

In Practice

Author Helen Pugh

'Breathing space': the impact of a more consensual approach

KEY POINTS

- Judicial heavyweights have called for contracting parties to renegotiate and for the common law to consider 'equitable' solutions to disputes.
- Companies in financial distress due to COVID-19 are more likely to need multilateral rather than bilateral solutions.
- Uncertainty in relation to how the courts will meet the challenge of COVID-19-distressed companies will likely add to the motivation to renegotiate and restructure in practice.
- Government rescue measures and likely reforms are expected to boost restructuring and renegotiation and may well suppress liquidations in the short term.

On 27 April 2020 the British Institute of International and Comparative Law (BIICL) published *Breathing Space – a Concept Note on the effect of the pandemic on commercial contracts*. The central thesis is that to mitigate the damaging effects of COVID-19 on the global economy, private law should encourage compromise and mediation rather than a zero-sum rush to terminate contracts and then to litigation and arbitration.

The Note acknowledges the need for the law to be predictable but states: '[i]n many jurisdictions procedural rules already encourage conciliation – can these be developed further to give a breathing space? The onus at least in the first instance would be for the continuance of a viable contract rather than bringing it to an immediate end.' Such an approach has obvious implications for restructuring and insolvency.

THE DETAIL

On 28 May 2020 the BIICL published *'Breathing Space' Concept Note 2*, which provides further particulars on the approach being recommended in relation to (1) the use of dispute resolution mechanisms and (2) the application of existing legal doctrine.

In relation to the use of dispute resolution mechanisms, the BIICL notes that in jurisdictions such as Germany and Switzerland, submission to a conciliation procedure is often a mandatory pre-action step

which parties must take prior to taking court action. In all cases Concept Note 2 suggests that litigating parties should be encouraged to try ADR and 'where appropriate, require' parties to undertake ADR.

In relation to the application of existing legal doctrine, Concept Note 2 makes a number of recommendations. Of particular relevance is the expectation that courts be more willing to find that there is an implied term obliging a party to grant the other party a short 'breathing space' until it is possible for that other party to resume performance.

The tenor of the Concept Notes corresponds with that of the unprecedented guidance issued on 7 May 2020 by the UK Cabinet Office on 'responsible contractual behaviour'. In the context of debtor-creditor disputes, this drive towards a *de facto* deferral of performance of obligations and mandatory ADR would mark a significant culture shift.

BILATERAL RENEGOTIATION

The Concept Notes envisage the renegotiation of bilateral contracts to ensure continuity of business where possible, rather than termination and subsequent litigation with its consequent economic effects. The option to renegotiate has always existed but parties, for various reasons, often prefer to enforce their strict legal rights. In the insolvency context, aggressive – or assertive – individual creditor action, such

as presenting a petition or appointing a receiver, often torpedoes renegotiation efforts and leads to a zero-sum outcome.

One solution which is clearly attractive to the BIICL is to compel parties to attempt to renegotiate. Yet whilst obliging parties to enter into a conciliation scheme prior to taking enforcement action may in some cases facilitate a rescue, in others it may deny creditors the protections which presenting a petition or taking self-help enforcement steps provide. It will also cause delay which too often leads to the worsening of a company's financial position to the detriment of existing and new creditors.

The Concept Notes do not focus on distressed businesses only. Yet if solvent parties engage in litigation or arbitration, whether due to COVID-19 opportunism or otherwise, then the public interest in erecting barriers to that or in compelling a renegotiation process or renegotiated outcome is not obvious. The public interest is clearer in cases of distressed businesses for whom expensive or unsuccessful litigation could be fatal. Yet in such cases the issue is not merely a bilateral one of enforcing a single contract, but has knock-on adverse effects for other creditors. Further, a bilateral renegotiation may do little in practice to rescue a failing business and any renegotiation is more likely to ultimately fail.

MULTILATERAL RENEGOTIATION

The BIICL call for 'breathing space' is not dissimilar to the call from much of the R&I profession for a general moratorium against creditor action. At present a moratorium is only enjoyed in limited circumstances, including companies in administration, small companies undergoing a CVA or by court order such as when a company is seeking the approval of a scheme of arrangement.

The draft Corporate Insolvency and Governance Bill envisages a more widely available free-standing moratorium. It

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Helen Pugh is a barrister at 3 Hare Court with expertise in personal and corporate insolvency. Her practice encompasses misfeasance actions, unlawful distribution and antecedent transaction claims, DDA matters and a range of bankruptcy issues. She is increasingly involved in claims with an international or multi-jurisdictional element. Email: helenpugh@3harecourt.com

is available to a company which is, or is approaching, insolvency if it is likely that it can be rescued as a going concern. The initial 20 day period can be extended for a further 20 days and then beyond with the consent of the creditors or the court. Not all companies are eligible, with a notable exemption for parties to a 'capital market arrangement' which is broadly defined and will essentially cover any company which is part of a group that has issued a debt capital markets instrument.

The envisaged moratorium will prevent creditors from taking enforcement steps and will provide companies with time, and creditors with incentive, to renegotiate contract terms during the moratorium period. The likely reform builds in safeguards for certain creditors, including those with pre-moratorium debts which are exempt from the payment holiday (including landlords in respect of rent during the moratorium period, certain employment liabilities and obligations arising out of financing arrangements) and those to whom debts are owed as a result of obligations incurred during the moratorium period. The company must be able to pay these debts in the course of the moratorium and, if the company ultimately enters into administration or liquidation within 12 weeks of the end of the moratorium, such debts will have 'super priority'. As currently drafted there are concerns that financial creditors could exploit this safeguard by accelerating their debt repayment obligations. It remains to be seen whether the final wording will be amended to prevent that.

Depending on how long a general moratorium lasted, it could provide a lifeline to COVID-19 affected companies which could attempt a bilateral renegotiation, CVA, scheme of arrangement or could simply pause the status quo until the impact on the company from the lockdown or relaxed restrictions is clearer. It could also lead to a successful rescue and the avoidance of court action.

A DUTY TO RENEGOTIATE IN GOOD FAITH OR AN IMPLIED TERM TO GIVE BREATHING SPACE?

There are hints in the first Concept Note that the authors anticipate something far more sweeping than increasing carrots and sticks

available to encourage ADR. Sir William Blair, a former judge of the London Commercial Court and co-author of the Note, is quoted as saying: *'within the principle of legal certainty, space needs to be found for renegotiation, and if the contract is no longer viable, equitable solutions'*. Sir David Edward, a former British judge of the European Court of Justice and co-author of the Note, is quoted as saying: *'the law cannot insist that parties' contracts must continue as if nothing has happened, or simply declare that frustration has brought them to an end. If commercial life is to go on, a rational and equitable solution must be found.'*

Even in today's extraordinary times it seems unlikely that the English common law would overcome its traditional hostility to general duties of good faith negotiation. Or that the legislature could be convinced to grant a discretion to judges to impose an 'equitable' solution to contractual disputes based upon a change of circumstances, including a pandemic. Typically legislative change has been required to adjust strict legal rights stemming from contracts, eg the Law Reform (Frustrated Contracts) Act 1943, or to impose requirements of good faith, eg in the definition of unfair terms in consumer rights legislation.

In Concept Note 2 the emphasis is upon a term implied by necessary implication obliging a party to allow a short 'breathing space' until it becomes possible to resume performance. There is reason to expect English courts to be sceptical that such a term was 'necessary', but even putting aside those doubts the real limitation is likely to be that this remains a bilateral solution. If a company is in financial distress, such an implied term would appear to prejudice commercial contract creditors relative to other types of creditors who would remain free to pursue legal or self-help options immediately. There is no obvious justification for this distinction.

Whilst the BIICL proposals are unlikely to be taken up by the courts, it is foreseeable that COVID-19 policy factors will affect judicial decision-making. It is conceivable that contractual clauses expressly requiring the good faith exercise of powers or requiring a renegotiation of terms – such as renewal terms – in good faith, will be upheld more readily. Insolvency and Companies Court judges may be more ready to grant an adjournment to facilitate

a renegotiation or restructuring. Courts may be willing to grant more latitude to a director seeking to rely on a reasonableness defence to defend the reversal of an antecedent transaction. One can also see the courts taking a stricter approach to cost sanctions against creditors who take an aggressive individualistic approach or to officer-holders who fail to engage with sensible proposals from directors, creditors or both.

Such changes in approach by the courts may be minor in form but have significant ramifications for how parties assess the cost/benefit of a compromise solution vs a contentious insolvency. Uncertainty as to how the courts would approach a case in the COVID-19 era is a strong incentive to parties to renegotiate and restructure where possible. Uncertainty does, however, make negotiations with creditors that much more complicated.

AN EMPHASIS ON RESTRUCTURING OVER INSOLVENCY

The BIICL focus on encouraging conciliation and mediation is unquestionably in tune with the government's own expressed priority of keeping companies trading and giving them breathing space that could help them avoid insolvency. All of which points to an increase in CVAs, schemes and a role for the government's new restructuring plan, originally proposed in 2018 and in the list of likely reforms to insolvency to meet the demands of the COVID-19 era.

Conversely, an emphasis on the renegotiation of bilateral contracts and the availability of a general moratorium would suggest a decline in the short-term in contentious insolvencies. Whilst reforms may well be aimed, expressly or otherwise, at COVID-19 affected companies, they are likely to be used opportunistically by many companies which may have otherwise failed.

The Concept Notes have the weighty support of two former presidents of the Supreme Court, Lord Neuberger and Lord Phillips so have undoubtedly added to the legal debate about the law's response to COVID-19. However, the reaction to their publication has been muted and it may be that legislative reforms, anticipated to include a general moratorium, have the same effect of encouraging dialogue. ■