that either this threat was not ultimately litigated or the case was settled privately. Both of these outcomes say a lot about IPs.

Bear Traps Generally

ADR practitioners should understand some key insolvency issues:-

1. Often IPs don't care about liabilities. There may be no available assets to meet them anyway, so IPs don't incur the costs of turning up to proceedings. Sometimes the insolvent company is the creditor though.
2. Pre-insolvency companies will often agree to anything, driven by desperation and, in some cases, a view that 'it's only creditors' money'.
3. IPs are litigious, but also very commercial.



Bear Traps Generally

Best practice tip: take insolvency advice if you encounter an insolvent party as a mediator or arbitrator.



Insolvency is different

A formal insolvency procedure brings a whole new regime – either administration (to try and rescue the company) or liquidation (to realise the company's assets).

So what happens to agreements to arbitrate or to mediate?

Starting point:

“no legal process (including legal proceedings ...) may be instituted or continued against a company ... except with the consent of the administrator or with permission of the court” (para 43(6) Schedule B1 to the Insolvency Act 1986)(administration); and

"no action or proceeding shall be proceeded with or against the company ... except by leave of the court" (section 130(2))(liquidation).

Domestic v International Arbitration

It is accepted law that the term "proceedings" includes quasi legal proceedings and arbitration (*A Straume (UK) Ltd v Bradlor Developments Ltd* [2000]).

But the situation is far more uncertain in international arbitration.

There are two international insolvency regimes, the UNCITRAL Model Code and the EU Insolvency Regulation, and the latter has given rise to litigation. Both regimes do not create supra-national codes, but create a hierarchy of national insolvency codes, depending upon where the insolvent debtor had its centre of main interests.

One theory with arbitration, especially international arbitration, is that it is purely contractual and therefore not bound by national court processes. Invariably insolvency is a national court process. Even more so, formal insolvency is the acceptance of the failure of contractual obligations. This is the theoretical crux to the clash between arbitration and insolvency.

International Arbitration

The clash is complicated by the nature of international arbitration and insolvency.

The arbitration clause will have a different law to the substantive law.

The centre of main interests ("COMI") of the insolvent debtor will often not be in either the jurisdiction applicable to the arbitration or that of the substantive law. As noted, international insolvency regimes look to a company's COMI as providing the lead insolvency law. So we now have a third legal system and this third will claim primacy.

International insolvency regimes provide for secondary non-COMI proceedings, but these defer in insolvency matters (but what constitutes an "insolvency matter"?) to the COMI jurisdiction.

The assets subject to the arbitration dispute may well be in none of the above jurisdictions. Indeed the majority of countries (unlike in the New York Arbitration Convention) do not subscribe to either of the international insolvency regimes. More often than not, they follow the traditional principle of 'local assets for local creditors'.

A pot pourri of confusion results.

International Arbitration: Vivendi clears the dust, slightly

In *Syska (Elektrim SA) v Vivendi Universal SA & Ors* [2009] EWCA Civ 677, the Court of Appeal (CoA) considered an appeal by Elektrim (E) that English law should govern the effect of Polish insolvency proceedings on a pending LCIA arbitration under the EU Regulation. CoA dismissed the appeal, but its conclusions as to the interpretation of the EU Regulation differed to those of the first instance judge.

E, a Polish company, entered into a Polish law contract with Vivendi (V) – this included an English LCIA arbitration clause. V commenced arbitration, but E was bankrupted in Poland. The LCIA held that the arbitration agreement was not abrogated upon E's bankruptcy. Polish insolvency law was inapplicable. E challenged the award as having been made without jurisdiction. This was at first instance rejected and the tribunal's award was upheld: the arbitration fell within the scope of "lawsuit pending" for the purposes of Articles 4.2(f) and 15 of the EU Regulation. There was a conflict between Article 4.2(e) on the one hand, and Articles 4.2(f) and 15 on the other. First instance held that Articles 4.2(f) and 15 should prevail as they were more specific provisions. Therefore, English law determined the effect of the Polish insolvency on the arbitration. Given that there was no provision under English law annulling the arbitration on the basis of the insolvency, the arbitrators were right to conclude that the arbitration could and should proceed. The fact that Article 4.2(e) applied Polish law to "current contracts" (including an agreement to arbitrate) made no difference as it was only a general provision and the specific provisions of Article 15 were applicable to "pending lawsuits". E appealed.

International Arbitration: Vivendi clears the dust, slightly

The CoA unanimously dismissed the appeal. Longmore LJ, giving the leading judgment, confirmed that the law of the State in which the insolvency proceedings are opened (the "*lex concursus*") will govern those proceedings. However, it was not difficult to see why a pending lawsuit should be excluded from the general application of the *lex concursus*. Until a particular claim is ascertained, it has no relevance to insolvency proceedings at all, and it is natural that it should be the law of the Member State where legal action has begun, or reference to arbitration is taking place, which should determine whether that action should be continued or not.

International Arbitration: Vivendi clears the dust, slightly

Although the CoA reached the same conclusion as the judge below, they concluded that it was wrong to characterise the dispute in terms of a conflict between the provisions of Article 4 and Article 15 of the EU Regulation. Also, although the underlying theme before Christopher Clarke J had been whether arbitration should be treated differently from litigation in an analysis of "lawsuit pending", this was not the focus of the CoA's judgment, it being generally accepted that a "lawsuit" would encompass an arbitration.

Instead, the CoA judgment focuses on the background to Articles 4 and 15 and the differences between commencing proceedings by way of execution and commencing proceedings to establish liability. The effect of an enforcement action will always be determined by the *lex concursus*, whereas the effect of a pending lawsuit will be determined by the place where that lawsuit is proceeding. The reason for this is that, as no enforcement action as such is sought with regard to a pending lawsuit, the insolvency proceedings themselves are not impaired to the disadvantage of others. If a party obtains a decision on the merits of a case, all that does is allow him to join in the body of creditors who already have a claim in the insolvency, rather than actually satisfying his interest in the insolvency.

International Arbitration: Vivendi clears the dust, slightly

So Vivendi said ‘It’s ok to arbitrate to determine a liability, but not to enforce payment of that liability as this will be determined by the law governing the insolvency proceedings’.



‘Liability OK’



‘Enforcement not OK’

This decision can be criticised for unrealistic ‘dancing on a pinhead logic’. But it is a leading judgement which advances the cause of arbitration in the field of cross-border insolvency.

Practical Arbitration Issues

Security

Arbitral tribunals may be able to order that a party provide security for costs or for the disputed amount. In some jurisdictions, this may run counter to the prevailing notion of *pari passu* (or equal) treatment of all creditors.

But what of the arbitrators' expenses and fees?



Practical Arbitration Issues

Costs

Usually arbitrants bear the costs of the proceedings equally, including payment of deposits on account of arbitrators' fees.

Obviously an insolvent company may face practical or legal obstacles in complying with this.

So what of the future of insolvency and ADR?

ADR insolvency-specific factors –

1. Insolvency is a ‘State-controlled collective statutory’ procedure, thus: (a) the State may jealousy guard its prerogatives, especially viz arbitration, but this tendency is decreasing, especially given the rise of international insolvency regimes; (b) does ‘collectivism’ run counter to arbitral bi-partisanship & ADR voluntariness; and (c) can individuals contract out of their statutory rights? Yet insolvency office holders are often given statutory power to arbitrate (Schedule 1 Insolvency Act 1986) and/or encouraged to consider ADR .
2. Company rescue requires speedy dispute resolution.
3. Insolvency consists of two camps: ‘those in the know’, insolvency specialists, who are wary of fellow professionals, especially if they were asked to be subject to their awards and ‘outsiders’ who rarely suffer the consequences of insolvency and who may be ignorant of any insolvency arbitration process.
4. The need for commercial secrecy is often greater in insolvency - ‘bad debts’ should not be publicised.
5. Costs are often a bigger issue, ‘one side insolvent’ and often ‘arguing over dividends, not the original debt’.
6. Insolvency law is unique: (a) ‘bust co’ is now a delinquent, too insolvent to live by the law: & (b) the specialism becomes not the industry-sector, but insolvency so one benefit of ADR, industry knowledge, not so important.
7. Settlements, especially in rescues may require more than can be offered by a court order.
8. Failure of the IP to turn up (Annie Fox and Others v. P G Wellfair Ltd. (in liquidation) [1981] 2 Lloyd's Rep 514).
9. Champerty and maintenance.



So what of the future of insolvency and ADR?

What sort of insolvency issues are arbitrable?

1. All the normal range of commercial disputes, but set within the unique insolvency context.
2. Creditor claims.
3. Post-insolvency business sales (which often involve complicated earn-outs).
4. Possibly voidable transactions (such as transactions at an undervalue, preferences, exorbitant credit etc). Whilst these require a court application, the parties can in theory agree otherwise.



THE END