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A Minimum Standard for Debt Discharge in Europe?

Comparative law; Discharge from bankruptcy; Forum shopping; Germany; Greece; Ireland; Netherlands; Poland

Introduction

This paper represents the product of a workshop entitled "As you like it?—(Minimum) Standards for Debt Discharge in Europe", which was held as part of the Second European Insolvency & Restructuring Congress under the auspices of the *Deutscher Anwaltsverein, Arebeitsgemeinschaft Insolvenzrecht und Sanierung*, on May 15-17, 2013.[1] In the course of the workshop, the writers, being representatives of the legal systems of Germany, Greece, the Republic of Ireland, the Netherlands, Poland and England & Wales, set out the approaches taken to the discharge of debt in their respective jurisdictions with a view to establishing whether common insolvency law principles could be identified and with the ultimate aim of making recommendations for a minimum pan-European standard that might go some way towards combating the growing phenomenon of forum shopping or "bankruptcy tourism".[2]

The tradition of discharging a debtor from his debt obligations is old.[3] In the ancient East the Babylonians cancelled debts by a process (still recalled in the expression "wiping the slate clean") that consisted of washing away the record of the debts by dissolving the clay tablets that recorded the debtor's obligations to his creditors.[4] In the West, the concept is rooted in the Judaeo-Christian tradition. The forgiveness of debt was recognised in the Old Testament tradition of the Jubilee:

> "At the end of every seven years thou shalt make a release. And this is the manner of the release: Every creditor that lendeth ought unto his neighbour shall release it; he shall not exact it of his neighbour, or of his brother; because it is called the Lord's release".[5]

The New Testament contemplated even more liberal terms of release based on the principle of mutuality.[6]

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The variety of modern approaches to the question of debt discharge[7] in the various European jurisdictions under consideration is puzzling in the light of this common tradition. That fact, coupled with recent reforms to the insolvency laws of Germany and Ireland,[8] emphasises both the difficulties of finding a modern common core as well as the desirability of endeavouring to do so in the light of what appears to be a tendency towards convergence in the direction of more liberal discharge provisions taking effect in a shorter period than previously envisaged.

Germany

Traditionally, German insolvency law was hostile to the idea of discharge. However, recent reforms have made considerable changes. In 1999 the new Insolvency Code (*Insolvenzordnung/InsO*) came into effect, introducing residual debt discharge for natural persons in Germany. The actual discharge period was to be seven years after completion of the insolvency proceedings which could themselves last any length of time. In 2001 the Code was amended such that the insolvency proceedings and discharge proceedings last in total for a period of six years.

German law provides for four stages at which (or by means of which) a debtor may obtain discharge from his debts.

First, a debtor must attempt to reach an out-of-court settlement with his creditors with the help of a professional adviser (such as a state recognised debt counseling agency comparable to a citizens' advice bureau, or by using a lawyer, notary or accountant). A report to the effect that an out-of-court settlement has failed is a necessary prerequisite for any subsequent court proceedings, for which application must be made within six months after the failure of the attempted settlement.[9]

Secondly, and following on from any attempt to settle out-of-court, the debtor may apply for insolvency proceedings to be opened, which must be combined with an application for residual debt discharge[10] if he/she seeks such relief. With the application the debtor must submit a plan for settlement of his or her debts.[11] If it can be shown that the settlement proposal has been approved by more than half of the creditors in number holding more than half of the total amount of claims in value, the court must, on the application of the debtor or a creditor, override the objections of a creditor to the proposal, provided it is not disadvantageous by comparison with the projected outcome of formal insolvency and discharge proceedings.[12]

Step one and step two do not apply if the debtor is self-employed or if he/she was self-employed and the assets and debts are not within reasonable limits or are connected with his/her former position as an employer.[13] In these cases the debtor may apply for insolvency and discharge proceedings without having to attempt a settlement beforehand.

Thirdly, insolvency proceedings may follow a traditional form: a court order opening the proceedings followed by the creditors making their claims, a general hearing to verify the claims, evaluation and realisation of the debtor's assets, then a final hearing and notification of discharge of any residual debt. A creditor may apply at the final hearing for debt discharge to be refused on the basis of the debtor's conduct before or during the insolvency proceedings.[14]

Fourthly and finally, after the termination of insolvency proceedings the actual debt discharge proceedings may commence as the so called "period of good conduct" (*Wohlverhaltensphase*). This period starts with the termination of the insolvency proceedings and lasts six years minus the duration of the insolvency proceedings. The application for residual debt discharge must be combined with a declaration of assignment of attachable claims of earnings to a trustee,[15] which comes into effect with the start of the period of good conduct. When the six years are over, the court will hear the debtor, his trustee and the creditors. The creditors can apply for debt discharge to be refused again on the basis of the debtor's conduct during the period of good conduct.

After the period of six years the debtor will be discharged from all claims arising in the period before the opening of the insolvency proceedings, the main exception being claims arising out of an intentional tort, and provided that there has not been a successful application to challenge discharge.

Discharge is not a matter of pure discretion, but it may be refused. Section 1 of the Insolvency Code provides that "honest debtors shall be given the chance to achieve discharge of residual debt". Note, however, that it does not follow that dishonesty necessarily leads to a refusal of debt discharge.

Section 290 of the Insolvency Code provides an exhaustive list of grounds for refusing discharge by reference to the debtor's conduct both before and during insolvency proceedings, though only on the application of a creditor at the final hearing in insolvency proceedings. The list of grounds is largely based on the requirement for the debtor to co-operate in the insolvency process.

Sections 295 and 297 also set out a number of grounds for refusing discharge by reference to the debtor's conduct during the period of good conduct: if the debtor culpably breaches an obligation during the period of good conduct and thereby damages the prospects of recovery for creditors, a creditor may apply for debt discharge to be refused.[16] He must make such an application within one year of the date he obtains knowledge of the facts establishing the breach of the obligation.

The debtor's main obligation is to engage in gainful employment or, if he is without employment, to make every effort to find such employment; he may not reject any reasonable offer of employment so that the assignment of attachable claims of earnings is rendered valueless for the creditors.

Recognition on the part of the German government that insolvency proceedings remained onerous compared to those in other European countries spurred a move to further reform. The 2009 coalition contract between the CDU, CSU and the FDP contained a pledge to provide entrepreneurs with a second chance by reducing the bankruptcy discharge period to three years. After a period of intense debate a bill was passed in parliament on May 16, 2013 which came into force on July 1, 2014.

The basic principles remain the same: the debtor can apply after the attempt at an out- of-court settlement (if the debtor is or was not self-employed, see above) for debt discharge in connection with an application to open insolvency proceedings, but he/she must assign any attachable earnings for the benefit of creditors for up to six years.

The debtor may apply for "early" discharge after three years if he/she has paid a minimum of 35 per cent of his/her debts and the costs of the proceedings; furthermore, the debtor may apply for discharge after five years if he/she has paid at least the costs of the proceedings. The reforms also introduced the option of an "insolvency-plan" as a means of settling with creditors during insolvency proceedings (the current law limits this option to proceedings connected with a former or present business of the debtor). The insolvency plan route provides several options to overrule opposing creditors in favour of a settlement and "early" discharge.

The new law also aims to strengthen the creditors´rights:

- first by introducing two additional exceptions from debts which are released on discharge: claims arising from tax evasion and as a result of breach of child maintenance obligations;
- secondly by increasing the grounds on which the creditors may apply for refusal of debt discharge and by simplifying the proceedings generally.

Republic of Ireland

In the Republic of Ireland too the law of personal insolvency has recently undergone radical reform.[17] The 12 years discharge period that obtained until recently provided little incentive to debtor rehabilitation, so that bankruptcy was rarely used as a legal process at all.[18]

The Irish personal insolvency legislation is found in the Bankruptcy Act 1988 and the Personal Insolvency Act 2012. In principle, every bankruptcy now ends with automatic discharge after three years.[19] Property owned by the bankrupt which has not been sold by the trustee in bankruptcy remains vested in the trustee until it has been sold. The three year discharge period does not affect unsold property. A bankrupt who is discharged from bankruptcy still has a duty to co-operate with the trustee in relation to the realisation and distribution of assets after the date of discharge. A certificate of discharge is issued by the trustee.

In certain circumstances, an objection can be raised to the discharge of the bankrupt. Such objection may be raised by:

(a) the trustee in bankruptcy; or
(b) a creditor.

Any objection to discharge must be raised before the discharge of the bankrupt, and must be made by application to the court.

The grounds for objection are that:

(a) the bankrupt has failed to co-operate with the trustee in the realisation of his assets; or
(b) he has hidden from or failed to disclose to his trustee income or assets which could be realised for the benefit of creditors.

If the court is satisfied that the objection is justified, the bankruptcy is not discharged. The court has power to postpone the discharge to a date not later than eight years after the date of bankruptcy. In other words, the "bankruptcy status" of a bankrupt can be prolonged but the bankrupt must be discharged from bankruptcy after a maximum of eight years. Once the court has made an order extending the discharge date, the date cannot be reviewed again.[20]

Apart from automatic discharge, a bankrupt is also entitled to an order discharging the bankruptcy where provision has been made for the payment of:

(a) the expenses of the bankruptcy;
(b) the fees;
(c) the costs;
(d) the claims of preferential creditors of the bankruptcy;

and the bankrupt has:

(e) paid 100 per cent dividend; or
(f) obtained consent from all creditors (agreeing to the discharge of the bankruptcy).

A bankruptcy can also be discharged where an offer has been made to pay:

(a) the expenses of the bankruptcy;
(b) the fees;
(c) the costs;
(d) the claims of preferential creditors; and
(e) an agreed sum either in cash or by instalments.[21]

In certain circumstances, the court may make an order requiring the bankrupt to make payments from his or her income or other assets for the benefit of the creditors after the date of discharge. The application to the court must be made before the bankrupt has been discharged. The order can apply for a maximum of five years. The order cannot apply after the eighth anniversary of the date of bankruptcy. Before deciding what (if anything) the bankrupt should pay, the court will take into account the reasonable living expenses of the bankrupt and his or her family. The order can be varied if there are material changes in the circumstances of the bankrupt. The court may order that the employer of the bankrupt make payments directly to the trustee.[22]

Greece

Greek law makes no provision for the bankruptcy of individuals who are not merchants: the Greek Insolvency Code[23] applies only to trading debtors, that is to say individuals or other legal entities engaged in commercial activity. Non-merchant debtors who seek release from their indebtedness must rely on the Law for the Arrangement of Debts of over-indebted Natural Persons[24] which was the first piece of Greek legislation dealing with non-trading insolvent individuals and providing them for the first time with a method of achieving a judicial settlement with creditors by a scheme of arrangement.

The debtor must show that he is insolvent and that his inability to pay his debts has not arisen intentionally.[25] Certain liabilities may not be included in the scheme of arrangement: in particular, debts incurred during the year prior to the application, obligations of a public nature (such as unpaid fines and taxes and social security contributions) as well as debts attributed to intentional wrongdoing.[26] By contrast, debts not yet due (contingent debts) may be included in such a scheme.[27]

In practice the debtor requires professional assistance, since he must first attempt to negotiate a settlement with his creditors. Unsuccessful settlement must be certified by one of a number of designated agents (such as the consumer ombudsman, the Mutual Settlement Committee or the banking mediator) or a lawyer.[28]

There is a requirement of full and frank disclosure on the part of the applicant debtor (in particular as regards information about his assets and liabilities); if disclosure is deemed dishonest after the scheme has been ratified by the court, the arrangement can be revoked and the creditors may rely on their original debts.[29]

The court will take into account the debtor's property, income, spousal contributions and living expenses for debtor and family.[30] The debtor's primary residence (if it does not exceed a certain value) may be exempted from realisation for the benefit of creditors, and the debtor may be permitted instead to make instalment payments to be set by the court at an aggregate value not exceeding 80 per cent of the value of the property.[31]

The debtor must also make reasonable efforts to obtain appropriate employment.[32] Changes in the debtor's property must be disclosed and may lead to modification of the scheme.[33]

It should be noted, however, that a scheme may take the form of a zero payment plan.[34]

The court (in the form of a justice of the peace) may ratify a scheme approved by a majority of creditors in value provided all the creditors are treated equally and no creditor can show that it would be in a better position but for the scheme.[35]

To the extent provided by a negotiated settlement ratified by a justice of the peace,[36] (including where the court ratifies a scheme based on majority creditor consent, as described above)[37] or a scheme imposed by a decision of a justice of the peace following the hearing of an application,[38] a debtor obtains discharge from his debts provided that he has complied with his obligations for a time period of three to five years, as the court may determine[39] (a creditor may seek the revival of its debt by filing an application based on non-performance of the scheme within 4 months of such default)[40] and that he has not been shown to have failed to provide honest disclosure.[41] There is no automatic discharge. Furthermore, discharge of the scheme debtor does not release co-obligors or guarantors.[42]

England & Wales[43]

Automatic discharge from bankruptcy is a relatively recent development in English law too.[44] Under the Bankruptcy Act 1914 an application had to be made to the court for discharge. The Insolvency Act 1986 introduced automatic discharge after three years.[45] With the coming into force of the Enterprise Act 2002 the three year period was further reduced in the majority of cases to one year.[46] Thus, now, the bankruptcy of an individual commences with the day on which the bankruptcy order is made and continues until the individual is discharged[47] at the end of the period of one year beginning with the date on which the bankruptcy order was made.[48]

However:

(a) That period may be shorter than one year if the official receiver files at court a notice stating that investigation of the bankrupt's conduct and affairs is either unnecessary or has been completed, in which case the bankrupt is discharged when the notice is filed.[49]

(b) That period may be lengthened by suspension of the running of the period until either (i) the end of a specified period or (ii) the fulfilment by the bankrupt of a specified condition.[50] Only the official receiver or trustee in bankruptcy may apply. The court may only suspend discharge "if satisfied that the bankrupt has failed or is failing to comply with his obligations".

(c) The official receiver may also apply for a bankruptcy restrictions order (or the bankrupt may give a bankruptcy restrictions undertaking) which is similar in effect to a suspension of discharge.[51]

Where a bankrupt is discharged he is released from his bankruptcy debts as defined.[52] His property, which will have vested in the official receiver or trustee in bankruptcy, does not re-vest in him but remains available for realisation for the benefit of creditors.

Furthermore:

(a) discharge does not affect the rights of secured creditors to enforce their security;

(b) the bankrupt is not released from debts arising in respect of:
- fraud/breach of trust;
- fines and other penalties, confiscation orders (in criminal and similar proceedings);
- certain damages claims (e.g. for negligence for personal injury);
- certain claims arising from orders made in family proceedings[53];
- liability for student loans [54];
- a debt incurred or arising after the making of the bankruptcy order.[55]

Bankruptcy debts are defined by s.382 IA 1986 and, broadly, include:

(a) any debt or liability to which the bankrupt was subject at the commencement of the bankruptcy;

(b) any similar debt or liability to which he becomes subject after commencement as a result of a liability arising before commencement;

(c) liability arising out of tort;

(d) interest.

Such liability may generally be actual or contingent.

Where a bankrupt is discharged he is also released from the other disqualifications and restrictions to which he is subject, notably:

- inability to act as a company director without permission of the court;
- inability to hold certain public offices;
- inability to obtain credit for more than GBP 250 without revealing his status as a bankrupt;
- inability to trade under a different name.

Whilst the bankrupt must deliver up his assets for realisation by his trustee and may be required to make payments out of his surplus income, discharge is not dependent on the bankrupt making any contribution towards the costs of the bankruptcy or the claims of creditors. The bankrupt is not obliged to engage in employment or even to seek employment, although if he does, his trustee may apply for an income payments order or seek an income payments agreement out of surplus income.[56]

A discharged bankrupt may apply to court for a certificate of discharge.[57]

There are a number of other ways in which a debtor may obtain a release from his debts.

First he may enter into a deed of arrangement under the Deeds of Arrangement Act 1914. A deed of arrangement is a contract between the debtor and his creditors, usually taking the form of a composition for his debts or an assignment of property to a trustee for the benefit of creditors. It requires the consent of a majority of creditors in number and value. The time at and manner in which the debtor is discharged from his obligations depends on the terms of the deed. The procedure is now very old fashioned and is almost never used.

Where the amount of the indebtedness and available assets is modest, a debtor may apply for a debt relief order under Part 7A Insolvency Act 1986.[58] A debt relief order is not made by the court but by the official receiver.

The debtor:

- must have qualifying debts of GBP 15,000 or less;
- must have assets or savings worth GBP 300 or less (but may have a vehicle worth up to GBP 1,000);
- must have available income of GBP 50 or less after paying normal household expenditure.

The order creates a moratorium. The process usually lasts for a year, during which period creditors are prevented from taking action against the debtor. At the end of the year the debtor is free of his qualifying debts.[59]

Clearly it has very limited application, designed as it is for debtors with limited debts and of limited means. Creditors have often complained that the debt relief system is abused and poorly monitored.

A debtor may propose to his creditors an individual voluntary arrangement under Pt VIII Insolvency Act 1986 (ss.252–263G) which may take the form of a composition for his debts or a scheme of arrangement of his affairs. He may do so using an out-of-court procedure, or, if he requires a moratorium, through the court by applying for an interim order, which stays proceedings and execution until a meeting of creditors has been held to consider the proposal.

An insolvency practitioner (the nominee) must consent to act and report that the debtor's proposal is fair and viable and is capable of implementation so that a meeting of creditors should be summoned to consider the proposal.

At the meeting of creditors the creditors may vote to accept the proposal with or without modifications. A majority in value of 75 per cent is required to obtain approval. A supervisor (usually the same person as the nominee) is then appointed to oversee implementation.

Provided the debtor keeps to the terms of his statutorily binding contract with his creditors, he is released from his debts on the contractual terms.

There is no prescribed minimum period after which the debtor is discharged from his obligations. As in the case of deeds of arrangement it will depend on what the debtor offers and what the creditors accept. An income based IVA, however, commonly runs for five years.[60]

Finally, a debtor may obtain discharge from his debts by informal means, for example by simple agreement or through debt management plans or similar arrangements. The disadvantage of such means is their informality and consequential difficulty in their enforcement.

Netherlands

Bankruptcy in the Netherlands is governed by the Bankruptcy Act (*Faillissementswet*) 1896 (Fw), as amended from time to time. The law provides for three types of proceedings:

(a) bankruptcy (*faillissement*), which applies to companies, other legal entities (such as foundations and associations), commercial partnerships and natural persons, in which the debtor's assets, including after-acquired assets, are realised to pay the creditors' claims;

(b) suspension of payments (*surséance van betaling*), a procedure available to most companies and legal entities as well as to natural persons carrying out a business or practising an independent profession, which gives the debtor temporary protection from the claims of creditors in order to reorganise and continue its business, and ultimately to satisfy creditors' claims in whole or in part; and

(c) a debt rescheduling scheme (*schuldsanering*) in which the debtor's assets are liquidated for the benefit of his creditors in addition to which the debtor must generate funds to repay his creditors in a period of three years, the aim being to give the debtor a "fresh start"; this procedure is available only to natural persons.

The procedures outlined in (a) and (b) above do not automatically lead to a release of the debtor's indebtedness. *Fallissement* does not lead to automatic discharge from debt. The matters that follow therefore concentrate on discharge arising from *schuldsanering*.

In order to achieve discharge from the debts of creditors a debtor must:

(a) establish that he is unable to pay his debts;
(b) demonstrate that he has attempted and failed to reach an out-of-court settlment with his creditors;
(c) prove that his debts have not been incurred in the last five years as a result of fraud, crime or irresponsible conduct;
(d) confirm that he has not engaged in a debt restructring procedure in the last 10 years;
(e) demonstrate his willingness (as opposed to ability: thus unemployment does not count against the debtor) to fulfil the demands of the debt restructuring procedure and provide both the court and trustee with the necessary information.

The foregoing requirements for admission to the process are set out in articles 284–294 of the Fw.

A "code of conduct" governing the procedure is set out in arts 295–331 Fw. The debtor must create no new debts, which means:

- not incurring arrears in fixed costs, such as rent, electricity and water;
- not allowing his bank account to become overdrawn;
- not allowing his obligations under the procedure to fall into arrears.

He is obliged to engage in work, to provide information as to his affairs, to surrender his surplus income (i.e. income above such amount as the trustee rules to be necessary for his daily needs).

The consequences and duration of the rescheduling are fixed by articles 349a—358 Fw. The procedure has a standard duration of three years, but that period can be extended by two years where the statutory provisions are not met by the debtor.

For as long as the process lasts:

- the estate is deemed to be in a state of insolvency and is available for liquidation;
- the debtor is deprived of his legal capacity to act;
- his debts are frozen;
- any attachment of his assets or income ceases to be valid and any execution is stayed;
- creditors are prevented from claiming interest after the opening of the procedure.

The procedure comes to an end by either "normal closure", which occurs at the end of the period subject to compliance by the debtor with his obligations, or by "simplified closure" where it is proved impossible for the debtor to fulfil his obligations in which case the court may bring the procedure to a close. The court may also order early closure where all the debts are paid sooner than expected or where the debtor himself frustrates the procedure.

Where the procedure ends with normal closure after three to five years or simplified closure, the debtor is released from his debts so he can start with a clean slate. Any unsatisfied debts are no longer enforceable. "Natural obligation" is all that remains, which in effect means that the debts still exist; they cannot be enforced, but there is no bar to their being paid.

Poland

Consumer insolvency was introduced in Poland as a result of insolvency reform in 2009.[61] Over 1 million people are estimated to be insolvent, although in 2012 only 50 orders were made opening insolvency proceedings. The aim of the 2009 bankruptcy reforms was to protect creditors' interests by ensuring that their claims are satisfied, even if only in part, and to provide debt relief for insolvent individuals.

The bankruptcy of individuals is now regulated by a special chapter of the Corporate Insolvency and Restructuring Act (arts 491(1) and 491(12)). The following categories of individuals are covered by the legislation: individuals who have not been self-employed for at least 1 year before the commencement of the proceeding and who are not engaged in business activity (even without registration) and members of a partnership.

Only the debtor may apply for insolvency, but he is not obliged to do so. Consumer insolvency can be declared only if the individual is insolvent due to circumstances beyond his control, for example as a result of the loss of his job by reason of termination of his employment contract without his consent, or as a result of illness or family circumstances. The debtor may only apply for insolvency once every 10 years. A debtor may not apply for bankruptcy where, inter alia, during the preceding 10 years insolvency proceedings have been brought against him in his capacity as a trader. Furthermore, a debtor may not apply for bankruptcy where his actions in the preceding 10 year period qualify as detrimental to his creditors (*actio Pauliana*).

The court in the district where the debtor resides has the jurisdiction to open the proceedings.

The debtor is obliged to disclose and deliver up all his assets to the insolvency practitioner appointed by the court. The most significant aspect of that obligation is the obligation on the part of the debtor to give up his flat or house which the insolvency practitioner is obliged to sell.[62] The court will give the debtor a sum out of the proceeds of sale to cover the costs of accommodation for a period of 12 months.

After the debtor has given up possession of his property, a plan is prepared for the repayment of creditors, and the court determines the period (which must not be longer than five years) for repayment of unsatisfied claims and decides what proportion of the total indebtedness should be written off.

The debtor has a number of obligations: first, to make payments in accordance with the plan determined by the court, secondly, to send a report to the court by April 30, each year as to his performance under the repayment plan and, thirdly, not to act outside the limits of the ordinary management of his affairs. If the debtor fails to comply with his obligations, the court will discontinue the bankruptcy proceedings. However, if the debtor fulfils his obligations, the court will decide the extent to which the debtor should be released from his remaining obligations and to terminate the proceedings.

A group of experts working under the auspices of the Ministry of Justice has made recommendations regarding a new insolvency law, one of the most important elements of which is new proposals for dealing with consumer insolvency (bankruptcy). A feature of the proposals is that the civil courts (as opposed to the insolvency courts) should take jurisdiction. The advantage would be to improve access to the courts and thus to information about debt relief as well as to the forms enabling a debtor to apply for relief.[63]

Under the recommendation every debtor would have the right (subject to the decision of the court) to discharge from his debts provided that the debtor's insolvency has not arisen as a result of fault (intentional wrongdoing) or gross negligence. The second condition would be that the debtor has not repaid any debts for at least three months. The court would be obliged to find that the debtor is unable to pay his debts (as opposed simply to being unwilling to do so).

The form which the debtor would have to complete would be very straightforward. The court would be obliged to check the information provided by the debtor against the records of the tax office and to check whether the debtor was a shareholder or director of an insolvent company.

The state should meet the debtor's costs of his application which would later be recovered from the debtor under the repayment plan approved by the court. If the debtor failed to meet his obligations under the plan, he would be prohibited from accessing the procedure again for 10 years.

The court would again determine the time for repayment, but under the new proposals a period of 36 months is envisaged. If, viewed objectively, the debtor is unable to repay within this period, the court would be able to grant an extension of up to 18 months. The debtor would be able to remain in his property if settlement with his creditors can be achieved without the need for it to be sold. The proposals also envisage a bar to creditors bringing enforcement proceedings against the debtor provided he complies with the obligations set out in his repayment plan. The proposals also envisage partial repayment to creditors with the balance of the debtor's indebtedness being written off so that the debtor is discharged from any further obligation to his creditors.

The cost of the procedure would be less than at present because the bankruptcy order would be not be gazetted in the *Monitor Sadowy* but only published online. The costs would thus be limited to the court fee (EUR 10), the insolvency practitioner's fees and the costs and expenses of the bankruptcy administration.

The typical debtor should be able to find and understand the relevant law fairly easily as it would be contained in one short legal Act consisting of only 20 articles. Of importance, though, would be the need to set up advice centres to advise debtors and assist them in preparing the bankruptcy application and providing the financial and psychological support with a view to helping debtors to learn how to manage their affairs in the future.[64]

Conclusions

The various legal systems examined above display a considerable diversity of approach to the question of the extent to which and manner by which a debtor may be discharged from his obligations to his creditors and achieve a release from his liabilities to them. Nonetheless, it is submitted that elements of convergence can be discerned (especially in the light of recent reforms with a greater emphasis on debtor rehabilitation) and that a common core of values can be identified, on the basis of which certain minimum standards for debt discharge can be posited.

First, it is common ground in all the legal systems examined that an individual debtor (whether a trading or consumer debtor) who is insolvent[65] ought to have access to an insolvency remedy or similar remedy that achieves the broad aims of discharge and debt release.

The relevant law should allow for the possibility of discharge and release from the bulk of the debtor's indebtedness but there should be a "margin of appreciation" as to:

(a) the discharge period (although three years would appear to be a developing common norm)

(b) whether discharge ought to be automatic or granted only on application

(c) the indebtedness that should be released by discharge[66]

If discharge is automatic, there should be safeguards enabling the trustee or a creditor or creditors to apply for discharge to be suspended.

Discharge should depend on and be conditional on full co-operation on the part of the debtor, which should include:

(a) full and frank disclosure regarding and delivery up of his assets for realisation for the benefit of his creditors;
(b) full and frank disclosure of antecedent transactions that may be susceptible of attack; and
(c) where appropriate, the debtor making a contribution to the claims of creditors out of surplus income (as defined by the local law in the light of the economic circumstances applicable to the relevant jurisdiction).

Discharge should release the debtor not only from his bankruptcy debts (as defined) but from any other civil restraints imposed as a result of the opening of insolvency proceedings, with a view to giving the debtor a fresh start.

The detail as to the balance between giving the debtor the fresh start that a modern society requires and fairness to the legitimate expectations of creditors may well, it is accepted, be something that can be resolved only by reference to the requirements of the economic circumstances of the individual jurisdictions.

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[1] The workshop was led by Prof. Dr. Heinz Vallender of Cologne; the members were Hildegard Allemand, Allemand & Kemperdick (Cologne), Dr Stephen Baister, chief bankruptcy registrar of the High Court of Justice (London), Pawel Kuglarz, Wolf Theiss (Warsaw), Hans Mathijsen, Willems Advocaten & Rechtsanwälte NV (Amsterdam), Barry O'Neill, Eugene F Collins (Dublin) and Stathis Potamitis, Potamitisvekris (Athens).

[2] Of particular concern to German and Irish creditors, given the recent numbers of German and Irish debtors seeking the protection of the English & Welsh courts and in some cases the courts of Northern Ireland. However, the problem of "bankruptcy tourism" may be overstated. Informal figures maintained by the Insolvency Service in London for 2012 indicate that only 217 debtors appear to have moved their centre of main interests for the purpose of entering bankruptcy in England & Wales. Of those 134 appear to have originated from Germany, 35 from Ireland and 48 from other countries. Only five were annulled.

[3] See Ch.4 of David Graeber, *Debt—The First 5,000 Years* (New York, 2011) for a detailed discussion of the topic. For an analysis of the ethics associated with bankruptcy and the concept of discharge see Jukka Kilpi, *The Ethics of Bankruptcy* (London, 1998).

[4] Michael Hudson, *The Lost Tradition of Biblical Debt Cancellations* (research paper presented at the Henry George School of Social Science, 1992); see also Michael Hudson, *Reconstructing the Origins of Interest-Bearing Debt and the Logic of Clean Slates in Debt and Economic Renewal in the Ancient Near East* (Bethesda, 2002).

[5] Deuteronomy, Ch.15 vv. 1-2. Note that v.3 makes clear that the release did not extend to a foreigner. Persons held in debt bondage were also freed, and family land was returned to its original owners, although this occurred only every 49 or 50 years (Leviticus, Ch.25).

[6] The Lord's Prayer, Matthew, Ch.6 v.12: the Greek Κοινη and Latin Vulgate both use the word for "debt"; its replacement by "sins" or "trespasses" in some languages was a later gloss.

[7] As will be apparent from what follows, the term discharge in this article generally means release from a debtor's bankruptcy debts rather than discharge in the sense used in English law.

[8] Of immediate relevance to the bankruptcy tourism phenomenon, but note the reforms discussed below in countries where this does not appear to be or to have been a problem.

[9] § 305 Absatz 1 Nr. 1 InsO.

[10] §§ 305 Absatz 1 Nr 2, 287 InsO.

[11] § 305 Absatz 1 Nr 4.

[12] § 309 InsO.

[13] § 304 InsO.

[14] § 290 InsO.

[15] Cf. an income payments order or agreement under the Insolvency Act 1986.

[16] § 296 InsO.

[17] As to the background to the reforms see Joseph Spooner, "Sympathy for the debtor? The modernisation of Irish Personal Insolvency Law", (2012) 25(7) *Insolvency Intelligence* 97–101.

[18] Before the economic crisis of 2008, there were fewer than ten bankruptcies per year. Since 2008, there has been an increase, but the numbers remain remarkably small.

[19] Section 85 Bankruptcy Act 1988 as amended.

[20] Section 85A Bankruptcy Act 1988, as amended.

[21] Section 85B Bankruptcy Act 1988, as amended.

[22] Section 85D Bankruptcy Act 1988, as amended.

[23] Law 3588/2007 as amended most recently by law 4161/2013, which also introduced relief measures for debtors who have not defaulted but have experienced a substantial decline to their income due to the current crisis.

[24] Law 3869/2010, as amended.

[25] Law 3869/2010 as amended, art.1 para.1. Apparently reckless behaviour does not deprive the debtor from access to the settlement proceeding, see Iakovos Venieris and Theodoros Katsas, *Efarmoge tou Nomou 3869/2010 gia ta Yperchreomena Physika Prosopa*, p.68.

[26] Law 3869/2010 as amended, art.1 para.2.

[27] This is the view of Professor Evangelos Perakis, in his recently revised *Insolvency Law* (Nomiki Vivliothiki, 2nd edition, 2012), pp.474–5.

[28] Law 3869/2010 as amended, art.2, para.2.

[29] Law 3869/2010 as amended, art.10, para.1.

[30] Law 3869/2010 as amended, art.8, para.2.

[31] Law 3869/2010 as amended, art.9, para.2 (as amended by virtue of art.17 para 1 &2 L. 4161/2013) reduced the maximum value to 80 per cent of the market value while allowing for the possibility of paying off that value over a period extending beyond the 20 year period initially provided, in particular, where the original debt's period was longer than for the same duration but not in excess of 35 years.

[32] Law 3869/2010 as amended, art. 8, para.3.

[33] Law 3869/2010 as amended, art.8 para.4.

[34] Law 3869/2010 as amended, art.8 para.5.

[35] Law 3869/2010 as amended, art.7 para.3.

[36] Law 3869/2010 as amended, art.2 para.1.

[37] Law 3869/2010 as amended, art.7 paras 2 and 3;

[38] Law 3869/2010, art.11 para.1, as amended.

[39] Law 3869/2010, as amended, art.8 para.2. The court would take into account the overall arrangement amount and the debtor's ability to make monthly payments (as the overall amount is expected to be paid off in equal monthly installments).

[40] Law 3869/2010, art.11 para.2.

[41] Law 3869/2010, art.10 para.1; a creditor can overturn a ratified scheme at the latest within two years from the date of discharge.

[42] Law 3869/2010, art.12.

[43] Readers are reminded that the legal system of Scotland differs significantly from that which applies in the remainder of the United Kingdom. The legal system governing the bankruptcy of individuals in Northern Ireland is substantially similar to that of England & Wales but is governed by the Insolvency (Northern Ireland) Order 1989.

[44] On the development of discharge in bankruptcy in the law of England and Wales generally see Dr John Tribe, Discharge in bankruptcy: an examination of personal insolvency's fresh start function, (article in three parts) (2012) 25(7) *Insolvency Intelligence* 108–111, 25(8) *Insolvency Intelligence* 117–120 and (2013) *Insolvency Intelligence* 26(1) 1–7. For the recent historical and economic background see Paolo Di Martino, *Law, class and entrepreneurship: bankruptcy and debt discharge in England and Wales, c. 1890-1939*, Manchester Papers in Economic and Social History (No. 64, April 2008).

[45] The concept of automatic discharge was first introduced by the Insolvency Act 1976, but only after five years and in limited circumstances.

[46] A counterbalance to the liberal discharge provisions was provided in the form of the introduction of so-called bankruptcy restrictions orders or undertakings, which could be imposed on a debtor for a period of between 2–15 years (s.281A and Sch. 4A Insolvency Act 1986).

[47] Section 278 Insolvency Act 1986.

[48] Section 279(1) IA 1986.

[49] Section 279(2) IA 1986; see also rule 6.214A Insolvency Rules 1986). This extremely liberal provision, which was introduced by the Enterprise Act 2002, could and did in the past result in discharge after as little as three months. It rapidly came into disrepute and is now rarely used.

[50] Section 279(3) IA 1986.

[51] Section 281A and Sch. 4A IA 1986.

[52] Section 281(1) IA 1986.
[53] Section 281(2)–(8).
[54] Section 42 Higher Education Act 2004.
[55] Section 382(1) IA 1986.
[56] Sections 310 and 310A IA 1986.
[57] Rule 6.220 Insolvency Rules 1986.
[58] Sections 251A–251X.
[59] Section 251I IA 1986.
[60] Thus providing the creditors with more than they would get on the basis of an income payment order or agreement in bankruptcy, which would run for a maximum of three years.
[61] Insolvency in Poland is governed by the Insolvency and Reconstruction Law of 2003 (Prawo upadłosciowe i naprawcze, Dz.U. 2003 nr 60 poz. 535).
[62] Outside insolvency proceedings the bailiff may evict, but the powers are more limited.
[63] There are 242 civil courts but only 46 insolvency courts in Poland. Access is also easier from the geographical point of view. Under the recommendation, the number of insolvency court would be reduced to 16.
[64] Cf. the Schuldberatungsstellen in Austria and Germany.
[65] In the sense of being unable to pay his debts as and when they fall due.
[66] Which could be subject to local policy considerations, especially as regards, for example, tax and matrimonial indebtedness.

An Old Measure With Sharpened Teeth. Insolvency Practitioners and Directors Beware of Personal Liability Notices

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Corporate insolvency; Directors' liabilities; Insolvency practitioners; National insurance contributions; PAYE

It is common for many businesses (whether insolvent or not) to have significant unpaid PAYE and National Insurance Contributions (NIC) arrears by the time Administrators or Liquidators are appointed or during a current trading financial period.

Although not a well known fact, directors and other officers of a company can be held personally liable for the payment of sums due to HM Revenue & Customs (HMRC). This effectively removes the protection otherwise afforded by incorporation. This frightening reality is contained in s.121C of the Social Security Administration Act 1992 (SSAA 1992) which allows HMRC to recover unpaid NIC (plus any interest and penalties) from the directors or other officers by issuing a Personal Liability Notice (PLN). This statute should be discussed with all directors when advising as to the solvency or otherwise of the Company and the implications of entering into Liquidation, Administration or any other Insolvency process. In simple terms, if you are advising a director and/or a company prior to entering into insolvency and advising on the best route available for the Company and/or Creditors and/or Directors then if there is unpaid NIC, personal liability could arise for those directors and officers.

History of the Provision

The current legislation introduces nothing new. Some readers will recall s.152(4) Social Security Act 1975 which provided that where a company failed to pay NIC, the directors of that company could be pursued for unpaid contributions. This provision was repealed by s.235(3) sch.10 Insolvency Act 1985 because it was thought at the time that officers of genuinely failed companies were being unfairly caught by the provisions. The provision then reappeared in 1998 when s.64 Social Security Act 1998 inserted s.121C into the SSAA 1992. This legislation is effective from April 6, 1999.

Outline of the Provision

A company has a statutory obligation to pay the PAYE and NIC to HMRC within 14 days of the end of the month in which the deductions were made in respect of employment income paid to its employees. If correct amounts of NIC are not paid then s.121C SSAA provides HMRC with the powers to recover unpaid NIC from the directors or other officers of the company by issuing a PLN against them.

Pursuant to s.121C SSAA 1992 HMRC may issue a PLN where:

1. a body corporate has failed to pay the contributions due at or within the prescribed time; and
2. that failure is in the opinion of HMRC, attributable to the fraud or neglect of one or more individuals who at the time were "officers" of the company. Such officers are known as "culpable officers".

The legislation defines "officer" as a director, manager, secretary or other similar officer of the company or any person purporting to act as such (including shadow & de facto directors). The legislation refers to "individuals" and not "persons" so it is thought that a corporate entity (such as a corporate company secretary) would appear to be outside the scope of this provision.[1]

Purpose of the legislation

According to its own guidance, HMRC claims the purpose of the legislation is to provide HMRC with a time and cost effective action to tackle abuse of the National Insurance system, and to act as a deterrent to the future abuses and losses to the National Insurance Fund.[2] During the House of Lords debate on the introduction of the legislation, speaking on behalf of the Government Lord Haskel stated that the aims of the legislation were to:

> " Recoup monies owing to the National Insurance Fund from which contributory benefits must be paid and, by showing that the Government mean business, to deter further thefts from the fund—for that is what they are ".

Notwithstanding this, due to the penal nature of these provisions, when they were being enacted the Government and HMRC provided assurances and undertakings that the application of the legislation would be limited. As such, in practice, and in order to protect officers of genuinely failed companies and those regarded to have taken all reasonable steps to minimise the company NIC debt, a PLN will only be issued where HMRC believes that the failure to pay the NIC was attributable to "fraud" or what is considered to be "more serious levels of neglect".[3]

Generally HMRC may consider a case to involve "more serious neglect" where it can be established that there was a persistent failure to pay NIC whilst making significant and/or regular payments to other creditors, connected persons or companies or in the form of directors salaries. A case may also be adjudged to involve more serious levels of neglect where "culpable officers" have been associated with previous companies that have demonstrated a failure to comply with their statutory tax obligations ("phoenix companies"). This is discussed in more detail below.

Procedure and investigation

Prior to a decision being made by HMRC to issue a PLN, an enquiry will be undertaken to establish the facts and circumstances behind the company failure to pay NIC. Responsibility for PLNs currently rests with a small national team within the HMRC Specialist Investigations, based in London. The team carries out all enquires and investigations. HMRC claims the PLN team follow clear and robust internal guidelines and procedures to ensure that the legislation is applied fairly, consistently and appropriately. A thorough enquiry will include a review of the available company books and records and inviting voluntary representations from the directors or other officers of the company.[4] This is a vital stage of the process and an opportunity for the directors to make competent representations as appropriate.

The duration of the PLN process starting from HMRC's initial enquiry letter to the actual issuing of the PLN varies on a case by case basis. Upon consideration of the previous cases and from our experience, it is apparent that the whole process can take up to two years depending how much investigation work is required.

The purpose of a PLN enquiry is to establish if there is sufficient evidence for HMRC to show "on the balance of probabilities" that the failure to pay the contributions due was attributable to the negligent or fraudulent conduct of one or more officers of the company.

In its guidance, HMRC recognises that it is important that directors of genuinely failed businesses are protected and as such, a thorough and rigorous enquiry is always carried out to prove fraudulent intent or negligent conduct.[5] The burden is on HMRC to establish that the officers have acted fraudulently or have been "seriously" negligent. We are of the opinion HMRC have to prove serious neglect not just neglect. The devil is in the detail and can be the difference between a withdrawal of a PLN or the issue of one.

Neglect is not defined in the legislation and as such, HMRC look to case law for its generally accepted meaning. HMRC often refer to the case of *Blyth v Birmingham Waterworks Co*[6] and the objective test of negligence laid down in that case:

> "Negligence is the omission to do something which a reasonable man, guided upon those considerations which ordinarily regulate the conduct of human affairs, would do, or doing something which a prudent and reasonable man would not do".

Notwithstanding HMRC's repeated references in its guidance to the objective test of negligence, the courts have recently held (rejecting the arguments of HMRC) that the test is not objective but rather subjective and that the mens rea of the individuals concerned forms an essential ingredient of assessing liability. The tribunal further held that the provisions should be construed as criminal rather than civil. As a result, the common law presumption applied, that conviction under a criminal provision generally requires mens rea (a guilty mind) even if that statute is silent on that point.[7] Accordingly, the burden is on HMRC to satisfy the subjective test as to the officer's state of mind.

Phoenix Companies

The legislation will often be applied to phoenix companies (the practice where directors carry on the same business or trade successively though a series of two or more companies which appear to be new trading vehicles for directors of previously failed businesses). HMRC is of the opinion that this practice of phoenixism goes some way to proving "more serious levels of neglect".

However, the legislation is in no way restricted to this circumstance. The first two reported cases (in which HMRC was successful) did *not* involve phoenix companies, *Inzani v HMRC*[8] and *Livingstone v HMRC*.[9]

Furthermore, the legislation does not restrict the issue of a PLN to liquidated companies. They may also be issued in respect of a current company where it is considered that the officer's previous record poses a risk to payment of outstanding NIC.

The PLN

If the decision is made to issue a PLN, the notice itself will specify the amount of NIC that has not been paid plus any interest and penalties chargeable on the contributions and require the individual to pay the amount at the prescribed date. Where there is more than one culpable officer, the PLN will specify the proportion of the total amount that is due from each individual officer, having taking into account the culpability of each of them.

Appeals

Section 121D SSAA 1992 allows for an individual served with a PLN to appeal the issue of the notice only on the grounds that are specified under paragraph (2) of that section. The specific grounds for appeal against the issue of a PLN are:

- All or part of the NIC specified in the PLN should not have been included;
- The failure to pay the NIC due was not the result of fraud or neglect on the part of that individual;
- The individual issued with the PLN was not an officer of the company at the time of the fraudulent or negligent failure to pay; and/or
- The level of the apportionment of the debt to the named individual was unreasonable.

If the individual disagrees with the decision of HMRC to issue a PLN they have 30 days from the date of the PLN to make an appeal to HMRC. The appeal must be made in writing and must state the ground(s) under s.121D(2) that the appeal is being made. If, following the initial appeal to HMRC, agreement cannot be reached then, providing the individual has been given the opportunity of requesting an internal review, an appeal can be made direct to the Tribunals service.[10] Any further appeal lies in the Court of Appeal.

The majority of the reported cases have been appeals on the ground that the failure to pay was not attributable to any fraud or neglect on the part of the officer concerned.

Overview of the relevant case law

In order to gain an understanding of the circumstances in which HMRC will invoke this oppressive power to transfer personal liability for unpaid NIC to officers of a company, it is necessary to look at some of the recent cases which have all involved an officer's appeal against a PLN.

Christine Roberts v HMRC[11]

The appellant director appealed against a PLN which was issued in respect of unpaid NIC by her company, which was in administration. The company had traded for 11 months without making payments of PAYE or NIC to HMRC even though appropriate deductions had been made from employees' pay. HMRC found that the failure was attributable to neglect by the directors and, pursuant to s.121C apportioned the amount owing equally between them. The appellant disagreed that she was guilty of neglect on the basis that she had acted on advice from the company's financial advisors and because HMRC had not contacted the company when they first became aware of the underpayments.

The appeal was dismissed. The company, through its directors, had a statutory duty to remit monthly NIC to HMRC, irrespective of any financial difficulties. The appellant and her fellow directors had been aware of that obligation and had failed to discharge it.

The main factors considered were:

- On the evidence, the company was in receipt of regular payments from its funder and the company's bank account had been significantly in credit and it had made significant payments for the benefit of connected companies. That created an irresistible inference that the company, through its directors, had deliberately withheld payments to HMRC in favour of funding its connected companies[12] and funded the business of the company with money which ought to have been remitted to HMRC to meet its statutory obligations.
- There was no evidence that the company had attempted to contact HMRC to discuss underpayments and make arrangements.[13] This argument is often used by HMRC to show that the officers in question failed to act in a manner that a reasonable and prudent person would have acted. As such, it is inferred from this that any evidence that the company contacted HMRC to attempt to agree a Time to Pay arrangement (TTP) can form part of a defence to a PLN.
- No payments of PAYE or NIC were made from the start of trading to liquidation.
- It is not a defence for a company's officer to argue that they acted on the advice on the company's advisors or financiers not to make payment to HMRC. It was held that the statutory obligation on officers to ensure that the company met its obligations was not one which could be delegated and therefore even if such advice had been tendered, this would not absolve the officer of responsibility.[14]
- The appellant had been associated with at least two other failed companies.

John Peter Smith v HMRC[15]

The appellant director appealed against HMRC's decision to issue a PLN against him in respect of unpaid NIC by his company, which was in liquidation. The appellant had been the director of two companies which had gone into administration owing substantial amounts in respect of PAYE and NIC. Between commencing and ceasing to trade, the company had only made one payment to HMRC in respect of PAYE and NIC, despite deducting those payments from its employees' wages on a monthly basis. A PLN was issued against the appellant.

Again this appeal was dismissed. As a signatory on the company's bank account and the only authorised user of the internet banking facility, the appellant would have signed all cheques for employees' wages or authorised their payment through the internet facility. Accordingly, he would have been aware that only one payment had ever been made to HMRC in respect of NIC and PAYE.

The tribunal took into account the following matters:

- Again, there had been no attempt on the part of the appellant to contact HMRC to negotiate a TTP arrangement.[16]
- Given that the appellant had been a director of two other companies which had both gone into administration owing substantial amounts in respect of PAYE and NIC, he would have known that employers were required to account monthly for those payments and he should have been particularly alert to that requirement. Furthermore, the board minutes of the company clearly evidenced that the appellant had taken advice in order to undertake a further phoenix operation with a view to him incorporating yet another company free from the liabilities to HMRC.[17]
- The fact that the company had delegated the day-to-day operation of certain finance functions to the financial controller did not lessen the directors' responsibilities. Directors were required to supervise the operation of the accounting functions and to ensure that they were properly undertaken. The fact that the financial controller might have been incompetent was no excuse because the responsibility for ensuring that the company was properly managed, including monitoring its cash flow and liquidity, remained with the directors.[18]

Livingstone v HMRC[19]

The appellant, who was the sole director of a company, appealed against a PLN. Although the company continued to deduct PAYE and NIC from its employees' wages, it made no payments of PAYE or NIC for 17 months before its liquidation. HMRC requested payment and warned of proceedings. The company's assets were then sold, which allowed it to pay off a bank overdraft, but the remaining funds were insufficient to meet the sums due to the company's creditors. Nevertheless, the appellant made payments to himself and another company in which he was also a director, as well as payments to other companies. The appellant submitted that the failure to pay was not attributable to any neglect on his part as he had been operating a policy where creditors were only paid when they applied sufficient pressure and the company had to settle in order to continue to trade, but HMRC had not exerted pressure.

The appeal was dismissed.

- At no time did the appellant approach HMRC to try to come to a TTP arrangement; and when funds did become available from the sale of the business, he still made no payment to the HMRC but made payments to himself and to connected companies.
- HMRC's alleged failure to pressure the company could not constitute grounds for excusing a director from his duty to pay NIC on a regular basis, even when the company was in financial difficulty.
- Section 121D(4) SSAA 1992 declares that on an appeal, the burden of proof as to any matter raised by a ground of appeal shall be on HMRC. HMRC had discharged that initial burden because it had shown on the balance of probabilities that the company's failure to pay was due to the appellant's neglect: he accepted that he had been aware of the failure to pay and that the responsibility for making or withholding payments rested with him.

Conclusion

PLNs are still relatively unused weapons in the armoury of HMRC and this is most likely as a result of the assurances of limited application given by HMRC and Parliament during debates on the introduction of the legislation. However, all practitioners should be aware that the wording of the legislation is much broader than this and as such, there is scope for the legislation to become more widely applied which it will be and bearing in mind most companies (especially those entering Liquidation) will have NIC debt, clear consideration of the risk of PLNs must be given.

[1] Peter Arrowsmith FCA, National Insurance Consultancy—Personal Liability Notices.
[2] HMRC National Insurance Manual (NIM) 12201—Class 1: Personal Liability Notices: Introduction.
[3] HMRC NIM 12206—Class 1: PLN—Considering issue of a PLN.
[4] HMRC NIM 12206—Class 1: PLN—Considering issue of a PLN.
[5] HMRC NIM 12206—Class 1: PLN: Considering issue of a PLN
[6] *Blyth v Birmingham Waterworks Co* (1856) 11 Ex Ch 781.
[7] *O'Rorke v HMRC* [2011] UKFTT 839 (TC); [2012] S.F.T.D. 553.
[8] *Inzani v HMRC* [2006] STC SCD 279
[9] *Livingstone v HMRC* [2010] UKFTT 56 (TC)
[10] HMRC NIM 12213—Class 1: PLN: Appeals.
[11] *Christine Roberts v HMRC* [2012] UKFTT 308 (TC).
[12] *Christine Roberts v HMRC* [2012] UKFTT 308 (TC) paras 38-42.
[13] *Christine Roberts v HMRC* [2012] UKFTT 308 (TC) para.31.
[14] *Christine Roberts v HMRC* [2012] UKFTT 308 (TC) para.44.
[15] *John Peter Smith v HMRC* [2012] UKFTT 428 (TC).
[16] *John Peter Smith v HMRC* [2012] UKFTT 428 (TC) para.44.
[17] *John Peter Smith v HMRC* [2012] UKFTT 428 (TC) para.43.
[18] *John Peter Smith v HMRC* [2012] UKFTT 428 (TC) paras 46–47.
[19] *Livingstone v HMRC* [2010] UKFTT 56 (TC)

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Case Digest

Proof Positive–Supreme Court Expands Scope of Provable Contingent Liabilities

Re: The Nortel Companies and the Lehman Companies [2013] UKSC 52; [2013] 3 W.L.R. 504.

By Gabriel Moss QC*

Administration; Contingent liabilities; Contribution notices; Financial support directions; Occupational pensions; Priorities

Introduction

The Supreme Court "Pensions" Case involving Nortel and Lehman companies has been widely commented on in the context of the pensions industry and insolvency. Whilst the case is of critical importance for the conjunction of pensions law and insolvency law, it has much wider ramifications in insolvency law in connection with the proof of contingent claims.

This case note looks briefly at the pensions context and then deals with the effect of the decision on provable claims.

The Pensions Context

Under the Pensions Act 2004, the Pensions Regulator has a number of "moral hazard" powers in the case of an occupational pensions scheme. The relevant powers in this case were to deal with group company situations in which the employing company had a pension scheme but was a mere service company or was insufficiently resourced, so that in an ensuing insolvency the pension fund was left with a shortfall. The shortfall was provable by the pension trustees under s.75 of the Pensions Act 1995. However, this would still usually leave a substantial shortfall, particularly in cases of service companies and where the employer was insufficiently resourced. It was for these cases that the Pensions Regulator was given special powers under the 2004 Act.

In certain defined circumstances the Pensions Regulator could issue a financial support direction (FSD) requiring certain related companies (known as "Targets"), to provide reasonable financial support to the underfunded scheme of the service company or the insufficiently resourced employer. If the FSD were not complied with, the Regulator could issue a Contribution Notice (CN), which created a specific monetary liability payable by a Target to the pension fund trustees: ss.47-49 Pensions Act 2004.

At first instance and in the Court of Appeal it had been held that where an FSD was issued after the start of an administration (such as those of the Nortel Companies and the Lehman Companies in question) the CN liability resulting from non-compliance would rank as an expense and be payable prior to provable claims. The Supreme Court reversed the decisions below and held that whether the FSD was issued before or after the commencement of the administration, any resultant CN would be a provable claim.

It is not clear whether in fact this ruling will make pension funds any worse off. In awarding a CN and calculating its amount, the Pensions Regulator had to have regard to the financial position of the Target. The Pensions Regulator took the view that the priority of any CN awarded would influence the amount of the CN.

On the other hand, the Supreme Court ruling was experienced as a relief for administrators and the rescue culture. In the courts below, the eventual CN had been regarded as a 'necessary disbursement', with a high priority in the payment of the expenses of the administration. In fact the priority was to be higher than the priority of the administrator's remuneration itself. Although it was likely that a court would use its statutory powers to promote the administrator's remuneration ahead of a CN, administrators had still felt concerned and had been worried that the priority of CNs as expenses would damage the rescue culture.

Accordingly, this is one of the few court decisions with which all parties can feel reasonably satisfied.

Provable Claims

The Courts below had felt themselves bound by previous authorities which suggested that this type of contingent claim was not provable. In particular, there was a line of bankruptcy cases dealing with costs, in which the courts had said consistently over a long period of years that costs awarded in the case of litigation begun prior to a bankruptcy but where the costs were actually awarded after the bankruptcy, did not constitute provable debts. This result did not seem problematic for the judges, since in bankruptcy the lack of provability meant that the bankrupt would not be discharged from the claim and his litigation opponent could pursue him for the money after his discharge. The cases however did not seem to observe that this would not produce a satisfactory result in the case of liquidation, where the provisions were similar. In liquidation, and later in a distributing administration, the company would rarely have an "afterlife" and if the debt were not provable, then unless it were an expense, it would not be likely ever to be paid, barring an eventual solvency, which was very rare.

The old costs cases, in my view, seem to reflect two particular judicial attitudes. One is a vindictive approach towards bankrupts, giving little weight to the policy of giving bankrupts a 'fresh start'. The other aspect one can infer from the cases is that judges like to feel in control of what is happening, and do not like the idea of awarding costs which will only be the subject of proof and will almost never be fully paid.

It would have been open to the Supreme Court, and, in my view, even the lower courts, to regard the cost cases as anomalous and out of line with the general approach to provable debts. Once you engage in litigation there is no doubt that in some sense you have taken on a contingent liability to pay adverse costs at some stage.

As against the costs cases, an altogether more sensible approach had been taken to contingent liabilities in a tax case, *Winter v Inland Revenue Commissioners*, in *Re Sutherland (deceased)*.[1] In that case, the House of Lords held that a taxpayer which had applied for and accepted certain allowances in respect of certain ships, had undertaken a contingent liability to make certain payments in relation to the ships which were the subject matter of the allowances, in certain events.

The Nature of Contingent Liabilities

A definition of a "contingent creditor" quoted in later cases is set out in *Re William Hockley Limited*[2]:

> "A person towards whom, under an existing obligation, the company may or will become subject to a present liability on the happening of some future event or at some future date."

This left the nature of the "existing obligation" rather vague. Moreover, the need for an "existing obligation" is not clear.

A wider definition, not laying down any prior requirement of "existing obligation" was given by Buckley L.J. subsequently in the context of a dispute about standing to petition in *Stonegate Securities v Gregory*[3]:

> "…the expression 'contingent creditor' means a creditor in respect of a debt which will only become due in an event which may or may not occur…"

A wider approach was also taken by Lord Reid in the House of Lords in the Sutherland case, where he said that a contingent liability was:-

> "A liability which, by reason of something done by the person bound, would necessarily arise or come into being upon an event or events which might or might not happen." [at 249].

The Statutory Provisions

The draftsman of the Insolvency Rules 1986 appears to have approached the contingent liability problem in two different ways. Rule 13.12(1)(a) defines "debt" as "any debt or liability to which the company is subject …". In order to make this as broad as possible, r.13.12(3) states:

> "For the purposes of references in any provision of the Act or Rules about winding up to a debt or liability, it is immaterial whether the debt or liability is present or future, whether it is certain or contingent, or whether its amount is fixed or liquidated, or is capable of being ascertained by fixed rules or as a matter of opinion; and references in any such provision to owing a debt are to be made accordingly."

Rule 13.12(5) applies Rule 13.12 to a company in administration as if the references to winding up were references to administration.

This first technique could be said to be consistent with the approaches of *Stonegate Securities v Gregory*[4] in the Court of Appeal and the majority of the House of Lords in *Winter v Inland Revenue Commissioners*, in *Re Sutherland (deceased)*.[5]

The other technique used by the draftsman was to set out in Rule 13.12(1)(b) a further type of debt, namely:

> "any debt or liability to which the company may become subject after that date by reason of any obligation incurred before that date …".

The Rule 13.12(1)(b) approach appears to be based on the definition in the Hockley case.

Lord Neuberger, in the Supreme Court, giving the lead judgment, considered that one could not ignore the "obligation incurred" qualification in r.13.12(b) by relying simply on r.13.12(1)(a) read together with 13.12(3). That would leave r.13.12(1)(b) redundant. He considered therefore, following David Richards J. in *Re T&N Limited [2006]*,[6] that r.13.12(1)(a) is concerned with liabilities to which the company "is subject" at the date of the insolvency event, whereas para (b) is directed to those liabilities to which it "may become subject" subsequent to that date, and that there is no overlap between these two categories. (Lord Neuberger at para.70).

This required Lord Neuberger to consider the meaning of the rather vague expression "obligation incurred" to be found in r.13.12(1)(b). At para.74 he points out that the meaning of "obligation" depends on its context. He further points out that in many contexts "obligation" will mean the same as "liability" but that cannot be right in the present context:

> "Indeed, in the context of Rule 13.12, it must imply a more inchoate, or imprecise meaning than 'liability', as the liability is what can be proved for, whereas the obligation is the anterior source of that liability."

At para.75 he points out that where liability arises after the insolvency event as a result of a contract entered into by the debtor company beforehand, there is no difficulty. The contract is regarded as creating obligations. At para.76 he points out that in non-contract cases "the position is not necessarily so straightforward".

Lord Neuberger points out at para.76 that it is clear from Rule 13.12(4) that an obligation for this purpose can arise other than under contract. Rule 13.12(4) extends the word "liability" so as to include a number of non-contractual sources of liability, including " … any liability under an enactment…".

At para.77 Lord Neuberger points out that the mere fact that a company could become under a liability pursuant to provision in a statute in force before the insolvency event could not mean that a liability arising after the insolvency event falls within r.13.12(b). He further considers that it is:

> "dangerous to try and suggest a universally applicable formula, given the many different statutory and other liabilities and obligations which could exist".

He does however set out what I calculate to be five criteria which "at least normally" would be required:

1. The debtor company must have taken or been subject to some step of combination of steps.
2. Those steps had some legal effect (such as putting it under some legal duty or into some legal relationship), and
3. The steps or steps have resulted in the debtor company being vulnerable to the specific liability in question, and
4. There was a "real prospect" of that liability being incurred, and

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5. It would be consistent with the regime under which the liabilities imposed to conclude that the step or the combination of steps gave rise to an obligation under r.13.12(1)(b).

At paras 78-81, Lord Neuberger gained assistance from the Sutherland case. At para 82 he pointed out that the approach to contingent liabilities in Sutherland had been considered helpful into insolvency cases decided by judges experienced in the field, namely *Pennycuick J. in Re SVA Properties Limited*,[7] and David Richards J. in *Re T&N Limited*.[8]

Application to the Pension Context

Lord Neuberger then considered that his test was met by the typical pensions situation before him. On the date that the relevant Nortel and Lehman companies went into administration, each of those "Target" companies was a member of a group of companies and had been such a member for the whole of the preceding two years, being the crucial look-back period under the Pensions Act 2004, enabling each of them to become "Targets".

Lord Neuberger considered that membership of a group of companies was:

> "undoubtedly a significant relationship in terms of law: it carries with it many legal rights and obligations in revenue company and common law".

Lord Neuberger further considered that by the date the relevant companies went into administration, the Lehman Group had a service company with a pension scheme and the Nortel companies had an insufficiently resourced company with a pension scheme and that that had been the position for more than the relevant two years.

It followed that the:

> " … Target companies were precisely the type of entities that were intended to be rendered liable under the FSD regime. Given that the group in each case was in very serious financial difficulties at the time the Target companies went into administration, this point is particularly telling".

The Costs Cases

Lord Neuberger's next task was to see off the costs cases. He did not take the simpler route of dismissing them simply as an anomalous line of authorities but bravely confronted and overturned them. He set out his view at para.89:

> "… By becoming a party to legal proceedings in this jurisdiction, a person is brought within a system governed by rules of court, which carry with them the potential for being rendered legally liable for costs, subject of course to the discretion of the court."

It followed from this that post insolvency cost orders fell within the criteria for the existence of a prior obligation and were therefore provable.

Lord Neuberger had no problem in overturning the long line of costs precedents. As he said at para.90:

> "I have little concern about overruling those earlier decisions, although they are long-standing. First, the judgments are very short of any reasoning, and consist of little but assertion. Secondly they were decided at a time when the legislature in the courts were less anxious than currently for an insolvency to clear all the liabilities of a bankrupt … Thirdly, those cases are impossible to reconcile logically with the earlier case of in Re Smith, ex p. Edwards (1886) 3 Morrell 179, where, on identical facts (save it was an arbitration rather than litigation) it was held that an order for costs did give rise to a provable debt. Fourthly, the unsatisfactory nature of those decisions can be seen from the way in which the Court of Appeal sought to evade their consequence in Day v Haine [2008] ICR 1102, a case which I consider to have been rightly decided."

In particular, Lord Neuberger overturned the well-known cost cases of Glenister v Rowe.[9]

The Applicable Principle

At para.92, Lord Neuberger quoted the "basic principle of the law of insolvency" set out in the Report of the Review Committee on Insolvency Law and Practice ("The Cork Report", 1892, Cmnd 8558) at para.1289, that "every debt or liability capable of being expressed in money terms should be eligible for proof" so that "the insolvency administration should deal comprehensively with, and in one way or another discharge, all such debts and liabilities".

At para.93 Lord Neuberger pointed out the "notion" that:

> "all possible liabilities within reason should be provable helps achieve equal justice to all creditors and potential creditors in any insolvency, and, in bankruptcy proceedings, helps to ensure that the former bankrupt can in due course start afresh."

The Legal Conundrum

The difficulty of dealing with "obligation incurred" is well described in the concurring judgment of Lord Sumption. He points out at para.130:

> "The context shows it means a legal rule applying before the date when the company goes into liquidation which may, contingently on some future event, give rise to a 'debt or liability' arising after that date. But it cannot extend to every legal rule which may on any contingency have that effect. Otherwise every debt or liability would be provable irrespective of the date when it accrued, unless the law changed after the company went into liquidation. Since the scheme depends on there being a common date as of which the fund forced to be valued and distributed pari passu, that cannot be right. Some limitation must be read into sub-paragraph (b)…"

At para.131 Lord Sumption mentions the fact that a contract is regarded as creating a prior 'obligation' and states:

> "Yet when one asks what it is about a contract that qualifies it as a relevant source of obligation, the answer must be that where a subsisting contract gives rise to a contingent debt or liability, a legal relationship between the company and the creditor exists from the moment that the contract is made and before the contingency occurs".

At para.132 Lord Sumption goes on to point out that contract is not the only legal basis on which a contingent obligation may arise, since a statute may also give rise to one. He gives two examples of non-contractual prior obligations: one is the case of a debt owed under a foreign judgment and the other the obligation of a creditor arising from the statutory scheme of distribution not to seek by litigation in a foreign court a priority inconsistent with the English statutory scheme.

Comment

There is no doubt that the Supreme Court judgments are a good result for all concerned, except for the Lehman companies arguing that post administration FSDs should not give rise to either provable debts or debts which have the priority of expenses.

The approach to proof however does give rise to considerable uncertainty. By choosing the r.13.12(1)(b) route, the Supreme Court have taken their stand on a basis which contains the elusive notion of prior 'obligation'. The five criteria set out by Lord Neuberger are obviously a help but their application lacks any certainty.

The five criteria are prefaced by the phrase "at least normally", which leaves a large area of doubt at the start. When is a situation not "normal"?

The first criterion, taking a step or combination of steps, is also vague. The second criterion of "some legal effect" is likewise vague. Being "vulnerable to the specific liability in question" is a little more specific, but it relates to a vague background and context. The fourth criterion of "a real prospect of that liability being incurred" is also difficult to guage. Likewise the fifth criterion of consistency with the statutory regime under which the liability arises.

None of the five tests is in any way scientific and each requires a considerable amount of judgment to be exercised. Reasonable people (including judges) will have plenty of scope to differ.

I would have thought that a better approach would have been to rely on the combination of r.13.12(1)(a) and 13.12(3). Such an approach would simply have required the existence of a present contingent liability, freed of the difficulty of finding a prior "obligation". No such prior obligation was required in Stonegate or Sutherland. I suspect that such a test would have been much easier and simpler to apply and potentially would have covered a wider range of liabilities. The guiding principle should, as Lord Neuberger appears to have accepted, be to make every possible money claim provable. This can be done by making every possible money claim a contingent liability.

The history of the subject of proof is the story of the legislature providing ever wider criteria for proof and the courts sabotaging the Parliamentary purpose by imposing artificial and unnecessary restrictions on the width of the right to prove. This was typically the case for example in the costs cases. It seems to me that the legislature intended in r.13.12(3) to liberate the question of provability from all such undesirable restrictions by having the widest possible wording. The draftsman in my view should have had the courage of his convictions and eliminated the prior "obligation" wording in r.13.12(1)(b). Alternatively, the Supreme Court could have taken the view that contingent liabilities were covered by two different approaches and that one should not act as a break on the other. In other words, r.13.12(1)(b) should not have been allowed to cut down the breadth of r.13.12(1)(a) and (3).

[*] Gabriel Moss QC is the Chairman of the Editorial Bard of Insolvency Intelligence and appeared as leading counsel for the Lehman pension trustees in the Nortel/Lehman pensions case.

[1] *Re Sutherland (deceased)* [1963] AC 235.

[2] *Re William Hockley Limited* [1962] 1 W.L.R. 555 at 558.

[3] *Stonegate Securities v Gregory* [1980] Ch. 576 at p.579 E-F.

[4] *Stonegate Securities v Gregory* [1980] Ch. 576 at p.579 E-F.

[5] *Re Sutherland (deceased)* [1963] AC 235.

[6] *Re T&N Limited [2006]* 1 W.L.R. 1728 para.115.

[7] *Pennycuick J. in Re SVA Properties Limited* [1967] 1 W.L.R. 799 at 802D–803E.

[8] *Re T&N Limited* [2006] 1 W.L.R. 1728 at paras 48-61.

[9] *Glenister v Rowe* [2000] Ch 76 and Steele [2006] 1 W.L.R. 2380.

Readers are invited to submit contributions to *Insolvency Intelligence* by contacting the General Editor, Steven Frieze: Steven.Frieze@wardhadaway.com.

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ILA President's Column

New Priorities

Administration; Contribution notices; Defined benefit schemes; Expenses; Financial support directions; Occupational pensions; Pari passu; Priorities

Last month I reflected on a handful of recent judgments and the mixed fortunes they bestowed upon employees of insolvent companies. I briefly referred to the then imminent—and highly anticipated—judgment of the Supreme Court in the joint Nortel/Lehman Brothers appeal. When the judgment was finally handed down and the parties' press statements were released, one could have been forgiven for wondering whether it was a good or bad news day for employees, as both the Pensions Regulator and the administrators claimed victory.

The Regulator had argued in the alternative that if Financial Support Directions (FSDs) and Contribution Notices (CNs) issued after the appointment of administrators do not rank as expense claims, they must rank as provable debts. Given that the Supreme Court did not conclude that FSDs issued post-appointment are unprovable debts (thereby falling into the so-called 'black hole'), the decision could justifiably be regarded as good news for trustees—and employees—of defined benefit pension schemes.

The administrators for their part had argued that FSDs and CNs issued in such circumstances should not attract super-priority status as they are not an expense incurred as part of the administration (albeit they may be incurred during that administration). Their position was that the Regulator should not be able to enhance its position in insolvency proceedings (effectively leap-frogging ahead of most other creditors) simply by delaying issuing an FSD until after administrators had been appointed. In finding that FSDs issued post-appointment are provable debts, the Supreme Court also allowed the administrators to claim victory. In fact, the Supreme Court's decision represents a very convincing victory for officeholders, as well as general creditors who will now rank *pari passu* with FSDs rather than behind them. The potential consequences of FSDs attracting super-priority status—ahead of even the administrator's own remuneration—has been well-documented and suffice to say it could have made administration unworkable as a rescue option in cases where the pension scheme deficit outstripped realisable assets. The decision is therefore (in the words of Lord Neuberger) a "fair" one, albeit the Supreme Court did have to overturn a series of existing cases on priority to reach it.

So what of the *Lehman* and *Nortel* employees and the holes in their pension pots? It is clear that any contribution asked or demanded by the Regulator has lost the super-priority status afforded to it by the decisions of the Court of Appeal and High Court before it. That liability will now rank as an ordinary unsecured debt because the Supreme Court concluded that the debt fell within the meaning of rule 13.12(1)(b), being a debt or liability to which the company may become subject after the appointment of administrators by reason of an obligation incurred before that date. Of course, the role of the Pension Protection Fund (PPF) is to compensate scheme members on precisely this kind of event - the insolvency of their employer. The real loser in the short term therefore seems to be the PPF, which will be hoping that deficits on the scale of Nortel do not arise too often. But it is worth remembering that the scope of this judgment is not confined to FSDs and the ranking of the Pensions Regulator.

The Supreme Court's decision has narrowed the scope of expense claims. Lord Neuberger considered that a liability should only be regarded as an administration expense if it is incurred as "part of" or is otherwise connected with that administration. For example, liabilities incurred under health and safety or environmental legislation after the appointment of administrators that could just as easily have been incurred pre-appointment as they could post-appointment will now rank as provable debts (rather than expense claims). This will be the case where the obligation giving rise to the contingent liability was incurred pre-appointment as a result of an existing legal duty or relationship with a real prospect of the liability being incurred post-appointment. The issue going forward will be whether a liability which may be incurred post-appointment satisfies the three limbs of the test in order to fall within the definition of a provable debt. How this will all play out when the Court of Appeal hears the appeal in *Game* on rent as an administration expense and *Luminar/Goldacre* issues remains to be seen. We will all be hoping that the Court of Appeal provides the clarity the issue deserves.

Articles on the matters raised by the judgment will be published in future issues.

Rita Lowe
ILA President

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