

Business

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Development in the UK Corporate Residence Test?***

Jessica Kemp and Joseph Sheldrick

**Book review: *Law Firm Strategies for the 21st Century: Strategies for
Success (2nd edn)***



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Business Law International

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Business Law International, published by the Legal Practice Division of the IBA, is the leading law journal devoted to issues of relevance to the international commercial, legal and academic community.

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BLI Speedread

A brief overview of the articles in the May 2021 issue of
Business Law International

Covid-19 Business Reliefs in the United Kingdom and the Netherlands: a Comparison

Marcel Willems and Douglas Hawthorn

The Covid-19 pandemic continues to have a profound effect on our societies and on our economies. Policy-makers across the globe are providing unprecedented support to citizens, businesses and financial markets, in order to keep our economies moving and to fuel recovery. Responses differ by jurisdiction, both in the level and in the nature of the support. This article examines the responses of policy-makers in the United Kingdom and the Netherlands, with a particular focus on business support, rescue and recovery, and considers whether the support packages may unintentionally be providing harbours for unviable businesses.

Revisiting the State's Role in the Private Sector: Reflections on the EU's System of Checks and Balances in the Age of Covid-19 – Part Two

Peter Alexiadis

This is the second part of an article; the first part was published in *Business Law International* Volume 22, Number 1 (January 2021).

This second part continues the article's exploration of those areas of EU law that permit a Member State legitimately to interfere in markets, coupled with the unique set of checks and balances available under EU law that are designed to ensure that a Member State, when exercising its legitimate interests, does not do so in ways that subvert the free trade principles upon which the EU is based. The working premise of this article is that those checks and balances within the EU legal order should mean that any state of 'new normal' in the business world in the wake of Covid-19 has the potential to revert to a more old-fashioned 'normal' once economic circumstances have changed fundamentally. The political and legal challenges for forging a new balance between the state and industry, given the lack of such instruments, might be much more challenging in many other parts of the world without the web of checks and balances that exist in the very special 'federal' structure that characterises the EU.

South African Business Rescue: Evaluating the Efficacy of Alterations of Creditors' Contractual Agreements

Paul Nkoane

With the ushering in of South Africa's Companies Act 71 2008 came innovative rules with provisions that are somewhat difficult to understand. Some of the puzzling and mysterious provisions that formed part of Act 71 were corrected through the Companies Amendment Act 3 2011. The aim of this article is to explain the provisions and effects of section 136(2) of the 2008 Act and section 87 of the Amendment Act. Both these sections relate to alteration of agreements. These sections are assessed to determine when and to what extent the alteration of agreements would apply to business rescue. The article seeks to demonstrate that business rescue provisions are crafted to balance the creditors' contractual rights with the methodologies intended to realise the rehabilitation of entities in distress. Lack of clarity on how business rescue affects contracts where both the creditor's and the company's performance is outstanding is also problematic; this issue is assessed. To highlight the importance of securing creditors' rights, a brief appraisal of the British corporate rescue regime is provided. Similarly, a look at the provisions of the EU Directive (2019/1023) on how to make business rescue more efficient provides valuable lessons.

The Non-Frustration Rule after Brexit

Rojina Thapa

The United Kingdom exited the European Union on 31 January 2020. By virtue of this, the EU Takeover Directive ceased to apply in the UK, and thus there was a need to amend the existing regulatory framework on takeovers for it to operate after the UK's exit from the EU. As a result, the Code Committee of the Takeover Panel published a Public Consultation Paper proposing amendments to the Takeover Code. A Response Statement was also published by the Code Committee with final proposed amendments. Final amendments to the Takeover Code were later published in Instrument 2019/3. Likewise, the Takeovers (Amendment) (EU Exit) Regulations 2019 made the necessary amendment to the Companies Act 2006.

The Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community, which entered into force on 31 January 2020, states however that there shall be 'a transition or implementation period, which shall start on the date of entry into force of this Agreement and end on 31 December 2020'. Such transition or implementation period can be extended 'for up to 1 or 2 years', with

the decision regarding the extension needing to be taken 'before 1 July 2020'. The UK decided not to request the extension of the transition or implementation period and thus the period ended on 31 December 2020.

The first part of this article discusses the Takeover Code and the Takeover Panel. This is then followed by an examination of the rules of the Takeover Code relating to the non-frustration rule. The article then delves into the duties of directors under the company law regime and expounds the desirability of the non-frustration rule. The article concludes by stating that the amendment to the regulatory framework on takeovers does not bring about a substantial change to the current regime and calls for the abolition of the non-frustration rule.

Case Comment: *HMRC v Development Securities*: An Unwelcome Development in the UK Corporate Residence Test?

Jessica Kemp and Joseph Sheldrick

In *HMRC v Development Securities*, the UK Court of Appeal reinstated the first-tier decision that Jersey-incorporated subsidiaries of a UK parent were UK tax resident by reason of having their central management and control in the UK on the basis that they were simply following the instructions of a UK parent without themselves considering the merits of entering the transaction. This arguably constitutes a widening of the test of corporate residence for UK tax purposes.

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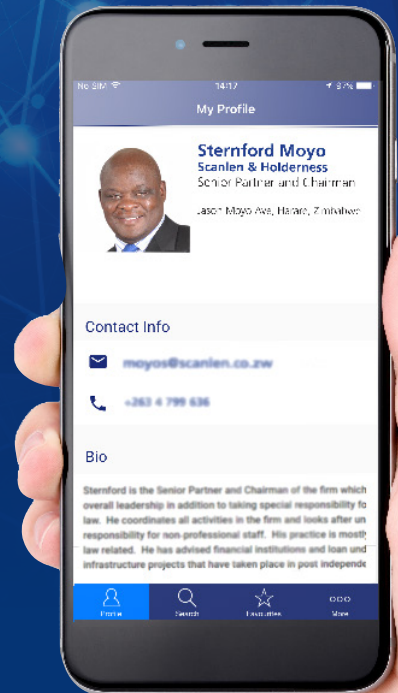
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Covid-19 Business Reliefs in the United Kingdom and the Netherlands: a Comparison

Marcel Willems and Douglas Hawthorn*

Introduction

The Covid-19 pandemic continues to have a profound effect on our societies and on our economies. This has been a crisis like no other, and policy-makers across the globe are providing unprecedented support to citizens, businesses and financial markets, in order to keep our economies moving and to fuel recovery.

Responses differ by jurisdiction, both in the level and in the nature of the support. At this stage, there is no ‘right’ response, and only in five to ten years’ time (or more), when the virus has been effectively suppressed and economies have recovered, could we draw any meaningful conclusions on what policymakers could and should do next time. The success or failure of the various measures might be determined by the length of the crisis. For countries with more state-driven, interventionist responses, and assuming economies remain muted, that support will have to be turned off at some point, and businesses will fail. With vaccines now being rolled out, there is of course reason to be optimistic about a return to semi-normality in the near future.

* Marcel Willems is a partner in Fieldfisher’s restructuring and insolvency group in Amsterdam, and Douglas Hawthorn is a partner in Osborne Clarke’s restructuring and insolvency group in London. They both specialise in advising on debt restructurings, turnaround and insolvency situations, acting for private equity sponsors, financial institutions, investors, companies, directors, turnaround professionals and insolvency practitioners.

The purpose of this article is to examine the responses of policy-makers in the United Kingdom and the Netherlands, with a particular focus on business support, rescue and recovery. As readers will discover, there are various similarities in the regimes, albeit there are differences in colour. On its face, the UK response is more extensive, including various government-backed loan schemes. The comparative severity of the crisis in the UK, teemed with initial difficulties of being outside the European Union, perhaps explain why the UK government had to respond in that way. On the other hand, initially, the UK government was slow in responding to the crisis, which meant that the UK economy was more heavily affected and therefore may need more time to recover.

This article is not intended to be a comprehensive summary of the reliefs in each jurisdiction. Instead, the authors have focused on what they consider to be the key policies in each case.

Practitioners in both jurisdictions have expressed concerns that the package of measures, which by necessity are broad in their application, could, in some circumstances, be encouraging businesses that were not viable even before the pandemic, and/or will not be viable after the pandemic, to continue trading and to incur credit. This could lead to a tidal wave of insolvencies or restructurings as and when the supports that are sustaining businesses are withdrawn. Moreover, the effect on some stakeholders receives little attention; for example, landlords (and the pension funds and other investors behind them) that are not receiving rent or service charge, and cannot enforce to recover that indebtedness and/or take control of their property.

United Kingdom

In the UK, the government has introduced a range of temporary and permanent changes to support businesses, and to facilitate recovery. The centrepiece of the government's response is the Corporate Insolvency and Governance Act 2020¹ (CIGA 2020), which passed through Parliament in just under six weeks. CIGA 2020 has been amended and/or supplemented by additional legislation and/or guidance.

1 Corporate Insolvency and Governance Act 2020.

Permanent reforms

RESTRUCTURING PLAN

CIGA 2020 introduced a new process for the reconstruction of companies in financial difficulties (a ‘restructuring plan’).² The ideas underpinning the restructuring plan have been around for some time, drawing on elements of a scheme of arrangement and Chapter 11 of the US Bankruptcy Code. The government consulted on similar proposals in 2016. In doing so, we assume it would have been mindful of the impending enactment of Directive (EU) 2019/1023 on preventive restructuring frameworks, on discharge of debt and disqualifications (the ‘Directive’).³ Among other things, the Directive requires EU Member States to provide access to a preventive restructuring framework that is compliant with the Directive on or before 17 July 2021.⁴ Of course, later in 2016, the UK voted to leave the EU, meaning that it would not ultimately become subject to the Directive. The restructuring plan was put to one side, at least until the pandemic. While the restructuring plan is not entirely compliant with the Directive (and does not have to be), it is a close approximation.

To summarise, a company that is suffering, or is likely to suffer, financial difficulties, may be made subject to a restructuring plan provided that the purpose of the plan is to eliminate, reduce or prevent, or mitigate the effect of, any of those financial difficulties;⁵ and the restructuring plan is approved by 75 per cent by value of each class of creditors and/or members.⁶ Crucially, dissenting classes of creditors and/or members can, subject to certain conditions, be bound (or ‘crammed down’) by a restructuring plan.⁷ That distinguishes a restructuring plan from a scheme of arrangement.

At the time of writing, only three restructuring plans have been sanctioned. On 26 September 2020, the court approved Virgin Airways’ restructuring plan⁸ to effect a comprehensive refinancing package; on 29 October 2020,

2 Section 7 of and Schedule 9 to CIGA 2020, and Part 26A of the Companies Act 2006 (CA 2006).

3 Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency).

4 Article 34 of the Directive.

5 Section 901A(3)(b) CA 2006.

6 Section 901F(1) CA 2006.

7 Section 901G CA 2006.

8 *Re Virgin Atlantic Airways Ltd* [2020] EWHC 2376 (Ch).

the court approved PizzaExpress' restructuring plan⁹ to effect a partial debt for debt and a partial debt for equity swap; and on 13 January 2021, the court approved DeepOcean's restructuring plan¹⁰ to wind up its unsustainable cable-laying and trenching division. The DeepOcean restructuring plan is the first to use the cross-class cram-down mechanism. Although seven out of eight creditor classes approved the restructuring plan, the requisite consent threshold (75 per cent) was not met in respect of the unsecured creditor class, and accordingly that class will be crammed down. Restructuring plans for Premier Oil and Gategroup have been launched but not yet sanctioned.

Like a scheme of arrangement, a restructuring plan is a court-led process and will take time and be expensive to implement. As such, small and medium-sized enterprises are not expected to use this mechanism. Restructuring plans can, at least in theory, be implemented under the protection of a new, free-standing moratorium (see further below).

On 24 December 2021, the UK and the European Union signed a free trade agreement.¹¹ Regrettably, it does not contain anything that will continue the effect of Regulation (EU) 2015/848 on insolvency proceedings (recast),¹² meaning that from 1 January 2021 UK insolvencies will not be automatically recognised in the EU. This might affect the popularity of the restructuring plan (assuming it would have been given status equivalent to Annex A status), particularly for businesses operating in multiple jurisdictions. Conversely, this might be a boon for the Dutch WHOA¹³ (as discussed further below) and other schemes implemented pursuant to the Directive.

THE MORATORIUM

Debtors (and their creditors) in the UK have enjoyed access to a mature, robust and creditor-friendly restructuring and insolvency toolkit. However, in some cases stakeholders are hindered in their ability to restructure and/or rescue a business because that toolkit lacked a free-standing moratorium to give stakeholders the necessary time and breathing space to effect a sale, new debt or equity funding, consensual restructuring, scheme of arrangement, company voluntary arrangement or restructuring plan.

9 *Re PizzaExpress Financing 2 plc* [2020] All ER (D) 126 (Oct).

10 *Re DeepOcean 1 UK Ltd and other companies* [2021] EWHC 138 (Ch).

11 Trade and cooperation agreement between the European Union and the European Atomic Energy Community, on the one part, and the United Kingdom of Great Britain and Northern Ireland, on the other part.

12 Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings.

13 *De Wet homologatie onderhands akkoord ter voorkoming van faillissement*.

CIGA 2020 contains provisions that enable an eligible company, in certain circumstances, to obtain a moratorium, giving it various protections from creditors.¹⁴ The principal requirements for obtaining a moratorium are that:

- the company is, or is likely to become, unable to pay its debts;
- it is likely that a moratorium would result in the rescue of the company as a going concern;
- the company can discharge certain prescribed pre-moratorium debts and all moratorium debts during the moratorium; and
- a monitor has been engaged, and is supportive.

Under the moratorium, a company is entitled to a payment holiday in respect of its debts except for:

- the monitor's fees and expenses for the moratorium period;
- any goods and services supplied during the moratorium period;
- rent payments for the moratorium period;
- wages and salaries;
- redundancy payments; and
- debts or other liabilities arising under a contract or other instrument involving financial services (eg, bank debt).¹⁵

These limitations, and in particular the requirement that a company must continue to pay its banks and other lenders, are expected to limit the use of the moratorium in practice.

IPSO FACTO PROVISION

For some years, the termination (or ipso facto) rights of those that supply essential services (electricity, gas, communications, etc) to a company subject to a relevant insolvency procedure have been fettered (albeit, certain conditions/requirements must be satisfied for suppliers to be obliged to continue supplying).¹⁶ Under CIGA 2020, those restrictions have been extended to all suppliers (subject to some carve-outs).¹⁷

CIGA 2020 provides that a provision of a contract for the supply of goods or services to a company ceases to have effect when the company becomes subject to a relevant insolvency procedure (including administration and liquidation). This applies if, and to the extent that, under the provision:

- the contract or the supply would terminate, or any other thing would take place, because the company becomes subject to the relevant insolvency procedure or because of an event occurring before the start of the insolvency period; or

¹⁴ Sections 1 to 6 of and Schedules 1 to 8 to CIGA 2020.

¹⁵ Section A18 of CIGA 2020.

¹⁶ Sections 233 and 233A of the Insolvency Act 1986 (IA 1986).

¹⁷ Sections 14 to 20 of CIGA 2020, and s 233B IA 1986.

- the supplier would be entitled to terminate the contract or the supply, or to do any other thing, because the company becomes subject to the relevant insolvency procedure or because of an event occurring before the start of the insolvency period.¹⁸

In addition, suppliers are prohibited from making it a condition of any ongoing supply of goods and services after the time when the company becomes subject to the relevant insolvency procedure, or do anything that has the effect of making it a condition of such a supply, that any outstanding charges in respect of a supply made to the company before that time are paid. To put it another way: suppliers cannot levy ransom charges for old debts.

CIGA 2020 does not prevent a supplier from terminating a contract in respect of some event or breach that occurs after the company enters into a relevant insolvency procedure. That is to say, insolvent companies must continue to operate in accordance with the contract and discharge all invoices raised for supplies/services corresponding to the insolvency period. Nothing prevents suppliers from shortening payment terms or requiring upfront payment.

These provisions do not apply to small suppliers. To paraphrase, a supplier is a small supplier if at least two of the following conditions were met in relation to its most recent financial year:

- Condition 1: Turnover was not more than £10.2m;
- Condition 2: Balance sheet total was not more than £5.1m;
- Condition 3: Number of employees was not more than 50.¹⁹

Temporary reforms

MODIFICATION OF WRONGFUL TRADING REGIME

If in the course of the administration or winding up of a company it appears that:

- (1) the company has gone into insolvent administration or liquidation;
- (2) at some time before the commencement of the administration or winding-up, a director (or shadow director) knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent administration or liquidation; and
- (3) that person was a director of the company at that time,

¹⁸ Section 233B(3) IA 1986.

¹⁹ Section 13 of CIGA 2020.

the court, on the application of the administrator or liquidator, may declare that that person is liable to make such contribution (if any) to the company's assets as the court thinks proper.²⁰

Any compensation order in respect of wrongful trading should be compensatory rather than penal. As a general proposition, the starting point (but not necessarily the endpoint) for determining the level of compensation is the net deficiency suffered by the company in consequence of the wrongful trading. CIGA 2020 provides that in determining the contribution (if any) to a company's assets that it is proper for a person to make, the court is to assume that the person is not responsible for any worsening of the financial position of the company or its creditors that occurs during the period 1 March 2020 to 31 October 2020 and/or (following an extension in November 2020) during the period of 26 November 2020 to 30 April 2021. Where wrongful trading occurred and caused a net deficiency, prior to 1 March 2020, directors remain liable.²¹

Various other fiduciary and statutory duties continue to apply to directors and have not been suspended (eg, the duty of directors to give consideration to the interests of creditors when a company is approaching or in the zone of insolvency). As the government cautioned, 'All of the other checks and balances that help to ensure directors fulfil their duties properly will remain in force'.²² Notwithstanding that, commentators have expressed concern that the liberalism of the regime is encouraging directors of companies that are not sustainable to continue to trade, and to incur additional credit that cannot realistically be expected to be serviced or repaid.

STATUTORY DEMANDS, WINDING-UP PETITIONS AND OTHER CREDITOR ENFORCEMENT RIGHTS

Creditors are prevented from presenting a winding-up petition against a company based on a statutory demand that was served between 1 March 2020 and 31 March 2021, and from presenting a winding-up petition between 1 March 2020 and 31 March 2021 based on the company's inability to pay its debts unless they have reasonable grounds for believing that Covid-19 has not had a financial effect on the company or the debt issues would have arisen anyway. In addition, the circumstances in which commercial landlords can recover commercial rent arrears and/or forfeit a lease have been restricted.²³

²⁰ Section 214 or 246ZB IA 1986.

²¹ Sections 12 and 13 of CIGA 2020.

²² Alok Sharma, UK Business Secretary, 28 March 2020.

²³ Sections 10 and 11 of and Schedules 10 and 11 to CIGA 2020, the Corporate Insolvency and Governance Act 2020 (Coronavirus) (Extension of the Relevant Period) Regulations 2020 and the Corporate Insolvency and Governance Act 2020 (Coronavirus) (Extension of the Relevant Period) (No 2) Regulations 2020.

CORONAVIRUS JOB SUPPORT SCHEME

Under the Coronavirus Job Retention Scheme (the ‘Scheme’) (now in its third iteration), an employer that is unable to maintain its workforce because its operations have been affected by the pandemic can furlough employees and apply for a grant to cover a portion of their usual monthly wage costs.²⁴ Under the current iteration of the Scheme, an employer can claim 80 per cent of an employee’s usual salary for hours not worked, up to a maximum of £2,500 per month. Under previous iterations of the Scheme, the amount that could be claimed tapered down from 80 per cent (up to £2,500), to 70 per cent (up to £2,187.50), to 60 per cent (up to £1,875), with employers being required to make up the difference to 80 per cent.

Employers can (1) fully furlough employees (affected employees cannot work while furloughed full time) or (2) flexibly furlough employees (affected employees can work for any amount of time, and on any work pattern, but they cannot work during hours that they are recorded as being on furlough). Employers must cover National Insurance and pension contributions. Statistical research shows that the Scheme disproportionately helped the young, those on a low income and those working for small employers. Workers in hospitality, arts and recreation and construction were furloughed the most, and those in finance and the public sector were least likely to be furloughed.²⁵

Employers are also able to reclaim statutory sick pay paid to employees due to Covid-19.²⁶

In addition, the government has provided some support to self-employed persons and sole traders through the Self-Employment Income Support Scheme, and there is a Kickstart Scheme to help those aged 16–24 into paid employment.²⁷

Finance schemes

Covid-19 loan or grant schemes include the HM Treasury and Bank of England Covid Corporate Financing Facility²⁸ (CCFF) (which provides

24 Sections 71 and 76 of the Coronavirus Act 2020, the Coronavirus Act 2020 Functions of Her Majesty’s Revenue and Customs (Coronavirus Job Retention Scheme) Direction (15 April 2020), the Coronavirus Act 2020 Functions of Her Majesty’s Revenue and Customs (Coronavirus Job Retention Scheme) Direction (22 May 2020), the Coronavirus Act 2020 Functions of Her Majesty’s Revenue and Customs (Coronavirus Job Retention Scheme) Direction (25 June 2020) and Treasury Directions dated 2 October 2020, 13 November 2020 and 25 January 2021.

25 Thomas Pope, Grant Dalton and Gemma Tetlow, ‘The Coronavirus Job Retention Scheme: How has it been used and what will happen when it ends?’ (Institute for Government).

26 The Coronavirus Statutory Sick Pay Rebate Scheme.

27 The Kickstart Scheme.

28 Launched on 17 March 2020.

funding by purchasing commercial paper of up to one-year maturity, issued by firms making a material contribution to the UK economy), the Bounce Back Loans Scheme²⁹ (BBLs) (loans of between £2,000 and £50,000 for small or medium-sized enterprises, guaranteed by the government), the Coronavirus Business Interruption Loan Scheme³⁰ (CBILS) (loans of up to £5 million for small or medium-sized enterprises, guaranteed by the government), the Coronavirus Large Business Interruption Loan Scheme³¹ (CLBILS) (loans, revolving credit facilities, invoice finance or asset finance of up to £200m, for medium or large-sized enterprises, guaranteed (up to 80 per cent) by the government), and the Future Fund (convertible loans of between £125,000 and £5m for start-ups, subject to applicants receiving matched funding from shareholders).

Taxes

All businesses are able to defer VAT payments due between 20 March 2020 and 30 June 2020.³²

Retail, hospitality and leisure businesses are not required to pay business rates for the current tax year.³³

Summary remarks concerning the United Kingdom's response

The UK's response has been extensive and, in some respects, genuinely impressive. In 2020, total government spending to support the economy through the crisis was estimated at £280bn,³⁴ or circa nine per cent of GDP. However, this 'big government', interventionist response has been driven by necessity, rather than philosophy. UK citizens have been subject to three material 'lockdowns' so far, with deaths and hospital admissions rising rapidly whenever restrictions are relaxed. Those problems have been compounded by government schemes such as Eat Out to Help Out, in which consumers were actively encouraged to return to busy pubs, restaurants, etc, with

29 Launched on 4 May 2020.

30 Launched on 23 March 2020.

31 Launched on 3 April 2020.

32 Taxpayers can defer VAT payments with businesses given until the end of the current financial year to make the deferred payments. The government subsequently announced that VAT payments deferred between March and June 2020 will be subject to a 'New Payment Scheme' allowing businesses to spread payments of the deferred VAT over the 2021–22 financial year in 11 equal instalments.

33 Effective from 18 March 2020.

34 Briefing Paper (Number 8866, 18 January 2021): Daniel Harari and Matthew Keep, 'Coronavirus: Economic impact'.

government-backed discounts being applied. A study found that between eight and 17 per cent of the newly detected Covid-19 infection clusters could be attributed to the scheme.³⁵ Accordingly, the economy remains stagnant and rates of unemployment continue to rise. The UK has entered the deepest recession in its history, and the IMF estimates that its GDP contracted by ten per cent in 2020.³⁶ Many businesses remain wholly dependent on the patchwork of 'life support'. The UK's difficulties in 2021 are expected to be compounded by the disruption caused by exiting the EU, which is already creating trading difficulties and political tensions. From a political perspective, it is interesting to note that the UK's interventionist Covid-19 response has been implemented by a Conservative government – typically the party of 'small government'.

Time will tell, but their furlough scheme appears to have been a success, and can reasonably be assumed that it has saved millions of jobs. While lending schemes, like the CBILS and the BBLs, and rents, taxes and rates deferrals have provided some welcome short-term help, those measures are, to different degrees, a form of 'kicking the can down the road', and it remains to be seen what happens when those supports are withdrawn, and companies must begin to discharge the increased liabilities that have accrued in more straitened circumstances.

Covid responses aside, the introduction of the restructuring plan and standalone moratorium are welcome additions to the UK's restructuring toolkit.

The Netherlands

The first infection in the Netherlands was officially diagnosed on 27 February 2020, but the virus was present before that.³⁷ The outbreak led to measures that were unprecedented for the Netherlands, whereby social interaction was largely halted. All schools, universities, libraries, cafés, hairdressers, museums, cinemas and restaurants, among others, closed their doors by order of the government. School exams, sports matches and many other events were cancelled. Everyone was asked to stay indoors and to work from home as much as possible. The government implemented an economic aid plan to support companies that experienced distress owing to the government measures. At the end

35 'Subsidizing the spread of COVID-19: Evidence from the UK's Eat Out to Help Out scheme', Dr Thiemo Fetzer of the CAGE Research Centre in the Economics Department at the University of Warwick.

36 International Monetary Fund, *World Economic Outlook*, January 2021.

37 Cyril Rosman and Niels Klaassen, 'Het coronavirus was al veel langer in Nederland', *Het Parool*, 23 April 2020.

of April 2020, the government estimated that the budget deficit that year would, in the best case, amount to €92bn, where prior to the Covid-19 pandemic a surplus of €9bn had been expected.³⁸

Permanent reforms

COURT CONFIRMATION OF EXTRAJUDICIAL RESTRUCTURING PLANS

Before there was any sign of Covid-19, the legislator had started drafting the act on Court Confirmation of Extrajudicial Restructuring Plans (CERP) (also known as WHOA³⁹). The outbreak of Covid-19 accelerated the legislative process, and on 6 October 2020 the proposal was adopted by the Senate. The act came into force on 1 January 2021.⁴⁰

CONTENT AND PURPOSE

Previously, a private restructuring of a company's indebtedness could only take place with the cooperation of a debtor's creditors. The CERP provides the possibility for companies and stakeholders (such as shareholders, but also creditors) to settle debts outside bankruptcy by means of an agreement, and to have this agreement approved by the court. If the court approves the agreement, it binds all affected stakeholders, including dissenting stakeholders.⁴¹

The CERP incorporates elements of the US Chapter 11 and UK scheme of arrangement, and combines them into a fast and efficient 'best of both worlds' restructuring scheme.⁴² The CERP aims to prevent (unnecessary) bankruptcies of viable companies, simplify the restructuring of companies and thereby preserve value and employment. In addition, the CERP provides for a controlled liquidation of companies that do not have any chance of survival if a better result is achieved by means of a settlement outside bankruptcy than with a settlement in bankruptcy.⁴³

38 Philip de Witt Wijnen, 'Corona duwt begrotingstekort naar ruim 90 miljard', *NRC Handelsblad*, 24 April 2020.

39 *Wet homologatie onderhands akkoord*.

40 Staatsblad 2020, 415.

41 Article 385 Insolvency Act.

42 Memorie van Toelichting, Tweede Kamer, vergaderjaar 2018–2019, 35 249, nr 3, p 4.

43 Memorie van Toelichting, Tweede Kamer, vergaderjaar 2018–2019, 35 249, nr 3, p 2.

THE AGREEMENT

The company itself can offer a settlement to its creditors.⁴⁴ This, however, can also be offered by a restructuring expert appointed at the request of creditors, shareholders or the company's works council.⁴⁵

The procedure is short once the initiative is taken; there are short deadlines and therefore a fast turnaround time. The CERP provides great freedom in terms of the form and content of the agreement, provided it meets certain preconditions. The preconditions include the following:⁴⁶

- (1) the agreement must be necessary and sufficient to avert bankruptcy;
- (2) the agreement must be reasonable, meaning:
 - (a) none of the creditors may be in a lesser position than in bankruptcy;
 - (b) the value that can be realised by the agreement must be fairly distributed among the classes of creditors and shareholders;
- (3) at least one class (creditors or shareholders) must vote in favour of the plan; and
- (4) the legal position of employees cannot be changed by an agreement.

The debtor is authorised to separate its creditors into different classes, and to offer a settlement to only one or more classes.⁴⁷ For example, one class can be offered a settlement, while another class retains its claim. Unlike in a bankruptcy,⁴⁸ the debtor retains its control and ownership of the assets.

After offering the agreement, creditors and shareholders must vote per class on whether they approve the agreement. The vote can take place in a physical meeting, by electronic communication or in writing.⁴⁹ A class consents to the agreement if creditors or shareholders who together represent at least two-thirds of the total amount of claims/issued capital of the creditors/shareholders who voted within that class vote in favour of the agreement.⁵⁰ If at least one class of creditors has approved the agreement, it may be submitted to the court for approval.⁵¹ The court will refuse approval if there is a violation of the (above-mentioned) preconditions or fraud, or if there are other compelling reasons.⁵² No appeal is possible against this decision.

44 Article 370 paragraph 1 Insolvency Act.

45 Article 371 paragraph 1 Insolvency Act.

46 *Memorie van Toelichting, Tweede Kamer, vergaderjaar 2018–2019, 35 249, nr 3, pp 5–6.*

47 Article 374 Insolvency Act.

48 Article 23 Insolvency Act.

49 Article 381 paragraph 6 Insolvency Act.

50 Article 381 paragraph 7 Insolvency Act.

51 Article 383 paragraph 1 Insolvency Act.

52 Article 384 paragraphs 1–5 Insolvency Act.

RECENT AMENDMENTS

During debates in the House of Representatives, some amendments were made to the CERP as compared to the original proposal. First, SMEs with an unsecured claim for goods or services supplied, or in tort, are entitled to at least 20 per cent of their claim. Secondly, secured creditors are only classified as secured creditors to the extent that their claim is covered by security; for the unsecured part of their claim they fall into the unsecured creditors class. The expected value in a bankruptcy situation is decisive for the question of which part of a claim is secured. Under the CERP, creditors of a dissenting class are entitled to a cash distribution of the amount they would receive in the event of bankruptcy. The latest amendment means that this right does not apply to secured creditors: they do not have the power to vote against the agreement if the debtor does not offer them cash.⁵³

EVALUATION

The CERP will be evaluated within three years of its entry into force.⁵⁴ The rationale for this is the concern that secured creditors and shareholders in particular will reap the benefits of this law, at the expense of unsecured creditors.

Temporary reforms

TEMPORARY PAYMENT DEFERRAL ACT 2020

To help alleviate the effects of the Covid-19 pandemic (and the corresponding infection control measures taken by the Dutch and other national governments), the Temporary Payment Deferral Act 2020 (TPDA)⁵⁵ entered into force on 17 December 2020. The purpose of the TPDA is to protect entrepreneurs from avoidable bankruptcies or recourse actions by creditors and to limit as much as possible the damage to the economy as a result of the Covid-19 pandemic.⁵⁶

53 Article 384 paragraph 4 Insolvency Act.

54 Article IIA Wet van 7 oktober 2020 tot wijziging van de Faillissementswet in verband met de invoering van de mogelijkheid tot homologatie van een onderhands akkoord (Wet homologatie onderhands akkoord).

55 Wet van 25 november 2020 tot wijziging van enkele wetten op het terrein van het Ministerie van Sociale Zaken en Werkgelegenheid en het Ministerie van Justitie en Veiligheid en de introductie van bepalingen ter invoering van de tijdelijke mogelijkheid voor de rechter om de behandeling van faillissementsverzoeken aan te houden en andere verhaalsacties te schorsen en een schuldenaar een tijdelijk betalingsuitstel te verlenen in verband met de uitbraak van COVID-19 (Tijdelijke wet COVID-19 SZW en JenV).

56 Memorie van Toelichting, Tweede Kamer vergaderjaar 2019–2020, 35557 nr 3 under 4.

REQUEST FOR STAY

Before the TPDA, a debtor that was made subject to bankruptcy proceedings could ask the court to grant a stay on the proceedings for a maximum of two weeks, extendable three times (meaning the stay could be extended by up to eight weeks in total).

Under the TPDA, a debtor that is made subject to bankruptcy proceedings may ask the court to grant a stay on the proceedings for a maximum of two months, extendable twice (meaning the stay can be extended for up to six months in total).⁵⁷ To this end, the debtor must demonstrate that it was unable to continue its business as usual, solely or mainly as a result of the restrictive measures that have been announced since 16 March 2020 in connection with Covid-19, and is therefore temporarily unable to continue paying its debts. The debtor must also demonstrate that:

- (1) it had sufficient income to settle its due and payable debts before the restrictive measures were announced; and
- (2) since those measures were announced, there has been a loss of turnover of at least 20 per cent.⁵⁸

Moreover, if there is the prospect that the debtor will be able to satisfy its creditors after the stay, and if the stay does not materially and unreasonably harm the interests of the creditor by whom the bankruptcy application was filed, the court will grant the request for the stay or its extension.⁵⁹

The debtor thus obtains a deferment of payment with regard to debts due prior to the bankruptcy petition. However, debts that arise during the stay must continue to be paid.

SUSPENSION OF REDRESS

If the stay is ordered, the court may, at the debtor's request, also determine that during the term of the stay, the creditor who filed for bankruptcy may not seek recourse against the debtor's property, except with the court's authorisation, and that attachments made by this creditor will be lifted during that period. Before the court takes a decision, the debtor and the creditor who filed for bankruptcy are given an opportunity to be heard.⁶⁰ No legal remedy is available against the court's decision.⁶¹

57 Article 2.2 paragraph 1 TPDA.

58 Article 2.2 paragraph 2 TPDA.

59 Article 2.2 paragraph 3 TPDA.

60 Article 2.2 paragraph 5 TPDA.

61 Article 2.2 paragraph 11 TPDA.

SUSPENSION OF ENFORCEMENT

Even without an application for bankruptcy having been filed, the debtor may need protection against (overly aggressive) creditors. A debtor can bring an action before the court for a stay of enforcement for a period of not more than two months, extendable twice (meaning the suspension can be extended for up to six months in total), or request the lifting of an attachment. These restrictions only apply to the creditor who has commenced enforcement action or has made the attachment.⁶²

Failure to fulfil a payment obligation prior to the start of the stay does not constitute grounds for amendment, suspension or dissolution of an agreement with the debtor during the stay. This rule, however, only applies to agreements between the debtor and the creditor who has filed for bankruptcy.⁶³ Thus, other creditors may still be able to dissolve their agreements, and attachments made by them may not be lifted either.

END OF THE STAY

The stay ends when the period for which it was granted expires. It can also be terminated by the court at the request of the creditor or *ex officio* and a decision will be taken on the application for bankruptcy if the conditions for the stay are no longer met, or if the debtor has harmed one or more of its creditors, has attempted to do so or if well-founded fear arises that it will attempt to do so.⁶⁴

CREDITORS' PROTECTION

The TPDA will also provide protection to creditors in two areas. Normally, the settlement of a due and payable debt can be avoided in bankruptcy by the bankruptcy trustee, if the beneficiary creditor knew at the time of payment that the application for the debtor's bankruptcy had been filed.⁶⁵

Because the debtor's debts are not meant to increase further during the arrest of the bankruptcy petition, the bankruptcy trustee – if the bankruptcy follows – cannot challenge the payment of a due and payable claim during the stay just because the creditor knew of the bankruptcy petition.⁶⁶

Furthermore, the bankruptcy trustee has the option of reversing settlements made in the run-up to the bankruptcy if the person who made

62 Article 2.3 TPDA.

63 Article 2.3 paragraph 2 in combination with article 2.2 paragraph 4 TPDA.

64 Article 2.2 paragraph 8 TPDA.

65 Article 47 Insolvency Act.

66 Article 2.4 paragraph 1 TPDA.

the set-off did not act in good faith. If the set-off took place during the stay and if it was made in the context of the financing of the continuation of the debtor's business and did not limit that financing, the TPDA provides that the person who set it off was in good faith. This provision is intended to prevent banks from freezing current account facilities as soon as the debtor starts negotiating an agreement.⁶⁷

The TPDA will expire on 1 February 2021, but may be extended by periods of up to two months. Such extension(s) is/are certainly to be expected.

LATE PUBLICATION OF ANNUAL ACCOUNTS NOT DEEMED MISMANAGEMENT

Directors must deposit the annual accounts of the company within 12 months following the end of the financial year. Non-compliance is considered improper performance in the event of a bankruptcy, which is deemed to have been an important cause for bankruptcy. Each director would then be held jointly and severally liable for the company's deficit by law, unless he/she would exculpate themselves by proving that this manifestly improper management was not an important cause of the bankruptcy. Now, with respect to the date of publication of annual accounts over the most recently expired financial year, the Temporary Act regarding COVID-19 Justice and Security withdraws such statutory presumption, if the late publication is due to the consequences of the Covid-19 pandemic.⁶⁸ What the effect of this change might be in court proceedings remains uncertain and will depend on the circumstances. The bankruptcy trustee must take this temporary withdrawal into consideration; however, the trustee may try to prove that the late publication of the annual accounts had not been caused by the Covid-19 pandemic.

CORONAVIRUS JOB SUPPORT SCHEME

The temporary Emergency Measure Bridging Employment (NOW)⁶⁹ has been introduced to accommodate employers who are faced with loss of turnover due to the Covid-19 crisis. With the NOW allowance, employers can continue to pay and retain their employees with a permanent and a flexible contract. In this way, as many jobs as possible are preserved.

67 Article 2.4 paragraph 2 TPDA.

68 Articles 15 and 22 Wet van 22 april 2020, houdende tijdelijke voorzieningen op het terrein van het Ministerie van Justitie en Veiligheid in verband met de uitbraak van COVID-19 (Tijdelijke wet COVID-19 Justitie en Veiligheid).

69 Tijdelijke Noodmaatregel Overbrugging voor Werkgelegenheid.

The first period for which NOW could be applied for concerned the months of April to June 2020. The criterion was a loss of revenue of at least 20 per cent for a period of three consecutive months. The maximum allowance per month was 90 per cent of the percentage of expected loss of revenue.

The second NOW period concerned the months of July to October.

During the third NOW period, concerning the months of October to December 2020, the maximum allowance per month was decreased to 80 per cent of the percentage of expected loss of revenue.⁷⁰

In addition, the government has provided some support to self-employed persons through the temporary bridging scheme for independent entrepreneurs (TOZO).⁷¹ It entitles self-employed persons to apply for support in the form of a supplementary subsistence allowance and/or a working capital loan. Several requirements apply, including that as a result of the Covid-19 crisis, the applicant has a household income below the social minimum and/or a liquidity problem for which he/she needs a business credit. TOZO 1 commenced on 1 March 2020 and ended on 31 May 2020. TOZO 2 covers the period June to September 2020. TOZO 3 covers the period from October 2020 to March 2021, following which TOZO 4 will run until 1 July 2021.⁷²

TAXES

The government has also responded to businesses and citizens in the area of taxation. The most important arrangement is that until 1 July 2021, a tax deferment can be requested of the tax authorities.⁷³ As soon as the request has been received, the tax authorities will stop the collection and the applicant will be granted deferred payment until 1 July 2021. Payment obligations that arise after the application do not have to be paid until that date. This concerns, among other things, income tax, corporate tax and VAT. In addition, the rate of recovery interest that becomes due after the expiry of the payment term has been reduced from four per cent to almost zero per cent for the period from 23 March 2020 to 1 January 2022.

70 <https://www.rijksoverheid.nl/onderwerpen/coronavirus-financiele-regelingen/overzicht-financiele-regelingen/now>.

71 Tijdelijke overbruggingsregeling zelfstandig ondernemers.

72 <https://www.rijksoverheid.nl/onderwerpen/coronavirus-financiele-regelingen/overzicht-financiele-regelingen/tozo>.

73 <https://www.belastingdienst.nl/wps/wcm/connect/nl/coronavirus/content/bijzonder-uitstel-van-betaling-vanwege-coronacrisis>.

SUMMARY REMARKS CONCERNING THE NETHERLAND'S RESPONSE

The Dutch government has taken a number of measures with the aim of mitigating the economic consequences of the Covid-19 pandemic. Given the uncertainties about the virus and especially (initially) how and when the virus might be defeated because the vaccines still had to be developed (and, of course, the huge amounts of money involved), it is understandable that most measures were for limited periods of time and were/are extended from time to time as and when required. So far, the results are remarkable. The number of insolvencies in the Netherlands since the outbreak of the virus is historically low. No one has a crystal ball that allows for predictions about what will happen as soon as lockdowns are no longer required and we are able to return to the 'pre-corona normal'. There are no signs, however, that the termination or expiration of the governmental measures simultaneous with a full 'reopening' of economic life will cause many entrepreneurs and businesses to file for bankruptcy.

Should businesses fall into distress despite all the economic measures taken by the Dutch government so far, the CERP may prove a lifeline of last resort. Coronavirus has caused many problems, but the enactment of CERP is generally considered a major step forward in solving the financial troubles of otherwise viable businesses.

Comparison and conclusions

While the detail is of course very different, in very broad terms the approaches of the UK and Dutch governments have not dissimilar goals. Both governments are seeking to ensure that debtors (and stakeholders) have access to a quick and efficient scheme for resolving debtor problems outside bankruptcy, give breathing space to debtors, encourage businesses to retain employees and reduce the tax burden. In the authors' opinion, that is sensible, because it enables viable businesses to continue trading and reduces unemployment.

The different approaches are summarised briefly as follows.

	United Kingdom	The Netherlands
Lending	Various lending schemes, including the CCEF, CBILS, CLBILS and so on, aimed at different enterprises	No specific provision
Stays, suspensions	New standalone moratorium introduced, and various restrictions (on enforcement, on winding up, etc) automatically apply to creditor enforcement	Restrictions apply to creditor enforcement via the TPDA, but debtors must apply to court

Employees	Extensive support via the coronavirus job support scheme. Support is calculated based on the employees' wages	Extensive support via the Emergency Measure Bridging Employment. Support is calculated based on loss of turnover
Taxation	Various taxes can be deferred	Various taxes can be deferred
New restructuring/insolvency tools	Restructuring plan	CERP ⁷⁴
Directors' duties	Wrongful trading regime relaxed, to give boards more comfort to continue trading	No specific provision

Broadly speaking, the UK's response has been more far-reaching, notably extending to finance schemes and a loosening of the directors' duties regime, but that reflects the severity of the crisis in that jurisdiction, and the prospective 'double-hit' of a Brexit adjustment period.

In the current circumstances, a more nuanced, business-by-business approach would be impossible, but there are concerns in both jurisdictions that the measures are facilitating the continued trading of businesses that were not viable before the pandemic, and/or that will not be viable after the pandemic. This is borne out by the statistics. In the UK, in the period June to November 2020, the number of company insolvencies decreased significantly compared to the same months in 2019. The picture is similar in the Netherlands. Bad businesses are likely to be sheltering in the safe harbours of the restrictions, and/or building credit that they cannot possibly service. Accepting that the supports and restrictions must, at some point, stop (or at least taper off), restructuring professionals are likely to face a tidal wave of workouts, restructurings and insolvencies at some point in the future.

One must also give some thought to creditors who, because they cannot recover from or enforce against their debtors, have their own liquidity problems. While most debtors cannot pay, some debtors have chosen not to pay, exploiting the forbearances they have been given. Among other creditor groups this has been a profound problem for commercial landlords, who are starved of income but remain subject to the same debt burdens. Some of the affected sectors will change forever. Consider, for example, office-based businesses (including law firms) where working from home, at least for some of the week, has been normalised and will probably remain, meaning reduced demand for large office footprints. Similarly, for the retail sector, the migration away from the traditional high street (and large and multiple stores), has been accelerated, and retailers will increasingly focus on digital growth strategies.

74 While not a response to Covid, its introduction coincided with the crisis.

Of course, the pandemic has also created profound issues for the public purse; with reduced tax receipts, expensive support packages, and so on. This is likely to inhibit investment and increase taxes in the short to medium term as governments battle to get their finances in order. Again, governments will face a delicate balancing act between restoring depleted resources and stimulating recovery.

None of this gloomy conclusion should be read as a criticism of our policy-makers, who continue to grapple with exceptional challenges; endeavouring to protect citizens' health on the one hand, while keeping businesses and enterprises afloat on the other. As we said at the outset, there are no 'right' responses to any of this, and it will perhaps take five to ten years before we can draw any real conclusions. It is the authors' hope that in 2021, and with an effective vaccine rollout, we will succeed in turning the tide on the pandemic, and can begin building back.

Revisiting the State's Role in the Private Sector: Reflections on the EU's System of Checks and Balances in the Age of Covid-19 – Part Two

Peter Alexiadis

Market discipline measures directed at Member States

There are two very unique legal instruments available under the EU legal order that act as a very real brake on the excesses of state intervention where those excesses are likely to distort competitive conditions on markets. Whereas Articles 101 and 102 TFEU respectively address the *anti-competitive practices* of private sector undertakings,¹ those same Treaty provisions are harnessed with other provisions of the Treaty that are directed specifically towards the *excesses of state intervention* that are capable of generating anti-competitive effects to the benefit of specific undertakings. Thus, Treaty-level legal obligations are imposed on Member States that address specific types of state action, namely:

- the creation of a quasi-regulatory obligation under Article 106(1), which prevents EU Member States from favouring state undertakings or undertakings to whom the state has granted 'special or privileged' rights – applied in combination with the abuse of a dominant position prohibited

1 Article 101(1) TFEU prohibits anti-competitive agreements or practices between undertakings that have the object or effect of distorting competition. By contrast, Art 102 TFEU prohibits the (unilateral) abuse of a dominant position by an undertaking or association of undertakings.

under Article 102 TFEU – where the implication of such actions is likely to be anti-competitive; and

- the obligation of ‘sincere cooperation’ imposed on Member States and the Commission under Article 4(3) TEU, which is designed to ensure that state rule-making that has an impact on market dynamics does not have the effect of distorting competition by creating situations where anti-competitive agreements or practices are encouraged contrary to the terms of Article 101 TFEU.

Along with the day-to-day discipline imposed on Member States by the Commission’s control of state aids (see immediately above), these legal obstacles to a Member State’s freedom of action ensure that benefits conferred on undertakings where the state is involved do not sacrifice the overriding commitment to competitive markets that is enshrined under EU competition rules. As such, they do not constitute stand-alone legal obligations, but need to be applied in combination with either Article 101 or 102 TFEU, as the case may be.

Article 106 TFEU

As mentioned earlier, the EU legal order is ‘agnostic’ as to whether or not a Member State takes a stake in a private sector company. However, to the extent that it does so, it must abide by the requirements of Article 106(1) TFEU or run the risk of being censured under the powers vested in the Commission under Article 106(3) TFEU. Only a very limited exception under Article 106(2) TFEU is envisaged to this legal framework, which involves those situations where the state has devolved powers to a firm in order that they perform services that are essentially of a public service nature (ie, could not be satisfied by a private sector firm operating under free market conditions) (see above).

According to the terms of Article 106(1) TFEU:

‘In the case of public undertakings and undertakings to which Member States grant special or exclusive rights, Member States shall neither enact nor maintain in force any measure contrary to the rules contained in the Treaties, in particular those rules provided in Article 18 and Articles 101 to 109.’

Where an infringement of Article 106(1) has been found to have taken place, Article 106(3) TFEU provides that: ‘The Commission shall ensure the application of the provisions of this Article and shall, where necessary, address appropriate directives or decisions to Member States.’

A SUI GENERIS PROVISION

The uniqueness of the prohibition under Article 106(1) TFEU is reflected in the fact that the Commission has unfettered discretion in terms of whether or not it decides to take action under Article 106 (ie, those decisions to refuse an action under Article 106(1) are not subject to an appeal to the Community courts). The way in which Articles 106(1) and (3) operate is both controversial and complex, given that these provisions allow the Commission to intervene against state undertakings or undertakings upon whom the state has conferred special or exclusive rights in a way that circumvents the usual legislative procedure (to address the identified problems through Directives) and truncates the usual investigation procedure that would otherwise be taken under Article 102 TFEU.

The measures adopted under Article 106(3) inevitably have a distinctive regulatory hue, as they often promote liberalisation measures that strike at the heart of problematic economic structures and, as such, impede any tendency on the part of a Member State to limit the impacts of any EU liberalisation policy. As a matter of practice, the Commission is relatively reluctant to use its legislative power under Article 106(3), given the political fall-out that would be associated with the circumvention of the usual legislative procedure that would otherwise involve other EU institutions such as the European Parliament and the Council.²

In applying the provisions of Articles 106(1) and 102 TFEU in tandem, private and public law principles are brought together by the Commission to shift liability from the undertaking whose practices are likely to be problematic (private) to the state whose legal regime supports such potentially anti-competitive behaviour (public). Although there is no automatic link between 'dominance' and 'special or exclusive rights' as a matter of law, the conferral of such rights means that the undertakings benefiting from such rights hold market positions that are tantamount to positions of market dominance. While the jurisprudence is not always consistent in clarifying the extent and scope of the link between special or exclusive rights that lead to dominance, and that are, in turn, actionable if they lead to anti-competitive results, the language of the European courts is nevertheless clear that actions may be brought under Article 106(1) where there is some link between the existence

2 The Commission's ability to address Directives towards Member States has been sparingly used after the initial wave of liberalisation measures in the late 1980s, it being understood that the Commission's powers to legislate under this provision severely compromise the usual legislative path followed by EU institutions, including the Council (which represents the interests of the Member States).

of the special or exclusive rights and the potential for anti-competitive effects flowing from the exercise of those rights.³

Over the years, the European courts have condoned Commission intervention under Article 106(1) TFEU, read in conjunction with Article 102 TFEU, under four broad categories, namely, where the grant of special or exclusive rights conferred upon the recipient undertaking:

1. provide it with the potential to *abuse* its market position owing to the structural characteristics of the market;⁴

3 See, for example, the different expressions of the competition test in *Porto di Genova* (Case 179/90) “merely by exercising the rights granted to it, the undertaking involved cannot avoid abusing its dominant position or such rights are liable to create a situation where the undertaking is induced to engage in such abuses”; *La Crespelle* (Case 323/93) “the abuse is the direct effect of the right conferred, which means that the undertaking cannot avoid abusing its dominant position”. The question is whether the practice in question constituted an alleged abuse that was the direct consequence of the national law (ie, creating the possibility of an infraction is not sufficient); *Höfner and Elser* (Case C-41/90) “in merely exercising the exclusive right granted to it, the undertaking could not avoid abusing its dominant position”; *ERT Dimotiki* (Case C-260/89) the state measure “should not create an opportunity for the undertaking to abuse its dominant position” (ie, a discriminatory broadcasting policy that would favour the undertaking’s own programmes) *Corsica Ferries* (Case C-266/96): the exclusive rights must be “liable to create a situation where the undertaking is led to commit abuses” (ie, exclusive rights for mooring services granted to local mooring groups are not problematic per se); *Deutsche Post* (Case C-147/97 and C-148/97) an abuse is the “inevitable result of granting exclusive rights to a statutory monopolist”; *Düsseldorf and Others* (Case C-203/96) Arts 106 and 102 are breached in combination if a law, regulation or administrative provision “enables the undertaking upon whom exclusive rights have been conferred to abuse its dominant position”; *Job Centre* (Case C-55/96) the maintenance of monopoly “creates a situation in which Art 102 cannot avoid being infringed”.

4 See, for example, in *Greek Lignite* (Case C-553/12P), where the CJEU overturned the General Court prohibition of a Commission Decision that had held that the Commission was required (and had failed) to prove the actual or potential abuse on the wholesale electricity market by the party exclusively exercising exploitation rights over lignite. By contrast, the CJEU held that it is not necessary for the Commission to identify an abuse, but only that a potential or actual anti-competitive consequence is liable to result from the state measure at issue. Thus, a violation can be established by reference to the structure of the market affected by the state measure by creating unequal conditions of competition, which allows the undertaking in question to maintain, strengthen or extend its dominant position over another market. In such circumstances, it is sufficient that the measure creates a ‘risk of abuse’, rather than needing to satisfy the burden of proof usually associated with Art 102 TFEU. Jurisprudence confirming the result of *Greek Lignite* can also be found in: *MOTOE* (Case 49/07) (where the measure ‘gives rise to a risk of abuse’ of a dominant position); *ERS Dimotiki* (Case C-260/89), *Porto di Genova* (Case 179/90), *Centro Europa* (Case C-380/06), *Servizi Ausiliari* (Case C-451/03), *Porto v OCS* (Cases C-180/98 to C-184/98), *Ambulanz Glöckner* (Case C-475/99) and *Raso and Others* (Case C-163/96) (where such rights are ‘liable to create a situation’ in which the undertaking would be led to commit abuses); *La Crespelle* (Case C-323/93) (the undertaking ‘cannot avoid abusing its dominant position’ when merely exercising its special or exclusive rights).

2. means that the market is *not served efficiently* because the recipient of those rights is unable to satisfy market demand;⁵
3. affords it the ability to *leverage its market power* into markets that are neighbouring, adjacent or related to the market in which the special or exclusive rights have been conferred;⁶
4. provides it with a privileged position at a particular level of the market vis-à-vis its competitors, thereby creating a *conflict of interest situation* as the recipient in practical terms is able to exercise regulatory functions

5 See, for example, *Höfner and Elser* (Case C-41/90) where the fact that only 28 per cent of employment vacancies could be satisfied meant that a recruitment office monopoly infringed Art 106 when read in conjunction with Art 102, where the grantee of the monopoly was either not willing or not able to carry out fully the tasks conferred upon it; *Pavlov and Others* (Cases C-180/98 to C-184/98) exclusive rights are actionable where the undertaking is 'manifestly not in a position to satisfy the demand prevailing on the market for activities of that kind'; *Ambulanz Glöckner* (Case C-475/99) an infringement of Arts 102 and 106 cannot be found to have taken place if existing demand could not be satisfied simply because of inefficient management in particular circumstances; *Port of Rødby* (94/119/EC) the Commission decided that a state measure/action can qualify as an infringement when possible future demand cannot be met as a result of a denial to deal, given that 'an improvement in the quality of the products or services offered or a reduction in price as a result of competition could also lead to an increase in demand which, in the present case, could be met by expanding the port'; *Slovak Post* (Case C-239/1) a state measure that leads to any kind of inability to meet demand will constitute an infringement; *Porto di Genova* (Case 179/90): a state measure that reinforces monopoly power is likely to create no incentives for an increase in productivity (ie, thereby creating a 'lazy monopolist').

6 See, for example, *Spain and Others v Commission* (Cases C-271/90, C-281/90 and C-289/90): the extension of the monopoly on the establishment and operation of the telephony network into the market in telephone equipment was prohibited in the absence of an objective justification; *Connect Austria* (Case C-462/99): national legislation extending additional frequencies in the DCS 1800 band to a dominant undertaking without paying spectrum fees creates a situation of inequality of opportunity, thereby infringing Art 106(1) in conjunction with Art 102; *Dusseldorp and Others* (Case C-203/96): a state measure obliging waste to be delivered to a national undertaking could not grant further exclusive rights to that undertaking to incinerate the waste; *GB-INNO-BM* (Case C-18/88): the state measure allocating to the public telecommunications network operator the exclusive rights of supply and approval of terminal equipment was an infringement of Art 106; *Ambulanz Glöckner* (Case C-475/99): the grant of a de facto monopoly to provide ambulance transport services to the public medical aid organisation was contrary to Art 106 because it was illegal for a dominant undertaking to reserve to itself, without objective justification, activities on a separate neighbouring market; *Greek Horse Race Betting* (Case AT.40265/2016): while rejecting the complaint against OPAP's monopoly rights with respect to horse race betting, on the ground that there was a lack of 'Community interest' for the Commission to pursue the case, the Commission was willing to entertain an argument that OPAP, by being de facto dominant over so many gaming services, was in a position to leverage market power into the horse race betting segment or market (based on an application of a 'conglomerate effects' theory approach).

or establish the rules under which competition will take place in the relevant market;⁷ and

5. is excessive in terms of its interference with the free market, where the special or exclusive right is linked with the provision of a clearly defined Service of General Economic Interest.⁸

CONCLUSIONS

It is clear that the breadth of the Article 106(1) TFEU prohibition means that the Commission is strongly placed to address a very broad range of structural market problems driven by the privileged position enjoyed by public undertakings or those undertakings that have benefited from the grant of special or exclusive rights. Insofar as individual Member States are tempted to prop up national champions by conferring upon them such rights, the Commission's powers under Article 106(3) TFEU provide a very valuable corrective measure. By the same token, the fact that the Commission is not under any legal obligation to pursue actions under Article 106(1) TFEU provides sceptics with some cause for concern that the use of the provision may be subject to political decision-making.

Anti-competitive state measures under Article 4(3) TEU

While Article 106(1) and (3) TFEU addresses the potentially problematic behaviour of undertakings by ensuring the removal of national measures that foster their anti-competitive unilateral behaviour in the manner understood by Article 102 TFEU, Article 4(3) TEU (Lisbon Treaty) provides the legal

7 The case law suggests that an infringement of Art 106 might occur in one of two types of situation: (1) where a Member State entrusts a public undertaking active in a competitive market with regulatory functions, see *MOTOE* (Case C-49/07), *Albany International BV* (Case C-67/96) and *RTT* (Case C-18/88), where the ability of an undertaking to take regulatory decisions against its own competitor in certain markets, in the absence of effective judicial control over its decision-making, created a conflict of interest that placed the public operator at a competitive advantage vis-à-vis its competitors; and (2) where a Member State confers upon an undertaking a bundle of exclusive commercial rights in relation to distinct commercial activities, see *ERT and Others* (C-260/89) and *Silvano Raso* (Case C-163/96), where the grant of comprehensive monopolies in divergent areas created the danger that the undertaking could discriminate against competitors.

8 Refer to *Corbeau* (Case C-320/91), where the CJEU held that a Belgian law which conferred special or exclusive rights upon an entity to provide postal services in the city of Liege, on the basis that these were Services of General Economic Interest, could not justify the fact that other private operators were being prevented from providing additional services not falling within the scope of the traditional postal service to the public, as the entity with the exclusive rights was not being compensated by the State for the performance of such additional services.

basis upon which state measures that support an anti-competitive legal framework that is contrary to the terms of Article 101 TFEU. Article 4(3) TEU requires that the Member States: 'shall facilitate the achievement of the Union's tasks and refrain from any measure which could jeopardize the attainment of the Union's objectives.'

The obligation is both positive (in promoting the importance of facilitating EU policies) and negative (in obliging undertakings to refrain from actions undermining such EU policies). This provision reflects what is commonly referred to as the principle of 'sincere cooperation', which is a reciprocal obligation that both Member States and the Commission must satisfy. It reflects the importance of the principle that Community law needs to be effectively enforced. This means, among other things, that respect for the positive obligation requires that Member States need to ensure the full application of Article 101 TFEU, must provide the conditions of effective judicial review of national competition authority (NCA) decisions and should ensure the rights of the defence.⁹ The negative obligation is satisfied where the Member State ensures that conflicts do not arise between European court judgments and Commission Decisions on the one hand, and NCA decisions and national court judgments on the other, nor can they adopt decisions that authorise or require conduct that would be contrary to EU competition law.¹⁰

The classic statement of principle in the case law is associated with the *INNO* case,¹¹ where the Court of Justice of the European Union (CJEU) ruled that 'while it is true that Article [101] is directed at undertakings, nonetheless it is also true that the Treaty imposes a duty on Member States not to adopt or maintain in force any measures which could deprive that provision of its effectiveness'.

This means that Member States are obliged to disapply national legislation that contravenes EU competition law, irrespective of whether that obligation attaches to the national courts or to national administrative bodies such as an NCA.¹² It also extends to those situations where national legislation deprives an NCA of its ability effectively to take responsibility for competition law actions.¹³ Where a national law is alleged to contravene the *INNO* principle, however, it must be shown that the national law is causally linked to the problematic competitive behaviour in question and in some meaningful way supports it.¹⁴ In addition, the existence of some other form

9 Many of these obligations are already specified clearly in Regulation 1/2003, which governs the key procedural elements of the Commission and NCAs when applying competition rules.

10 See Case 66/86 *Ahmed Saeed Flugreisen*.

11 See Case 13/77 *INNO v ATAB*.

12 See Case 198/01 *Fiammiferi*.

13 An example of which can be seen in Case 267/86 *Van Eycke v ASPA*.

14 For example, refer to Case C-2/91 *Ming*, Case 231/83 *Cullet v Centre Leclerc*.

of effective Member State relief, effected in accordance with clear public policy principles, will mean that Article 4(3) TEU should not be triggered.

The availability of Article 4(3) TEU, applied in tandem with Article 101 TFEU, provides a strong legal break on the temptations of Member States engaging in more general legal measures that indirectly support their national champions or government-supported undertakings against the workings of the marketplace. While it is the case that the conditions for the application of the *INNO* principle are anything but straightforward, the Commission has been willing to invoke Article 4(3) TEU against Member States that introduce measures that jeopardise the effective application of EU competition rules.

Merger control: limits on Member State intervention

As discussed in the first part of this article, a recent generation of political pressures – unconnected by the Covid-19 pandemic but whose effects have acted as a catalyst to action being taken in response to those pressures – has resulted in the introduction of a new foreign direct investment (FDI) screening mechanism and in the proposal of sweeping powers of intervention and remedy in the case of acquisitions of EU-origin undertakings by acquirers that are subsidised by foreign states.¹⁵

Beyond these FDI and anti-foreign subsidy instruments, however, the ability of the Commission to exercise exclusive jurisdiction over large mergers falling within the terms of the EU Merger Regulation¹⁶ arguably acts as an effective bar against Member States pursuing a protectionist line in support of ‘national champions’ or firms in which their governments have a significant shareholding. Indeed, both of these measures have arguably been adopted in their current form with a view to maintaining the integrity of the EU merger review process and its adherence to competition law principles as the sole basis of its analysis.

There are only three avenues that a Member State can fall back upon to deny the Commission its exclusive jurisdiction, and each of these avenues is narrow in its scope.

Avenue No 1: review if ‘distinct’ markets exist within a Member State

A Member State is entitled under Article 9 of the EU Merger Regulation to make a request to the Commission that a merger be referred to

15 See ‘Coordinated foreign investment curbs’ and ‘Addressing distortions created by foreign subsidies’ in the first part of this article at (2021) 22 BLI 21.

16 Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings, EC OJ L24/1.

the Member State because any threat to competition identified is to a 'distinct market'. Even the Commission has the power, at its own initiative, to suggest that the affected Member State(s) avail themselves of this possibility where it is clear that sub-national markets are involved, or where certain national markets are characterised by very particular public service obligations.

Obvious candidates for Article 9 references are those cases with uniquely local characteristics, which rely on the location of facilities, distinctive regional food or beverage markets, local retailing outlets and even certain network industries whose catchment area for competition is determined by the extent of physical deployment of a network. In some cases, the Commission has been willing to defer jurisdiction to a Member State where the market in question has a unique competitive dynamic based on the form of regulatory intervention in place.

Although there are no hard-and-fast rules as regards when the Commission will be unwilling to accept an Article 9 referral request, it is safe to say that markets that cover the whole of a national territory, unless characterised by uniquely national patterns of demand and regulatory system, will be unlikely to result in a national merger review at the expense of the Commission's power of review. Even where markets are clearly defined as being national in scope for competition law purposes, the Commission has readily assumed that its one-stop-shop jurisdiction should not be compromised, preferring to rely on the fact that many national market players have international operations that span numerous EU Member States.¹⁷

In conclusion, those Member States wishing to protect national champions or state-sponsored firms from the rigours of a full merger review have an uphill battle in convincing the Commission that its one-stop-shop principle should be departed from. The fact that the Commission has the final word on this matter, even though its decisions are inevitably reasoned, suggests that there is little scope for individual Member State freedom of action.¹⁸

Avenue No 2: the protection of 'legitimate interests'

Article 21(4) of the EU Merger Regulation foresees that Member States will be entitled to 'take appropriate measures to protect legitimate interests other than those taken into consideration by [the Merger Regulation] and

17 For example, a spate of spurned requests over the past decade from Member States to seize jurisdiction over national-only mergers has been consistently refused by the Commission.

18 For a detailed discussion on the way in which the Commission deals with such referral requests in network sectors, for example, refer to the discussion in P Alexiadis, 'Merger Control in Regulated Sectors: A Bridge Too Far?', Liber Amicorum Ian S Forrester QC LLD, 23 September 2015.

compatible with the general principles and other provisions of Community law'. What this means in practice is that the Commission, while retaining its one-stop shop merger review capability under the notified merger, must also allow affected Member States to review a merger on specified non-competition law grounds.

However, as is also made clear under the EU Merger Regulation, the only 'legitimate interests' that can justify such parallel Member State review are narrowly defined categories consisting of 'public security, plurality of the media or prudential rules'. This is supported by European case law, which holds that these categories will be interpreted strictly, with the Commission subjecting Member State requests to very rigorous scrutiny that they satisfy the criteria set forth in the EU Merger Regulation.

It will be up to the Commission to authorise the Member State in question to exercise these parallel powers of review. In addition, any measures adopted in furtherance of these listed policy goals need to be proportionate in their scope, with the Commission having the responsibility to determine whether the Member State's request is 'appropriate, proportionate and non-discriminatory' in accordance with the general principles of Community law.

For example, the Commission has taken the view on a number of occasions that the existence of effective regulatory obligations may obviate the need for a Member State to use its powers of intervention under Article 21(4) of the EU Merger Regulation. In particular, the Commission has been very circumspect about whether a Member State can justify its intervention on the ground that a domestic industry (often the energy sector) is suffering some form of security of supply concern. This is especially the case given the fact that European energy harmonisation measures are instrumental in ensuring the free flow of energy across national frontiers in the EU. By contrast, Member States enjoy a greater degree of flexibility when citing 'media plurality' concerns as the basis for their parallel interventions, given the relatively unique freedom of speech tradition in each Member State and the relative lack of harmonisation measures in the media sector beyond the scope of those contained in the Audio-visual Services Directive.

The narrow interpretation of the Article 21(4) exception means that Member States are limited in the extent to which they can distort market conditions by subjecting private sector firms to additional non-competition driven obligations, including those firms in which the state has injected capital and can leverage that influence to compel that firm to engage in government policy directions.

Avenue No 3: the application of the 'two-thirds' rule

Finally, there exists the possibility that a relatively large merger that would otherwise satisfy the turnover thresholds set forth in the EU Merger Regulation will fall outside the Commission's power of review where both the buyer and the seller generate two-thirds of their respective revenues in one and the same Member State (Article 1(3)). This exception is not triggered often in practice, given the large volume of revenues that need to be generated in the same Member State by buyer and seller alike.

Although this is a strict legal exception that is not subject to any discretionary interpretation by the Commission or the Member State concerned, the Commission will need to be convinced that the apportionment of revenues has been made accurately and consistently. This is not always the most straightforward of tasks, especially where the consumption of goods or services occurs other than in the physical location where the contract goods or services were procured. Accordingly, receiving the Commission's acknowledgement that revenues have been allocated appropriately is necessary as a matter of practice.

The four freedoms

Insofar as an investor from a third country is able to acquire an EU target company or to establish itself in an EU Member State, the logic of the Common Market means that the state cannot impede that foreign origin undertaking from increasing its footprint within the EU or providing its goods or services across the EU. The internal market principles that would stand in the way of any such form of state intervention are collectively referred to as the 'four freedoms'. Individually and collectively, each of these freedoms provides the bedrock of the EU legal order, especially given that they are established as part of the EU constitutional order in the form of the Treaties, rather as part of secondary legislation. With the sole exception of the free movement of goods, each of the other three rights has 'directly effect' in terms of its legal impact, in that it can be used directly to enforce rights acquired under EU law.¹⁹ The scope of each of these four freedoms justifies individual consideration.

19 Rather than as a defence in an action brought by a Member State against them (ie, use as a 'shield' rather than as a 'sword').

Free movement of goods

One of the main aims of the internal market is to ensure the free movement of goods within the territory of the Union. The prohibition on customs duties and charges having equivalent effect to customs duties (Article 30 TFEU) and the prohibition of discriminatory taxation (Article 110 TFEU) ensure the elimination of fiscal barriers to trade. However, this would be of little consequence if Member States could then impose restrictions on the actual flow of goods between Member States. Accordingly, EU Member States are prohibited from imposing restrictions on the flow of goods. Typically, restrictions on trade in goods are aimed at protecting domestic production and take the form of customs duties, discriminatory taxation and other trade restrictions (eg, quotas and/or prohibition on imports to shelter domestic production from competition). Consequently, EU law prohibits all three forms of trade restriction, while also establishing a customs union.

Thus, Articles 34 and 35 TFEU prohibit Member States from imposing quantitative restrictions and measures having equivalent effect on imports, exports and goods in transit. Article 36 TFEU allows the Member States to retain such measures in order to protect limited 'legitimate interests'. While the concept of a quantitative restriction has not given rise to problems of interpretation, the concept of a 'measure having equivalent effect' to a quantitative restriction has resulted in a significant body of case law.

The CJEU explained in *Geddo* that 'the prohibition on quantitative restrictions covers measures which amount to a total or partial restraint of, according to the circumstances, imports, exports, or goods in transit'.²⁰ Hence, a total prohibition on imports is considered to be a zero quota, and therefore qualifies as a quantitative restriction. Examples of such quantitative restrictions include the Italian authorities' suspensions of imports of pork into Italy from other Member States in June 1960;²¹ a statutory prohibition in the UK on the import of pornographic material;²² and a restriction in the UK on imports of main crop potatoes.²³

Turning to measures having equivalent effect to a quantitative restriction on imports, the CJEU in the seminal case of *Dassonville* interpreted that concept broadly as encompassing any direct or indirect, actual or potential obstacles to intra-EU trade.²⁴ Subsequently, the CJEU issued its *Cassis de Dijon* ruling, which is one of the great formative events in the establishment of the internal market. The ruling in *Cassis de Dijon* is notable for two main

20 Case 2/73 *Geddo v Ente Nazionale Risi* (1973).

21 Case 7/61 *Commission v Italy* (1961).

22 Case 34/79 *Henn and Darby* (1979).

23 Case 118/78 *Meijer* (1979).

24 Case 8/74 *Procureur du Roi v Dassonville* [1974] ECR 837, at para 5.

reasons: first, it lays down the principle of 'mutual recognition'; and second, it lays down the 'mandatory requirements' doctrine. According to the principle of mutual recognition, a Member State must recognise regulatory standards in other Member States so that once the goods have been lawfully produced in one of the Member States they should be able to circulate freely and be marketed everywhere in the EU, unless there is a valid reason to stop them. The importing Member State can impose its own rules on imported products only to the extent to which that is necessary to protect a mandatory requirement of public interest, such as consumer protection, fiscal supervision and so forth. The mutual recognition principle thus allows the free movement of goods, while at the same time leaving in place the principle of regulatory differentiation between Member States. As a result of the *Cassis de Dijon* ruling, the need for positive integration (ie, the setting of one standard for all of the EU) is reduced to the minimum level necessary, due to the fact that market integration in significant areas can be achieved via mutual recognition (ie, negative integration).

It is thus only when the Member States successfully invoke a justification for imposing their own rules on imported products (ie, when they successfully rely on the mandatory requirements doctrine) under the second limb of *Cassis de Dijon* that there will be the need to remove such barriers through positive harmonisation.²⁵ In the case of labelling requirements (which are measures having equivalent effect falling within the scope of Article 34 TFEU), for example, it is clearly in the interests of consumer protection that product labels can be easily understood by consumers, and therefore Member States should be allowed to require that labels are in the official language or at least in a language widely spoken in their territory. However, given that consumer protection is not mentioned in Article 36 TFEU as one of the interests that allows Member States to derogate expressly from Articles 34 and 35 TFEU, the 'mandatory requirements' doctrine addresses this problem. However, such grounds of public interest can be invoked only if the rules are not directly discriminatory, ie, if they apply in law to domestic and imported products alike. Furthermore, such rules must also be necessary to the achievement of the stated aim, as well as being proportionate. Finally, according to the *Keck* ruling, while it is true that rules regulating the physical qualities of a product (product requirements) automatically fall within the scope of Article 34 TFEU,²⁶ rules that merely discipline *the way in which a*

25 Case 120/78 *Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein* (1979), at para 8.

26 Joined Cases C-267 and 268/91 *Keck and Mithouard* (1993), at para 15.

product is sold (ie, selling arrangements) in principle fall outside the scope of Article 34 TFEU, unless they have a direct or indirect discriminatory effect.²⁷

Free movement of workers

Since the establishment of a common market requires the removal of all obstacles to the free movement of the factors of production, as well as of goods and services, the free movement of workers in the EU, which is secured under Article 45 TFEU,²⁸ may be seen simply as a prerequisite to the achievement of an economic objective. In order for Article 45 TFEU to apply, there needs to be a cross-border element.²⁹ This provision, along with the other provisions of the Treaty relating to freedom of movement for persons, are intended to facilitate the pursuit of occupational activities of all kinds throughout the EU and preclude national legislation that might place EU nationals at a disadvantage when they extend their activities beyond a single Member State.³⁰

Until the early 1990s, the CJEU had limited the scope of Article 45 TFEU to encompass only direct and indirect discriminatory restrictions. It then broadened the scope of the free movement of workers also to encompass a prohibition on (certain) non-discriminatory barriers. In principle, Member States cannot impose nationality conditions for access to employment. The exception to this rule is that Member States are entitled to reserve some posts in the public service to their own nationals.

Right of establishment and free movement of services

The TFEU also guarantees the right of establishment, and the freedom to provide services between Member States. In other words, the rights that Article 45 TFEU provides for the employee is matched by Articles 49 and 56 TFEU in terms of the rights that they provide for the employer, the entrepreneur and the professional. The employed and self-employed activities covered by these provisions are not confined to typical commercial activities.³¹

27 Above at paras 16–17. By the same token, if a rule can be qualified at the same time as a product requirement and as a selling arrangement, it will fall automatically within the scope of Art 34 TFEU by virtue of being a product requirement. See Case C-368/95 *Familiapress* (1997).

28 Case 175/78 *Saunders* (1979).

29 Joined Cases 35 and 36/82 *Morson* (1982); Case 180/83 *Moser* (1984).

30 Case C-443/93 *Ioannis Vougioukas* [1995] ECR I-4033, at para 39.

31 Case 196/87 *Steymann* (1987), at paras 14 and 16.

Subject to certain limited exceptions, the right of establishment is granted to natural and legal persons to allow all types of self-employed activity to be taken up and pursued on the territory of any other Member State, undertakings to be formed and operated, and agencies, branches and subsidiaries to be established.³² It follows that a person may be 'established', within the meaning of the Treaty, in more than one Member State – in particular, in the case of companies, through the setting up of agencies, branches or subsidiaries and, in the case of the members of professions, by establishing a second professional base.³³ The concept of 'establishment' within the meaning of the Treaty is therefore a very broad one, allowing an EU national to participate, on a stable and continuous basis, in the economic life of a Member State other than his or her state of origin and to profit therefrom.³⁴ Accordingly, the CJEU has held that an undertaking of one Member State that maintains a permanent presence in another is nevertheless covered by the provisions on the freedom of establishment:

'even if that presence does not take the form of a branch or agency, but consists merely of an office managed by the undertaking's own staff or by a person who is independent but authorised to act on a permanent basis for the undertaking as would be the case with an agency.'³⁵

The right of establishment is to be contrasted with the freedom to provide services. The former entails settlement in a Member State for economic purposes, and permanent integration into the host State's economy, usually by the setting up of agencies, branches or subsidiaries. The latter entails a person or undertaking established in one Member State providing services in another on a temporary basis. In practice, the distinction may not always be clear-cut, especially where the provision of services may involve temporary residence in the host Member State. As long as such residence is temporary, the activities in question will fall within the scope of Articles 56–62 TFEU on the freedom to provide services. If the activities are carried out on a permanent basis, or without a foreseeable limit to their duration, and from a fixed place of business in the host Member State, they will be regulated by reference to the right of establishment.³⁶

In order to invoke the freedom to provide services set forth in Article 56 TFEU, nationals must be 'established' in a Member State. In the case of those undertakings whose registered office is situated inside the EU, but whose central management or principal place of business is situated elsewhere,

32 Case C-55/94 *Gebhard* (1995), at para 23.

33 See n 31 above, at para 24.

34 See n 31 above, at para 25.

35 Case 205/84 *Commission v Germany* (1986), at para 21.

36 Case 196/87 *Steymann* (1987), at para 16.

the extent of this requirement is explained by the General Programme on Services, which asserts that this provision is satisfied where the activities have:

‘a real and continuous link with the economy of a Member State, excluding the possibility that this link might depend on nationality, particularly the nationality of the partners or the members of the managing or supervisory bodies, or of persons holding the capital stock.’

The CJEU has held that services as diverse as the broadcasting of television signals,³⁷ cable transmissions³⁸ and medical treatment³⁹ are covered by the provisions on the freedom to provide services. While restrictions on the right of establishment and the freedom to provide services may be justified on grounds of public policy, public security or public health, these are not the only grounds upon which measures that hinder the exercise of fundamental freedoms may be justified. The Court has also interpreted the relevant Treaty provisions in such a way that restrictions based on considerations described as imperative requirements, or overriding requirements, in the general interest, are not regarded as comprising prohibited obstacles to the right of establishment or to the freedom to provide services.

Free movement of capital

Articles 67–73 EEC contained the original provisions on free movement of capital, but they were less pre-emptive than those applicable to free movement of goods, workers, services and establishment. While Article 67(1) EEC imposed an obligation to abolish progressively restrictions on capital movements, this was only to the extent necessary to ensure the proper functioning of the common market.

The Maastricht Treaty completely revised the provisions on free movement of capital, effective 1 January 1994, with Article 63 TFEU now providing that:

‘1. [w]ithin the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.

2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited.’

It will be for the Court to decide whether a measure constitutes a restriction on the movement of capital. Thus, a national prohibition on the creation of a

³⁷ Case 155/73 *Sacchi* (1974), at para 6.

³⁸ Case C-17/00 *De Coster* (2001), at para 28.

³⁹ Case C-157/99 *Smits and Peerbooms* (2001).

mortgage in a foreign currency has been prohibited under Article 63 TFEU.⁴⁰ The Court has also held that restrictions on share dealings and 'golden shares' fall within Article 63,⁴¹ as do restrictions on the acquisition and disposal of property.⁴² Measures taken by a Member State that are liable to dissuade its residents from obtaining loans or making investments in other Member States constitute restrictions on the movement of capital.⁴³ While direct taxation measures remain within the exclusive competence of the Member States, they are obliged to exercise that competence consistently with EU law and avoid discrimination on the grounds of nationality.⁴⁴

It is thus clear that Article 63 TFEU covers not only measures that discriminate on grounds of nationality, but also measures that may impede capital movements, even if they are not discriminatory in nature.⁴⁵ This must inevitably provide a great deal of comfort to non-EU origin undertakings that wish to expand their operational footprint in the EU.

Corporate establishment and the practical operation of EU freedoms

In understanding the relative freedom afforded to undertakings of non-EU origin that seek to benefit from the freedom of establishment, it is helpful to investigate through the case law how this right combines with the other freedoms to facilitate full market access. When judged by reference to these freedoms, such market access cannot be impeded by any Member State insofar as it would violate these fundamental freedoms.

The freedom of establishment captures within its scope a number of distinctive rights. One is the right of a natural or legal personality to leave their Member State of origin or establishment in order to accomplish a shift in their primary establishment, or to set up a secondary establishment, in another Member State. Another is the right to have more than one place of business in the EU. Another is the right to carry on business under the conditions laid down for its own nationals by the law of the host Member State. The fourth right is much broader in its scope, consisting of the right to resist the application of national measures that are liable to hinder or make less attractive the exercise of the right of establishment guaranteed by the Treaty, unless such measures can be justified.

40 Case C-464/98 *Westdeutsche Landesbank Girozentrale v Stefan and Republik Österreich* (2001).

41 Case C-182/08 *Glaxo Wellcome GmbH & Co KG v Finanzamt München II* (2009).

42 Case C-443/06 *Erika Waltraud Ilse Hollmann v Fazenda Pública* (2007).

43 Case C-513/03 *Heirs of van Hilten-van der Heijden* (2006), at para 44.

44 Case C-346/04 *Conjin v Finanzamt Hamburg-Nord* (2006), at paras 14–15.

45 Case C-375/12 *Bouanich v Directeur des services fiscaux de la Drôme* (2014).

The right of establishment is enjoyed by companies and firms, as well as by natural persons. Article 54(1) TFEU thus provides that:

‘[c]ompanies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.’

An undertaking formed in accordance with the law of a Member State is therefore entitled to exercise the right of establishment if it has its registered office, its central administration or its principal place of business within the EU. The Court has held that the immediate consequence of Article 54 TFEU is that ‘those companies are entitled to carry on their business in another Member State through an agency, branch of subsidiary’, and that the location of their registered office, central administration or principal place of business ‘serves as the connecting factor with the legal system of a particular State in the same way as does nationality in the case of a natural person’.⁴⁶

The law governing the establishment of companies is more complex than that governing natural persons, mainly due to the differences between national company laws. Rather than await legislative harmonisation at EU level, however, the CJEU has required host Member States to permit companies validly incorporated in another Member State, even under a very different corporate law regime, to exercise rights of secondary establishment in a host Member State without imposing undue regulatory restrictions.

The Court’s case law on corporate establishment in effect holds that an individual or company is entitled to choose the law of a Member State to provide the legal form in which to conduct its business activities, even if no business activities are to be conducted in the Member State of incorporation, and all business activities are to be conducted elsewhere, provided only that this is permitted under the law of the Member State of incorporation. If permissible in one Member State, another Member State cannot refuse to recognise the existence of the company in question, even if it remains entitled to place limits on the extent to which companies incorporated under their laws can ‘export’ the location and control of their business activities. These developments have increased flexibility for businesses wishing to operate on a pan-European basis, and have reduced their costs, thus contributing to the overall competitiveness of businesses in the EU.

⁴⁶ Case C-212/97 *Centros* (1999), at para 20.

Country-of-origin principle

The high-water mark of the EU's four freedoms policies lies in the practice of the 'country of origin' principle governing pan-European commercial relationships across the EU. Where certain industrial sectors have been subjected to a sufficient level of harmonisation, the country of origin principle is deployed to allow parties that have an EU presence in a particular EU Member State to be regulated *only* in that Member State in relation to the services they provide, as a precondition to being able to provide those services across all Member States where they are established. These specific sectoral authorisations include the following:

- Directive 89/552/EC (the Television without Frontiers Directive);⁴⁷
- Directive 2000/31/EC (the e-Commerce Directive);⁴⁸
- Directive 2002/65 (on distant selling of financial services);⁴⁹
- Directive 2006/123/EC (on services in the internal market);⁵⁰
- Regulation (EU) 2017/1128 (on cross-border portability of online content services in the internal market);⁵¹
- Directive (EU) 2018/1808 (on the coordination of certain provisions laid down by law, regulation or administrative action in Member States concerning the provision of audiovisual media services requiring modifications to Directive 89/552/EC (the Television Without Frontiers Directive) – the Audiovisual Media Services Directive⁵² – in view of changing market realities.

All of these legal instruments require that a Member State respect the right of service providers licensed or authorised somewhere in the EU to supply services and to guarantee those providers free access to, and the free exercise of, a particular service activity within its territory. The importance of such rights being made available to international commerce should not be underestimated. They have led to a large number of US companies in the various high-tech sectors basing their EU-wide operations in Ireland or Luxembourg, while the City of London's financial firms have historically used the country of origin principle (prior to the UK's departure from the EU) as the basis upon which they provide their financial services offerings across the EU.

47 OJ L298, 17.10.1989.

48 OJ L178, 17.07.2000.

49 OJ L271, 9.10.2002.

50 OJ L376, 27.12.2006.

51 OJ L168, 30.06.2017.

52 OJ L303, 28.11.2018.

State monopolies of a commercial character

Sitting among the various Treaty provisions that establish the ‘four freedoms’ is Article 37 TFEU, which deals with state monopolies of a commercial character dealing with goods (but does not cover the free flow of services or capital),⁵³ and which is of direct legal effect.⁵⁴ According to Article 37(1), it is provided that ‘Member States shall adjust any State monopolies of a commercial character so as to ensure that no discrimination regarding the conditions under which goods are procured and marketed exists between nationals of Member States’.

This obligation on Member States extends to any body that a Member State supervises, determines or appreciably influences the flow of imports or exports of goods between Member States, and to monopolies delegated by the state to others. In addition, Article 37(2) TFEU obliges Member States to refrain from introducing any new measure by which state monopolies of a commercial character would discriminate against nationals of other Member States or would restrict the scope of the provisions dealing with the prohibition of customs duties and quantitative restrictions between Member States (ie, the freedom of goods principle).

Consistent with the agnostic nature of Community law regarding the private or public nature of undertakings, Article 37 TFEU simply provides that existing monopolies need to adjust their behaviour in such ways as to eliminate the possibility of discrimination taking place, rather than a prohibition on the monopoly. The Article applies in circumstances where the state either grants: (1) exclusive purchase or sales rights (similar to the manner envisaged under Article 106(1) TFEU – see above) that makes it possible for the beneficiary undertaking to control imports or exports in relation to the Member State in question; or (2) rights to a state undertaking or institution or, through the act of delegation, a private organisation.

Where a Member State is suspected to have infringed the provision, the Commission may bring an infringement action either under Article 258 TFEU before the CJEU or even under the Commission’s extensive powers available under Article 106(3) TFEU (by adopting either a Decision or a Directive). Because Article 37 also has direct effect, it is also open to an undertaking that has suffered damage as a result of the infringement to seek damages before a national court. The Commission has brought a number of infringement actions against Member States

53 See Case 155/73 *Sacchi* (1974).

54 Case 91/78 *Hansen GmbH & Co v Hauptzollamt Flensburg* (1979).

under these provisions with a view to ensuring that discrimination by a monopoly provider would not occur, among others, in the fields of supply of gas and electricity,⁵⁵ medical preparations⁵⁶ and petroleum derivatives.⁵⁷

Conclusions

The existence of the four freedoms, as facilitated by the Commission's policies in secondary legislation and the scope of the Article 37 TFEU prohibition, and as endorsed consistently by the European courts, acts as a significant deterrent to those Member States attempting to erect trade barriers on foreign investors in order to protect their national champions or other state-sponsored undertakings. The momentum behind Member States to invest in national undertakings (whether public or private in nature) in response to the Covid-19 pandemic should not alter this state of affairs. Because the key law-maker in the domain of preserving the sanctity of the four freedoms is the CJEU itself, political influence exercised at a national level that is designed to undermine those rights is in principle unlikely to carry as much weight as they would wish.

Oversight by independent regulators

Last, but definitely not least, Member State involvement in firms that play a role in some of the more strategically sensitive sectors of the economy, such as network sectors and public utilities, is subject to very real and effective limits on the ability of those affected undertakings to distort free markets because of the existence of independent sector-specific regulators and competition authorities.

Independence from government or industry influence for an institution responsible for administering sector-specific regulation or competition rules is critical to the effective implementation of both *ex ante* and *ex post* disciplines. In order to secure independence of national regulatory authorities (NRAs) and NCAs, it is usual for legal systems to establish certain measures that could insulate the agency from pressures and undue influence directed by private parties and the central government. Some of the common institutional features to guarantee the independence of NCAs and NRAs are:

55 Case C-157/94 *Commission v Netherlands* (1997).

56 Case C-438/02 *Krister Hammer (Sweden)* (2005).

57 Case C-347/88 *Commission v Greece* (1990).

1. fixed and stable mandates for senior officials;
2. administrative autonomy and absence of hierarchical controls from central government; and
3. financial and budgetary autonomy.⁵⁸

In the *ex ante* field of regulation, concerns about regulatory ‘capture’ are arguably at their highest because the degree of independence of the agency might be compromised either because its members are drawn from the ranks of the historical incumbent operator subject to regulation (or expect to join one of the operators in the regulated sector after leaving the agency) or because they are unlikely to apply economic regulation independently of political influence (usually directed at supporting the historical incumbent operator). These concerns are heightened where state-owned enterprises compete with private providers. In such cases, the lack of independence can also lead to the ‘capture’ of the regulator by the government itself in favour of the state-owned enterprise.

The imperative for a competition regulator to act in such an independent fashion is just as strong, but is arguably less likely to require rules at the same level of detail to ensure independence, given that the risk of ‘capture’ across a broad range of sectors is arguably more difficult to orchestrate, and the fact that the industrial policy directions of government may vary greatly across all of the sectors of the economy. As has been noted in an Organisation for Economic Cooperation and Development (OECD) survey on competition policy, ‘greater independence was the factor most frequently identified as likely to lead to a better promotion of competition law objectives’.⁵⁹

Independence in an EU context

The axiom that a regulator must be able to act independently of political influence is reinforced in the EU context, where it is necessary that an NRA and/or NCA must also be acting in the defined interests of the integration

58 The OECD provides a more detailed list: ‘the most frequently used dimensions of regulatory independence are: (i) budget independence; (ii) conditions for dismissal of the head of the regulatory agency; (iii) appointment of members/head of the regulatory agency by parliament or the legislature; (iv) accountability and reporting to executive, legislature, or representatives from regulated industry; (v) power to set tariffs or price-setting by the executive; and (vi) power to review or approve contract terms between regulated entities or market actors.’ OECD, *Being an Independent Regulator*, The Governance of Regulators, 2016, p 42, DOI: <https://dx.doi.org/10.1787/9789264255401-en>.

59 Refer to Peter Alexiadis and Caio Mario da Silva Pereira Neto, ‘Competition Architectures for Regulatory and Competition Law Governance’ (2019) *European University Institute*, <https://cadmus.eui.eu/bitstream/handle/1814/63285/Competing%20Architectures%20for%20Regulatory%20and%20Competition%20Law%20Governance.pdf?sequence=1&isAllowed=y>.

goals of the EU, rather than in the national self-interest.⁶⁰ This policy imperative for independence is not surprising in the institutional landscape of the EU, particularly given that the Commission is itself subject to an express obligation of independence (see Article 17(3) TEU). Moreover, the EU Member States are bound to respect the independence of members of the Commission, and are obliged not to seek 'to influence them in the performance of their tasks' (Article 245 TFEU). Thus, within the EU, the policy of *not* supporting 'national champions' or 'national only' solutions has long been an explicit policy goal of EU competition law enforcement.

Within the EU, the notion of the truly 'independent' regulatory institution has evolved over time, but has been driven since the 1990s by the model of independent regulators initially developed in the UK in the late 1980s. This is particularly important at a time when EU legislation increasingly promotes the use of more flexible, discretionary powers by NRAs to implement evolving policy.⁶¹ If this discretion is exercised in the shadow of populist movements at national level, the risk is exacerbated that harmonised EU policy-making might be undermined.⁶²

EU competition authorities

The essential elements necessary to establish the independence of NCA decision-making within the EU can be found in Council Regulation 1/2003,⁶³ the procedural legislation that sets forth the *modus operandi* of the Commission and national EU Member State NCAs when applying EU competition rules. Neither Regulation 1/2003 nor its predecessor

60 For a detailed overview of EU legislation, refer to the discussion in Peter Alexiadis and Caio Mario da Silva Pereira Neto, 'Competition Architectures for Regulatory and Competition Law Governance' (2019) *European University Institute*, <https://cadmus.eui.eu/bitstream/handle/1814/63285/Competing%20Architectures%20for%20Regulatory%20and%20Competition%20Law%20Governance.pdf?sequence=1&isAllowed=y>.

61 Case C-424/15 *Ormaetxea Garai and Lorenzo Almendros*, judgment of 19 October 2016 (ECLI:EU:C:2016:780).

62 At the heart of the desire to ensure independence in decision-making is the idea that regulators need to be structured in such a way as to avoid conflicts of interest. The administrative practice of the Commission under Article 106(1) TFEU (see discussion above) provides some insight into the sort of public policy mischief that a conflict of interest can generate. See Case C-49/07 *Motosykletistiki Omospondia Ellados NPID (MOTOE) v Elliniki Dimosio*, ECLI:EU:C:2008:376; Case C-18/88 *RTT v GB-Inno-BM*, ECLI:EU:C:1991:47; Case C-67/96 *Albany International BV v Stichting*, ECLI:EU:C:1999:430; Case C-260/89 *ERT and Others v DEP and Others*, ECLI:EU:C:1991:254 and Case C-163/96 *Silvano Roso and Others*, ECLI:EU:C:1998:54.

63 Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of rules on competition laid down in Arts 81 and 82 of the Treaty, OJ L1, 4 January 2003.

Regulation 17⁶⁴ contained any detailed prescription regarding the need for independence of NCAs vis-à-vis their Member State governments. With the influx of ten new Member States in 2004 (predominantly central and Eastern European countries), however, the momentum to specify working rules to ensure NCA independence increased significantly.

This led to a significant ramping up of legal prerequisites for NCAs to ensure their independence in the implementation of the next generation of the EU competition law procedures, to be found in the recently adopted ECN+ Directive,⁶⁵ which is particularly concerned that ‘a genuine risk of influence by other state bodies exists where state-owned companies or activities by state bodies are subject of an investigation by the NCA or where its enforcement action would interfere with other public interests’.⁶⁶ Accordingly, the ECN+ Directive specifies in several provisions that NCAs must be independent by reference to a number of criteria. In particular, it introduces guarantees aimed at insulating the staff and management of NCAs from external influences, including political pressure, when enforcing EU competition rules. Through provisions that guarantee the tenure of senior officials, avoid conflict of interests and support operational capabilities, the ECN+ Directive reinforces significantly the requirement of independence for NCAs, while establishing clearer objective criteria designed to satisfy these requirements.⁶⁷ As such, it is an important addition to the institutional framework of European competition law.

Regulatory authorities

The principle of independence for sector-specific regulators has been at the heart of EU policy since the early 1990s in relation to the electronic communications sector. Thus, the Framework Directive 2002/21/EC of 2002⁶⁸ provides a number of references on the importance of Member States acting as guarantors of an NRA’s independence. For example, Member States are required to guarantee the independence of NRAs by ensuring that

64 EEC Council Regulation No 17/62, OJ O.13, 21 February 1962.

65 Directive EU 2019/1 of 11 December 2018 to empower the competition authorities of Member States to be more effective enforcers to ensure the proper functioning of the internal market, OJ L.11, 14 January 2019.

66 See Commission Staff Working Document, ‘Impact Assessment accompanying the Proposal for a Directive of the European Parliament and of the Council to empower the competition authorities of the Member States to be more effective enforcers and to ensure the proper functioning of the internal market’, SWD (2017) 114 of 22 March 2017, Part 1/2, at p 26.

67 See especially Art 4 of the ECN+ Directive.

68 Directive 2002/21/EC of 7 March 2002 on a common regulatory framework for electronic communications networks and services (Framework Directive) OJ L.108/33 of 24 April 2002.

they are (1) legally distinct from, and (2) functionally independent of, all organisations providing electronic communications networks, equipment or services. To the degree that Member States retain the ownership of control of an operator in the sector, they are required at least to ensure an 'effective structural separation of the regulatory function from activities associated with ownership or control', and to ensure that NRAs 'exercise their powers impartially and transparently'. To this end, NRAs should be 'in possession of all the necessary resources, in terms of staffing, expertise and financial means, for the performance of their tasks'.⁶⁹

Building on the original requirements of the Framework Directive, the Directive establishing the European Electronic Communications Code (EECC),⁷⁰ which was adopted in December 2018 and came into effect on 20 December 2020 (although not all Member States have completed the enactment of their respective national implementation measures), lays down several provisions concerning the degree of independence that a Member State should guarantee to its NRAs 'to ensure the impartiality of their decisions', with key aspects of economic regulation needing to be performed independently 'both from the sector and from any external intervention or political pressure'. Any such external influence would otherwise render an NRA compromised in its ability 'to act as [an NRA] under the regulatory framework'.⁷¹

The requirement of independence is no less important in the administration of regulation in the energy sector, where national incumbent operators were historically owned and operated by government bodies. At EU level, the prescriptions designed to ensure independence and to avoid NRA conflicts of interest in the sector have been strengthened incrementally over the years, largely in response to shifts in economic regulation, which have demanded an ever-growing sensitivity to independent decision-making. Where the critical interventions in that sector consist of the structural and functional separation of retail and wholesale functions, NRAs in the sector arguably have a more limited role to play in terms of 'pure' economic regulation than their telecommunications NRA counterparts.

Similarly, the latest phase of rail sector liberalisation insists upon the maintenance of independence of railway operators and of infrastructure managers from Member States (specified in terms of the need to control their own assets, budgets and accounts). NRAs in the rail sector must thus be in a position to act independently in terms of their organisational, functional,

69 See Framework Directive, Arts 3(2) and 3(3), Recital 11.

70 Directive (EU) 2018/1972 of 11 December 2018 establishing the European Electronic Communications Code, L 321/36 of 17 December 2018.

71 See Recital 37, EECC.

hierarchical and decision-making capabilities.⁷² This independence will, in turn, influence whether railway undertakings can be managed according to the performance parameters that apply to private undertakings for the provision of efficient and appropriate service provision.⁷³

In the aviation sector, the independence of airport coordinators is set forth in Article 4 of Council Regulation (EEC) No 95/93.⁷⁴ According to the EFTA Court, this requirement of independence is framed in terms of the need to ensure that ‘neither the authorities of the [Member State] concerned nor any other party can unduly influence the coordinator before, during and after the allocation process’.⁷⁵

European policy-makers have also taken the view that the importance of achieving independence is at its most compelling when the protection of a European citizen’s personal data is at issue. Thus, when exercising their powers of overview under the recently implemented General Data Protection Regulation (GDPR),⁷⁶ the standard that needs to be satisfied is that of ‘complete independence’. Recourse to such a high standard probably reflects the sanctity accorded at EU level to data privacy issues affecting individual citizens, but also their vulnerability to being circumvented by national authorities on the basis of politically inspired ‘security’ reasons. In the wake of the Covid-19 pandemic, one can imagine that the pressures on some national governments to exercise certain types of sweeping ‘track and trace’ powers that override fundamental principles of data privacy might be sorely put to the test. In such circumstances, the ability of the data protection authority in place in any given Member State to exercise its supervisory powers without political pressure is a key public policy driver.

Even at the Pan-European level, the requirement of ‘independence’ has also been extended to those bodies representing NRAs in the telecommunications and energy sectors where the member NRAs act as a

72 Refer especially to Arts 55 and 56 of Directive 2012/34/EU of 21 November 2012 establishing a single European railway area (SERA). Also refer to Art 56(10) of SERA as regards the availability of judicial review.

73 Refer to Arts 4 and 5 of SERA.

74 Regulation of 18 January 1993 on common rules for the allocation of slots at Community airports, OJ L 14, 22.1.1993, pp 1–6, <http://data.europa.eu/eli/reg/1993/95/oj>.

75 Case E-18/14 *Wow air v Icelandic Competition Authority and Others*, judgment of 10 December 2014.

76 See Regulation 2016/679 of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data. Refer especially to Arts 51–54 of the GDPR. Details are provided under the GDPR regarding the requirements that affect the various organisational, financial and personnel-related issues relevant to the independence of authorities responsible for data protection issues. CJEU precedent is also reflected in the GDPR, including the observation that the financial control of a data protection authority’s actions by the Member State in question shall not affect its independence.

collective forum at European level. Such bodies include the Body of European Regulators for Electronic Communications (BEREC)⁷⁷ in the context of the electronic communications sector and the European Union Agency for the Cooperation of Energy Regulators (ACER)⁷⁸ in the context of the energy sector. BEREC, for example, is mandated to perform its allocated tasks 'independently, impartially and transparently'. In order to guarantee such independence, members of the management board needed to undertake that they are not subject to any direct or indirect interest that is capable of prejudicing their independence, and need to recuse themselves from taking positions on issues where conflicts of interest arise.⁷⁹

Conclusions

The principle of independence in decision-making has, over the years, become a hallmark of the EU legal order. While the level of independence expected of regulatory institutions across the EU may be considered outside the confines of the EU to be excessive, that independence has become a defining aspect of the twin goals of liberalisation and harmonisation that underpin all Common Market initiatives. As such, it plays a pivotal role in the effective implementation of EU law. It also ensures that the involvement of the state in the free market is less likely to distort competitive conditions to the benefit of state-sponsored firms. In having Member State authorities perform critical tasks that play an integral role in the effective enforcement of EU policy, they must do so while not dancing to the tune of their Member State's ruling political class at any given point in time.

Conclusions

Led by the Commission, the EU response to the Covid-19 pandemic in economic terms has been both swift and generous. At the same time, much of European industry has had little choice other than to embrace the involvement of the state in the private sector as the quid pro quo for economic survival. As this article has argued, however, the drift towards increasing state ownership and public involvement in the private sector is

77 BEREC was established by Regulation (EU) 2018/1971 of 11 December 2018, OJ L321/1 of 17 December 2018 (amending Regulation (EU) 2015/2120 and repealing Regulation (EC) No 1211/2009).

78 For example, according to the proposed recast of the Regulation establishing ACER, legislative proposal 2016/0378 (COD), ACER will have regulatory oversight over future 'Regional Coordination Centres', a regional cooperation mechanism for transmission system operators to remedy the negative effects of fragmented and uncoordinated national actions.

79 See Art 42 of Regulation (EU) 2018/1971.

not a policy paradigm that will necessarily result in lasting change to the face of European industry, which effectively reverses the liberalisation agenda in many European markets and has them operating in the shadow of public undertakings in privileged market positions. Not only does the temporary state aid regime that has been crafted by the Commission to address the significant economic hardships generated by the pandemic foresee a reversion to the status quo pre-Covid, but that state aid regime has also actively built in safeguards that provide strong incentives for undertakings to revert to full private ownership. Most importantly, throughout the duration of their 'public' persona, undertakings that have benefited from state aid measures will be subject to the full range of legal instruments that have been designed to ensure that public undertakings are not in a position to distort markets.

Those legal instruments at the Commission's disposal to further this goal are numerous and varied, with the Commission not being reluctant to have recourse to them over the years. In other words, the EU legal regime that has been in place for many decades – which coincides with the steady retreat of the state from the private sector – dissipates much of the interest of national politicians that would prefer to create 'national champions' that are not burdened by the discipline otherwise exerted by free markets. By the same token, the Commission has worked hard over the years to introduce a range of techniques that allow undertakings to take advantage of a single market, including the introduction of truly independent national regulatory and competition law bodies, and hence to benefit from the famous 'four freedoms' afforded to them under the Treaties. In parallel, the CJEU has been instrumental in ensuring that the four freedoms are respected. By doing so, the Court has ensured that any would-be national champions cannot insulate themselves from the challenges posed by undertakings outside their home borders within the EU.

When it comes to protectionist measures being adopted at EU level that arguably shield public undertakings, state-subsidised undertakings and national champions from foreign competition or takeover, the situation has most recently taken on a rather different complexion. Faced with non-EU governments that wish to erect trade barriers, on the one hand, and the clamour from segments of EU industry that argue that EU merger policy is far too removed from geopolitical realities, the Commission has introduced two sets of sweeping policy changes into the EU legal order. The first of these has created a screening mechanism for foreign direct investment, while the latter proposes to attack subsidies granted by non-EU states to their undertakings that allows them to acquire EU-origin targets. Whereas the first of these measures seems well balanced in taking much of the sting

out of arbitrary or disproportionate Member State protectionist measures, the latter seems open to the very broad exercise of discretion in the hands of the Commission (when determining whether acquisitions of EU target undertakings can take place) and the Member States (when determining whether foreign-origin bidders can tender for public contracts). As this last set of measures is still in the proposal stage, it may be premature to speculate whether the Commission may be departing from its traditional respect and support for open markets. Time will tell.

South African Business Rescue: Evaluating the Efficacy of Alterations of Creditors' Contractual Agreements

Paul Nkoane*

Introduction

As a consequence of the procedural difficulties involved in judicial management and given its lack of success in rescuing companies that were in financial distress,¹ the South African legislature enacted the Companies Act 2008, which comprises innovative business rescue provisions. The improved business rescue rules are meant to effectively facilitate the recovery of companies in distress. Initially, the object of the legislature was to enact mechanisms that empowered the business rescue practitioner to cancel, amend and suspend the terms of any contract entered by the company before the rescue proceedings.² However, some of the provisions on business rescue contained in the Companies Act 2008 did not stand the test of time. These provisions were corrected through the enactment of section 87 of the Companies Amendment Act 3 2011.

This article examines section 136(2) of Act 71 of 2008 and the amendment (particularly section 87) to determine the feasibility of alterations of contracts.

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1 See A H Olver, 'Judicial Management: A Case for Law Reform' (1986) 49 THRHR 84; P Kloppers, 'Judicial Management: A Corporate Rescue Mechanism in Need of Reform?' (1999) 10 Stell LR 417 and H Rajak and J Henning, 'Business Rescue for South Africa' (1999) 116 SALJ 262, 267-268.

2 Section 136(2) of the Companies Act 71 of 2008.

Although business rescue provisions are authoritative, they nevertheless contain contractual issues that raise serious questions. An example would be cancelling a clause that requires payment by the company in a contract of sale, yet demands delivery of the goods.³ In the amendment, the courts are vested with the duty of managing the cancellation of contract terms. This requires the courts to sanction cancellation. Thus, the authority previously entrusted to the practitioner unilaterally to cancel a contract term is no longer applicable under the prevailing rules. The issue of concern regarding alterations (cancellation or suspension)⁴ of contract terms involves the obligations of both the company and the creditor, particularly where both parties have not rendered performance. The dynamics of contractual alterations, in this respect, affect the success of business rescue in many ways, and thus require clarity.

The courts have held that they will not approve a rescue proposal if the evidence led is unreliable or is largely constructed on surmise.⁵ In other words, the proposed rescue must have a substantial prospect of success. Thus, successful recovery should not depend on whether contracts in dispute could be successfully enforced. The good prospect for a successful recovery must not be hinged on feeble odds. It is fair to argue that most contracts are concluded on the *quid pro quo* basis, where both performance and counter-performance must be satisfactory. The parties that have not performed (potential creditors) may refuse to have certain terms of their contracts altered, even where alteration merely postpones the date for counter-performance of the company. Where potential creditors are hesitant to extend performance to an ailing company even when under a contract with the same, additional resources that could improve the financial position of the ailing company may not be obtained. Equally, the prospect of improving the financial position of the company would not be improved, thus the successful recovery may become difficult. It could be argued that the court could compel the potential creditor to perform, but it is trite that the court would not enforce specific performance where it cannot supervise the same, particularly where the creditor has grounds to resist specific performance.⁶

3 The constitutional implication here is the right to equality and freedom of association. Viewed from a literal interpretation of the Act's wording, it is supposedly possible that this right could be compromised by the law entrusting the practitioner with the powers to alter contracts (and still insist that the creditor continue to be part of the rescue by performing as per the new arrangement). The point is that one cannot be compelled to continue with an agreement that brings into question the right of freedom to trade.

4 To avoid repetition and confusion, the word 'alteration' is used to represent the cancellation and suspension of contractual terms.

5 See *Nedbank Ltd v Bestvest 153 (Pty) Ltd; Essa v Bestvest 153 (Pty) Ltd* 2012 (5) SA 515 (GSJ).

6 *Benson v SA Mutual Life Assurance Society* 1986 (1) SA 776 (A).

The author provides a minor assessment of the British corporate rescue regime to better understand the rights of parties affected by rescue proceedings. The focus is placed on the duty of the insolvency practitioner (recently the monitor) and the measures that may be adopted to facilitate a successful rescue. Since the British rescue regime is similar to the South African scheme, it may prove useful in assessing the limits of the rescue proceedings. The article, moreover, peruses the European Directive (2019/1023) to determine how contracts where both the creditor and the company in distress are still to perform should be managed.

The UK's corporate rescue scheme

In the United Kingdom, the administration procedure established through the Enterprise Act 2002 was the main, formal procedure for effecting corporate rescue.⁷ The Enterprise Act allowed administration to become a largely out-of-court process. This statute permitted the company, its directors and secured creditors to appoint an administrator directly through a ballot.⁸ The Enterprise Act was subsequently incorporated in the Insolvency Act 1986. The scheme empowered the administrator to adopt measures to rescue the company as a going concern. This included measures to achieve a better return for the company's creditors as a whole than would be the case if the company were wound up and to facilitate the realisation of property in order to make a distribution to one or more secured or preferential creditors.⁹ This may encompass measures that limit contractual rights in some cases. In this regard, the Insolvency Act 1986 statute espouses legal machinery that seeks to provide a cessation of claims against the company during corporate rescue. In the UK, control of rescue was placed largely in the hands of an independent professional – the insolvency practitioner (IP) – who acted as the company's administrator in rescue proceedings.¹⁰ The administrator's main function was to steer the company to a good financial position,¹¹ and he or she could adopt necessary measures to realise this task.¹² This may involve the alteration of terms that stem from the agreements the company entered into prior to the business rescue.

The spectrum of agreements that may be subject to administration may include hire-purchase agreements including conditional sale agreements,

7 V Finch, 'Corporate Rescue: A Game of Three Halves' (2012) 32 *Legal Studies* 302, 303.

8 O M Brupbacher, 'Functional Analysis of Corporate Rescue Procedures: A Proposal from an Anglo-Swiss Perspective' (2005) 5 *J Corp L Stud* 105, 111.

9 V Finch, 'Control and Co-Ordination in Corporate Rescue' (2005) 25 *Legal Studies* 374, 378.

10 V Finch, 'Control and Co-Ordination in Corporate Rescue' (2005) 25 *Legal Studies* 374.

11 Section 8(2) and (3) of the Insolvency Act 1986.

12 Section 14(1) of the Insolvency Act 1986.

chattel leasing agreements and retention of title agreements.¹³ These contracts may be the focus of suspension, particularly terms that may prove unfavourable to the rescue process. The administrator, as a person devolved with a duty to manage the affairs of the company, was empowered to adopt measures that should successfully provide affected persons with better financial returns. When an administrator has been appointed, there is a general moratorium on the enforcement of contractual terms; the enforcement is only allowed where the consent of the administrator or the permission of the court is granted.¹⁴ The moratorium suspends the powers to enforce rights but does not destroy such rights, it ensures that the company cannot be wound up and demands that the consent of the administrator or the leave of the court is attained for actions such as enforcing a security against the company, repossessing goods in the company's possession under a hire purchase agreement or exercising a right of forfeiture by re-entry.¹⁵

Even so, the regime promotes the notion that the interests of all creditors should be considered in the decision-making process. In the grand scheme of things, corporate rescue involves the balancing of various interests and rights. It goes well past the mere enforcement of private rights because the success or failure of enterprises touches the welfare of individuals and communities.¹⁶ Overtly, the communities comprise creditors and potential creditors whose welfare and rights must be considered. In this respect, the avoidance of altering creditors' rights and interests without their expressed consent informs the fundamental aim of business rescue.¹⁷ Thus, only when creditors assent to alterations of their agreements would the limit to their contractual rights be permissible. The interests of creditors must not be unreasonably limited under the rescue process, as business rescue is primarily intended to enhance affected parties' positions.

To enhance the effectiveness of business rescue, the UK legislature revised its business rescue laws to temper the inadequacies that affected rescue proceedings. The statute was enacted to aid the rehabilitation of ailing companies. The Corporate Insolvency and Governance Act 2020 espouses instruments intended to achieve the rehabilitation task. The explicit change is that of the management of the company during the moratorium. The directors may continue to manage the day-to-day running of the

13 Section 10(4) of the Insolvency Act 1986.

14 Finch (2012) 32 *Legal Studies* 302, 305.

15 Section 10(1)(b) of the Insolvency Act 1986. Also see Finch (2012) 32 *Legal Studies* 302, 305.

16 Brupbacher (2005) 5 *J Corp L Stud* 105, 106.

17 Brupbacher (2005) 5 *J Corp L Stud* 105, 108.

company;¹⁸ however, the monitor assesses most of the critical transactions.¹⁹ Thus, the roles of the monitor (previously the insolvency practitioner) and the company's directors are profoundly affected during the moratorium period. The directors, under the supervision of the monitor, must steer the company to a healthy financial position. It is not clear what would happen if the directors are liable for landing the company in rough financial terrain. Would it be ideal for the directors to continue running the affairs of the company if they have managed it incompetently?

Even so, the company through its directorship must create leeway so that its affairs can be managed effectively and properly.²⁰ One of the measures that can be adopted is the creation of a moratorium that allows the suspension of certain terms of contracts and legal proceedings. This implies that the company may not discharge its debts until the suspension period expires.²¹ The moratorium comprises other mechanisms that provide the ailing company with the scope to revise its financial position for the purpose of rehabilitation. Thus, the ailing company may not be subjected to insolvency proceedings, particularly the winding up of its business, except if the directors initiate the same.²² Similarly, there is a general restriction on enforcement of contracts and legal proceedings directed against the ailing company.²³ A landlord or other person to whom rent is payable, therefore, may not exercise a right of forfeiture through amiable re-entry in relation to premises let to the company except with the permission of the court.²⁴ No measures may be adopted to enforce any security over the company's property, unless the measures are commenced under the accepted financial regulations, or the court permits the undertaking of the measures.²⁵ Unless the court permits, no measures may be taken to repossess goods in the company's possession under any hire-purchase agreement.²⁶ Apart from employment contracts or with the permission of the court, no legal process (including legal proceedings, execution, distress or diligence) may be instituted, carried out or continued against the company or its property.²⁷ Accordingly, the courts will not entertain any application for the enforcement of a pre-moratorium debt for

18 Section A44 of the Corporate Insolvency and Governance Act 2020.

19 Section A35 of the Corporate Insolvency and Governance Act 2020.

20 Section A7 of the Corporate Insolvency and Governance Act 2020.

21 Sections A18(2) and (3) of the Corporate Insolvency and Governance Act 2020.

22 Section A20 of the Corporate Insolvency and Governance Act 2020.

23 Section A21 of the Corporate Insolvency and Governance Act 2020.

24 Section A21(1)(a) of the Corporate Insolvency and Governance Act 2020.

25 Section A21(1)(c) of the Corporate Insolvency and Governance Act 2020.

26 Section A21(1)(d) of the Corporate Insolvency and Governance Act 2020.

27 Section A21(1)(e) of the Corporate Insolvency and Governance Act 2020.

which the company has a payment holiday during the moratorium.²⁸ Where the company grants security during moratorium, the security may only be enforceable if the monitor consented to the granting of the same.²⁹ Equally, the monitor has to consent to the discharge of a pre-moratorium debt if the debt exceeds the specified maximum amount.³⁰ Pre-moratorium debts can also be discharged under a court order,³¹ or in instances where the company sells some of its property or disposes some of the hire-purchase property.³²

All affected creditors or members of the company whose rights are affected by the moratorium must be permitted to participate in a meeting that affects their rights or interests.³³ If a number representing 75 per cent in value of the creditors or class of creditors or members or class of members (as the case may be), present and voting either in person or by proxy at the meeting, agree to a compromise or arrangement, the court may sanction the compromise or arrangement.³⁴ If there are dissenting creditors and the vote cannot be passed with a required 75 per cent of the vote, the court may set aside the vote and sanction the arrangement or compromise provided that those creditors would not be in a worse off position.³⁵ Where the court sanctions the arrangement or compromise, the arrangement or compromise binds all affected parties.³⁶ The voting to adopt a compromise or an arrangement does not apply to a class of creditors or members of the company that the court is satisfied does not have a genuine economic interest in the company.³⁷ It is not quite clear whether those who have prior agreements with the company, but ones that both the company and the same creditors have not performed, could be regarded as having a genuine economic interest. Since the compromise and arrangement may not directly affect the rights and interests of potential creditors, the creditors may not have the right to vote on matters relating to the rescue process. Since potential creditors do not have the right to vote, they cannot be forced to perform during the moratorium.

In the South African regime, the business rescue statute may have appeared to have relegated creditors to mere spectators where contractual

28 Section A21(2) of the Corporate Insolvency and Governance Act 2020.

29 Section A21(2) of the Corporate Insolvency and Governance Act 2020.

30 Section A28(1)(a) of the Corporate Insolvency and Governance Act 2020.

31 Section A28(1)(b) of the Corporate Insolvency and Governance Act 2020.

32 Sections A31(3) and A32(3) of the Corporate Insolvency and Governance Act 2020.

33 Section 901C(3) of the Corporate Insolvency and Governance Act 2020.

34 Section 901F of the Corporate Insolvency and Governance Act 2020.

35 Section 901G of the Corporate Insolvency and Governance Act 2020.

36 Section 901F(5) of the Corporate Insolvency and Governance Act 2020.

37 Section 901C(4) of the Corporate Insolvency and Governance Act 2020.

alterations were at issue.³⁸ This was perhaps an erroneous impression founded on narrow views. Seeing how business rescue is conducted in the UK, the impression cannot be more fallacious. The UK's business rescue statute is intended to highlight the importance of the inclusion of creditors in matters affecting their rights and interest. Even though the initial South African business rescue regime appeared to have marginalised creditors, an analysis of the law in general reveals that creditors had machinery at their disposal to resist alteration of their rights when their consent was not attained. This article explains how the limit of the creditors' rights can be achieved and when such a scheme may be hard to implement.

Assessing creditors' rights during the rescue

Creditors' leverage upon moratorium of claims in South Africa

The attitude of creditors (particularly debt investors) towards business rescue in the South African landscape demonstrates a pattern that is anti-business rescue.³⁹ Creditors perceive liquidation as a far more appropriate system for extinguishing debt. Thus, there has always been tension when creditors had to approve a business rescue or the rescue plan. This tension even extends to the creditors' ballot. Some creditors may refuse to adopt a ballot to approve the rescue plan while others may be in favour of the proposed plan.⁴⁰ The creditors who appoint the practitioner would most likely drive the narrative in the rescue plan, which brings into focus the independence of the practitioner.⁴¹ The narrative may not be deemed to be appropriate by other creditors and this may lead to an impasse. The ballot for the approval of the business rescue plan may have opposing creditors on different sides of the fence. To break the impasse, the creditors who voted in favour of the rescue plan could acquire the voting rights of the dissenting creditors. This implies that a binding offer could be extended to the dissenting creditors

38 See A Loubser, 'The business rescue proceedings in the Companies Act of 2008: concerns and questions (part 1)' (2010) TSAR 501 and A Loubser, 'The business rescue proceedings in the Companies Act of 2008: concerns and questions (part 2)' (2010) TSAR 689. The author raises important issues that affected contract law.

39 *DH Brothers Industries (Pty) Ltd v Gribnitz NO and Others* (38782013) 2014 (1) SA 103 (KZP); *FirstRand Bank Ltd v KJ Foods CC (In business rescue)* (7342015) 2017 (5) SA 40 (SCA); *Ferrostaal Gmb and Another v Transnet SOC Limited t/a Transnet National Ports Authority and Another* (133422019) 2019 (6) SA 490 (WCC) and *Gqwaru v Magalela Architects CC and Another* (199592016) [2017] ZAGPJHC 32 (23 February 2017) unreported.

40 *African Banking Corporation of Botswana Ltd v Kariba Furniture Manufacturers (Pty) Ltd and Others* 2013 (6) SA 471 (GNP).

41 *Griessel v Lizemore* 2016 (6) SA 236 (GJ) and *Ferrostaal Gmb and Another v Transnet SOC Limited t/a Transnet National Ports Authority and Another* (133422019) 2019 (6) SA 490 (WCC).

and, if accepted, would extinguish the debt, paving the way for business rescue.⁴² Perhaps the cancellation of contract terms, which is something that could be entirely at the discretion of the courts and the practitioner, and the vague business rescue plans justify this reluctance. This situation could possibly benefit from mechanics that should persuade creditors to buy into the whole business rescue ideology.

During consultation with creditors, it is possible that the practitioner's proposal to cancel contract terms considered to be an impediment to the business rescue could certainly be met with objection and rejection. The practitioner may approach the court to set aside the creditors' vote if the vote is inappropriate.⁴³ The court would pass a judgment it considers to be just. Conversely, if the rescue proposal (which requires cancellation of certain terms of contracts) is adopted by a required majority,⁴⁴ it binds the company, each creditor and every holder of securities.⁴⁵ This implies that the dissenting creditors cannot challenge the alteration of the contract outside the courts. Even when resorting to judicial intervention they are unlikely to succeed. Once the creditors' vote is approved, the alteration of the contracts binds all creditors, including those who opposed the rescue resolution. Thus, no creditor can enforce the agreement via the courts, but may resort to other remedies meant to secure the rights and interests of the dissenting creditors.

Of course, once a business rescue plan is adopted, the dissenting creditors' contracts become unenforceable and the suit for damages becomes the only legal remedy available to them. The Companies Act 2008 states that if the practitioner's conduct in pursuance of facilitating a rescue plan prejudices the creditor, the creditor can assert a claim for damages.⁴⁶ An independent expert must determine the value of damages, and the damages should be limited to the value that the creditor would receive if the company were liquidated.⁴⁷ However, the determination of that value remains a contentious issue.⁴⁸ Similarly, those who accepted the business rescue plan would have accepted the alteration of the terms of their contracts.

42 *African Banking Corporation of Botswana v Kariba Furniture Manufacturers & Others* 2015 (5) SA 192 (SCA).

43 Section 153(1)(a) of the Companies Act 71 of 2008.

44 Section 152(2) of the Companies Act 71 of 2008. This should be 75 per cent of at least half of the independent creditors.

45 Section 152(4)(a) of the Companies Act 71 of 2008.

46 Section 136 of the Companies Act 71 of 2008.

47 *African Banking Corporation of Botswana Ltd v Kariba Furniture Manufacturers (Pty) Ltd and Others* 2013 (6) SA 471 (GNP) para 38.

48 *DH Brothers Industries (Pty) Ltd v Gribnitz NO and Others (38782013)* 2014 (1) SA 103 (KZP) para 55.

Vis-à-vis the issue of alteration of contract terms, the legislature has jettisoned the rule vesting the practitioner with the authority unilaterally to cancel a contract provision.⁴⁹ By tradition, the higher courts are vested with authority to decide matters that adversely affect rights.⁵⁰ One can thus assume that the practitioner's authority to cancel contract terms had to be transferred to a competent judicial body as the matter encroaches on the rights of the parties. Accordingly, the court has become the only vehicle to the destination of cancellation of contract terms. Any matter concerning cancellation of contract terms must be approved by the courts regardless of the creditors' rejection of the proposed business rescue plan⁵¹ and the practitioner's impression of the rejection of the proposed plan.⁵²

The limitation of contractual rights under the South African regime

It is explicit that some of the contractual terms that may impede the rescue of the company in distress may either be cancelled or suspended. The suspension of contracts provides a temporary cessation of the rights of claimants against the company or in respect of any property in its possession.⁵³ This provides the company in distress the scope to implement the rescue plans without having to contend with numerous creditors' claims and demands that may undermine the rescue process. Thus, the courts would not enforce contracts during rescue proceedings,⁵⁴ unless failure to grant relief would lead to injustice.⁵⁵ However, the court in *BP Southern Africa (Pty) Ltd v Intertrans Oil SA (Pty) Ltd*⁵⁶ held that the suspension of a contract means that any obligation between the contracting parties is extinguished.⁵⁷ This means that when the practitioner suspends payment for inventory or for services rendered, the creditor is similarly entitled to withhold performance. This, in a contractual context, is correct. However, the performance already rendered cannot be withheld or withdrawn. Equally, the view that the

49 Section 136(2) of the Companies Act 71 of 2008. When reading this section, it was quite unclear whether the practitioner had to consult with the relevant creditors first or could cancel a term of its own accord (in such a case the creditor can pursue a claim for damages, see para 3 of the same section).

50 *Qozeleni v Minister of Law and Order and another* 1994 (3) SA 625 (E) and *Da Silva Mendes and another v Kitching and another* 1995 (12) BCLR 1672 (E). Also see, s 128(1)(e) of the Companies Act 71 of 2008.

51 Section 145(2)(a) of the Companies Act 71 of 2008.

52 Section 153(1)(a) of the Companies Act 71 of 2008.

53 Section 128(1)(b)(ii) of the Companies Act 71 of 2008.

54 *Chetty t/a Nationwide Electrical v Hart* 2015 (6) SA 424 (SCA) para 47.

55 Section 85 of the Companies Amendment Act 3 of 2011.

56 2017 (4) SA 592 (GJ).

57 Above para 40.

creditor can withhold access to the premises the company is letting defeats the very essence of the suspension rule. The suspension of a contract or its terms entails that the rights of the creditor are merely suspended, and not terminated. Thus, it is inaccurate to suggest that the contract would be terminated, as there is no fundamental breach that warrants termination of the contract.⁵⁸ Equally, cancelling a contract provision would mean that there would be a new agreement, which substitutes the prior one. This implies that the rights may be forever lost, unless cancellation is intended for a time frame, in which case it may amount to a postponement.

During business rescue proceedings, no legal suits, including enforcement actions, or in relation to any property belonging to the company, or lawfully in its possession, may be commenced against the company in any forum.⁵⁹ This excludes legal action commenced with the written consent of the practitioner; with the leave of the court and in accordance with any terms the court considers suitable; as a set-off against any claim made by the company in any legal proceedings, irrespective of whether the legal suit commenced before or after the business rescue proceedings began; criminal action against the company or any of its directors or officers; a legal action concerning any property or right over which the company exercises the powers of a trustee.⁶⁰ This limits various legal challenges that may be levelled against the company in distress, and provides the practitioner with the space to implement the restructuring plan, including the alteration of contracts.

The European Directive on the limitation of contractual rights

The European Directive (2019/1023) on corporate rescue also encourages the limiting of contractual rights during business rescue. This includes suspension of the terms of the contract for the purpose of restructuring, but there is no provision for the cancellation of a contract term unless the cancellation would amount to suspension.⁶¹ The Directive states that Member States shall ensure that distressed companies can benefit from a

58 *Culverwell v Brown* 1990 (1) SA 7 (A) at 15.

59 Section 133(1) of the Companies Act 71 of 2008.

60 Section 133(1) of the Companies Act 71 of 2008.

61 Article 1(1) of the EU Directive (2019/1023): 'restructuring' means measures aimed at restructuring the debtor's business that include changing the composition, conditions or structure of a debtor's assets and liabilities or any other part of the debtor's capital structure, such as sales of assets or parts of the business and, where so provided under national law, the sale of the business as a going concern, as well as any necessary operational changes, or a combination of those elements.

stay of individual enforcement actions⁶² to support the negotiations of a restructuring plan in a preventive restructuring framework.⁶³ This implies that no creditor should be allowed to enforce the contract when business rescue is commenced. A Member State must ensure that its rules guarantee that a stay of individual enforcement actions can cover all types of claims, including secured claims and preferential claims.⁶⁴ Of course, not all contracts should be limited. The exclusion of contracts the enforcement of which is unlikely to jeopardise the restructuring of the business, or the stay would unfairly prejudice the creditors of those claims, is necessary.⁶⁵ Workers' claims are similarly excluded from the suspension rule.⁶⁶ Member States shall ensure that judicial or administrative authorities can lift a stay of individual enforcement actions, where it would be justifiable to do so.⁶⁷ Member States may limit the authority to lift the stay of individual enforcement actions to circumstances where creditors had not had the opportunity to be heard before the stay came into force. These rules are to a large extent identical to the South African and the UK business rescue rules, as contracts that hinder the rescue of the company in distress are limited for the purpose of restructuring. There is also clear contrast as the Directive does not permit the cancellation of contractual terms.

Assessing the possible effects of altering contractual terms of potential creditors

The perusal of various legal systems on matters that may have a significant bearing on the success of rehabilitating business entities may prove indispensable. The South African business rescue regime is silent on how

62 Article 1(4) of the EU Directive (2019/1023): “stay of individual enforcement actions” means a temporary suspension, granted by a judicial or administrative authority or applied by operation of law, of the right of a creditor to enforce a claim against a debtor and, where so provided for by national law, against a third-party security provider, in the context of a judicial, administrative or other procedure, or of the right to seize or realise out of court the assets or business of the debtor’.

63 Article 6(1) of the EU Directive (2019/1023).

64 Article 6(2) of the EU Directive (2019/1023).

65 Article 6(4) of the EU Directive (2019/1023).

66 Article 6(5) of the EU Directive (2019/1023).

67 Article 6(9) of the EU Directive (2019/1023). Where (a) the stay no longer fulfils the objective of supporting the negotiations on the restructuring plan, for example if it becomes apparent that a proportion of creditors, which, under national law, could prevent the adoption of the restructuring plan do not support the continuation of the negotiations; (b) at the request of the debtor or the practitioner in the field of restructuring; (c) where so provided for in national law, if one or more creditors or one or more classes of creditors are, or would be, unfairly prejudiced by a stay of individual enforcement actions; or (d) where so provided for in national law, if the stay gives rise to the insolvency of a creditor.

the rescue process should affect potential creditors' contracts. This silence leads to the examination of a regime that encompasses various contracts, including those where all parties are yet to perform. The European Directive contains machinery that manages contracts where both parties are still to perform and provides direction in this regard. The European Directive states that Member States shall provide for rules preventing creditors to which the stay applies from withholding performance or terminating, accelerating or, in any other way, modifying essential executory contracts to the detriment of the debtor,⁶⁸ for debts that came into existence prior to the stay, solely by virtue of the fact that they were not paid by the debtor.⁶⁹ Member States shall guarantee that creditors are not permitted to withhold performance or terminate, accelerate or, in any other way, modify executory contracts to the detriment of the debtor by virtue of a contractual clause providing for such measures.⁷⁰ The Directive does recognise the necessity of ensuring fairness where contracts entered into have to be suspended. It is held that Member States should afford creditors appropriate safeguards with a view to preventing unfair prejudice being caused to such creditors as a result of a stay of individual enforcement actions.⁷¹ Similarly, a stay of individual enforcement actions does not apply where national law provides that, if one or more creditors or one or more classes of creditors are, or would be, unfairly prejudiced,⁷² or where so provided for in national law, if the stay gives rise to the insolvency of a creditor.⁷³ In the South African law, the limiting of contractual rights during business rescue may be hard to implement in certain circumstances.⁷⁴ These circumstances may prove decisive in whether the creditor succeeds in quelling demand from the entity in distress where both parties are yet to perform.

Under the South African law, it is unclear whether the alteration of contracts can apply to contracts where none of the parties has performed, but it is seemingly doubtful.⁷⁵ The alteration of contracts remains a moot issue. It similarly proves confusing whether alterations apply to contracts

68 'Essential executory contracts' shall be understood to mean executory contracts that are necessary for the continuation of the day-to-day operations of the business, including contracts concerning supplies, the suspension of which would lead to the debtor's activities coming to a standstill.

69 Article 7(4) of the EU Directive (2019/1023).

70 Article 7(5) of the EU Directive (2019/1023).

71 Article 7(4) of the EU Directive (2019/1023).

72 Article 6(9)(c) of the EU Directive (2019/1023).

73 Article 6(9)(d) of the EU Directive (2019/1023).

74 See subheading '*exceptio non adimpleti contractus*' below.

75 *Blignaut v Stalcor* 2014 (6) SA 398 (FB) and *DH Brothers Industries (Pty) Ltd v Gribnitz NO* 2014 (1) SA 103 (KZN) 132.

where both parties are yet to perform.⁷⁶ Section 136(2) of the Companies Act 2008 cannot be intended to apply to reciprocal legitimate contracts of parties who have not consented to alterations, particularly those who must render performance and have contracted without any malice. However, section 136(2) could be applicable to agreements that are tilted in favour of the creditor and appear to have been crafted improperly to benefit the creditor. In this instance, the practitioner may have certain provisions cancelled and still demand counter performance. In the course of dissecting section 136(2), a distinction must be drawn between suspended and cancelled provisions of the contract. Suspending a provision means a right or interest is still intact but cannot be enforced until the appropriate time. As already indicated above, cancelling a provision implies that a right or an interest will be lost forever; lest cancellation is directed at a time frame, in which case it may amount to postponement. Similarly, cancelling a contract implies termination of the agreement. This entails that further obligations are extinguished save for payment of damages. However, the company under distress should still enjoy the performance that the creditor rendered without rendering counter-performance during business rescue. Thus, there is no effect on the success of business rescue when a creditor that has performed cancels a contract. Nevertheless, alteration of contracts could be problematic to implement in contracts where both parties still must perform. A potential creditor could invoke certain rules and principles under the South African law to ward off the demand to render performance during business rescue.

The Bill of Rights and business rescue

What effect does the Bill of Rights have on this issue? An analysis of the Bill of Rights contained in the Constitution of South Africa 1996 affirms that one duty of the courts is to vindicate rights.⁷⁷ A proper analysis of section 136(2) creates an impression that the section is applicable to suspicious contracts or to consenting parties. In the theory of *laissez-faire*, the state should avoid interfering in private affairs, and this notion is equally accepted in the South African jurisprudence.⁷⁸ Freedom means that the liberty of action is naturally devolved to the actor. The Constitution has explicitly granted society the right to exercise freedom.⁷⁹ The extent to which a person exercises his/

76 Cassim raises various issues concerning the property of third parties that has been leased or is under the use of a company that is under business rescue; see M F Cassim, 'The safeguards and protective measures for property owners during business rescue' (2018) (1) SA Merc LJ 40.

77 Sections 12(1)(a) and 22 of the Constitution of the Republic of South Africa 1996.

78 *Botha v Rich NO* 2014 (4) SA 124 (CC) para 46.

79 *Affordable Medicines Trust v Minister of Health* 2006 (3) SA 247 (CC) para 59.

her freedom is very significant in determining the weight that should be afforded to freedom in a constitutional sense.⁸⁰ It would not be out of context to suggest that the freedom to contract is constitutionally fundamental, a right enshrined in the Constitution for a significant purpose.⁸¹ However, the freedom to contract must be constitutionally acceptable and balanced.⁸² The courts have an explicit duty to secure rights. Currie and de Waal assert that:

‘In most constitutional jurisdictions, the state is entitled to place substantial burdens on the economic association. The primary reason is that business associations control the distribution of important social (public) good and must be subject to rules of fair play. In addition, where existing regulations strike far into the heart of an association’s membership policies or limit the associational choices of an individual, a constitutional attack is more likely to be based on the infringements of the rights to trade, profession or occupation or the right to property.’⁸³

Similarly, applicable to alterations of agreements is a right to equal treatment; equality before the law is buttressed in South African jurisprudence.⁸⁴ Equality before the law cannot be undermined through the granting of undue preference to an ailing entity, which also derives force from the Constitution.⁸⁵ The Constitutional Court held that:

‘with regard to mere differentiation the constitutional state is expected to act in a rational manner. It should not regulate in an arbitrary manner or manifest “naked preferences” that serve no legitimate governmental purpose, for that would be counter to the rule of law and the fundamental principles of the constitutional state. The purpose of this aspect of equality is, therefore, to ensure that the state is compelled to operate in a rational manner.’⁸⁶

This constitutional standard delivers no particular goodwill to a particular individual, the standard is formulated to guarantee that justice is always done. In the Companies Act 2008, the importance of the Bill of Rights is entirely acknowledged.⁸⁷ This means that if there is a fundamental change in the

80 *Barkhuizen v Napier* 2007 (5) SA 323 (CC) para 57.

81 Section 22 of the Constitution of the Republic of South Africa 1996 states: ‘Every citizen has the right to choose their trade, occupation or profession freely; also see section 18 which states that [e]very one has the right to freedom of association.’

82 *Barkhuizen v Napier* 2007 (5) SA 323 (CC).

83 I Currie and J de Waal, *The Bill of Rights Handbook* (6th edn, Juta, 2013), 18.2(c) (iv).

84 Section 9(2) of the Constitution of the Republic of South Africa 1996 states: ‘[e]quality includes the full and equal enjoyment of all rights and freedoms. There is no doubt the freedoms include freedom to contract.’

85 Section 9(1) of the Constitution of the Republic of South Africa 1996 states: ‘[e]very one is equal before the law and has the right to equal protection and benefit of the law.’

86 *Prinsloo v Van der Linde* 1997 (6) BCLR 759 (CC) para 25.

87 Section 7 of the Companies Act 71 of 2008.

terms of a contract, one is not precluded from cancelling the contract and contracting elsewhere. Thus, if a creditor decides that the new terms are not to his benefit, the creditor cannot be compelled to honour them.

Of course, relevant to the theory of hardship is that the alteration of agreements should provide relief to a party in distress. However, the limitation of hardship for one party should not lead to the creation of hardship for another.⁸⁸ Thus the alteration of contract terms must not shift hardship from one party to another. The test to assess whether hardship would be suffered must be applied in an objective and subjective manner.⁸⁹ Similarly, the right to exercise freedom does not depend on the need to relieve hardship, it inherently promotes the choosing to associate with, or disassociate from, any entity or organisation. Moreover, the right to exercise freedom is hinged on the notion that a person has the discretion to determine their own course. Freedom entitles the creditor to withhold performance where immediate and adequate counter-performance is not promised or rendered. Of course, those who have rendered performance have a limited freedom to enforce counter performance. This is evident where the statute states that those whose contracts are altered may seek relief in the form of damages.⁹⁰

Thus, it would be erroneous to argue that alterations of contract terms could apply to contracting parties who refused to consent to new terms. Indeed, considering the force of legislation, it could be strongly argued that the common law and court precedent cannot supersede legislation imperatives. Then again, it would be difficult to enforce laws that are unclear

88 R H Christie and G B Bradfield, *Christie's The law of contract in South Africa* (6th edn, 2011), 547: the courts in their discretion will naturally not subject a defendant to the danger of contempt of court in cases where compliance with the order would be impossible, unduly onerous, difficult to enforce or insufficiently clear-cut, so that opinions might legitimately differ on whether there had been performance. In *Benson v Mutual Life Assurance Society* 1986 (1) SA 776 (A) 782–783, the court held that its discretion is aimed at preventing an injustice – for cases do arise where justice demands that a plaintiff be denied his right to performance – and the basic principle thus is that the order which the Court makes, should not produce an unjust result which will be the case, eg if, in the particular circumstances, the order will operate unduly harshly to the defendant. Where enforcement of a contract will bring about unfairness or hardship, in regard to its execution and operation, the court will refuse to decree any order because of the adverse consequences that may ensue; see *Tamarillo (Pty) Ltd v BN Aitken (Pty) Ltd* 1982 (1) All SA 191 (A) 206. The court in *Haynes v Kingwilliamstown Municipality* 1950 (3) SA 841 (E) 849 stated: 'in considering the hardship which may flow from the execution of the contract, which was not present at the time to the minds of the parties, seems to be a point.' It should be remembered that this applies to creditors that still have to perform and whose contracts the practitioner intends to reconstruct.

89 Subjectively, the creditors' financial position has to be examined to see whether they can bear the proposed financial alteration. Objectively, the court will have to determine the logic of the proposed variation in relation to all parties involved.

90 Section 136(3) of the Companies Act of 2008.

on the matter, particularly where the common law and court precedent better promote constitutional standards.⁹¹

Understanding contractual consensus

Let us suppose that a potential creditor refused to have its agreement altered or did not have a right to vote during proceedings, and the court endorses the practitioner's proposal. It is evident that the parties would not have reached consensus on the matter, which means that there could not be a binding agreement. It is explicit that the varying of the terms of the contract – albeit with the court's approval, but without the consent of the affected creditor – has the effect of defeating consensus. The law must not be interpreted in a manner that leads to the innocent party being caught between a rock and a hard place. The courts should be and are cognisant of this fact. In matters where hardship may be experienced or there is supervening impossibility, the court may alter or terminate agreements accordingly. Where hardship is experienced, both litigants are afforded a platform to address their grievances and should at least consent to the order.⁹² A literal interpretation of section 136(2) creates the impression that the contract continues and is altered without the consent of the affected party. Where the contract is continuing, the alteration should be conducted based on mutual agreement and proper consultation. To do otherwise would defeat the very notion of contractual consensus. The requirements for contractual consensus are as follows:

1. a mutual understanding between the parties of the result they wish to bring into existence;
2. a mutual understanding between the parties that they intend to bind themselves legally; and
3. the parties ought to be conscious of their mutual understanding.

Regardless of the impression that the wording of section 136 creates – metaphorically speaking, 'no one should be forced to jump into a crocodile-infested river' – one should be permitted to take a leap of fate at one's own accord. Thus, mutual agreement is generally accepted as an underlying basis of contractual liability.⁹³ The lack of awareness or disagreement about what terms of the agreement should be altered defeats the whole object of

91 *In re Hyundai Motor Distributors (Pty) Ltd v Smit* NO 2001 (1) SA 545 (CC) paras 21 and 22; Langa DP said the following: 'This means that all statutes must be interpreted through the prism of the Bill of Rights. All law-making authority must be exercised in accordance with the Constitution.'

92 Where an order will result in the party suffering undue hardship, the court will not grant the relief sought; see *Haynes v Kingwilliamstown Municipality* 1950 (3) SA 841 (E) 849.

93 *Saambou-Nasionale Bouvereniging v Friedman* 1979 (3) SA 978 (A).

contractual consensus.⁹⁴ In other words, the offer to alter the contract must be accepted by the other party.⁹⁵ Where there is ambiguity in the wording of an offer or the conduct of the offeror is ambiguous, the acceptance of the offer cannot give rise to a contract.⁹⁶ Thus, even in the case of novation⁹⁷ (which is what would happen in terms of section 136(2)) both parties have to agree to the new terms. The operative word here is 'agreement', which in a contractual context entails that there can never be novation where there is no consensus on new terms. Therefore, where intent to be bona fide bound by the contract cannot be established, there can never be a binding contract.⁹⁸ If the parties cannot agree on the terms of the contract or the terms are vague, there is dissensus, and accordingly no contract exists.⁹⁹

When considering that the establishment of consensus underlies contractual liability, then it would be problematic to argue that a contract exists where consensus is not reached. Thus, it becomes plausible to argue that contracts cannot be unilaterally changed – hence a contract cannot be operative where the contracting parties have failed to reach consensus. Surely it would be problematic to argue that a contracting party should be bound to honour terms that it never agreed to in the first place.

Of course, for the sake of the economy and to promote commerce, lawmakers should do whatever is necessary to sustain business activities.¹⁰⁰ Nevertheless, such necessity cannot afford the legislature the warrant to trample upon or ignore other rules of law. It is, therefore, necessary that where the legislature amends or enacts laws, it should first be confident that effecting improvements would not create uncertainties or conflict of laws.

Exceptio non adimpleti contractus

Where alterations of contract terms are improperly implemented, a creditor may be empowered to petition the *exceptio non adimpleti contractus* (*exceptio*) as a defence. A party can invoke the *exceptio* even where there is no fundamental breach of consensus.¹⁰¹ Equally, it should be stated that there is a connection

94 *Bloom v The American Swiss Watch Co* 1915 AD 100.

95 M A Fouché, *Legal Principles of Contracts and Negotiable Instruments* (1992), 38–39.

96 *Humphreys v Cassell* 1923 TPD 180.

97 Novation means that the original agreement is extinguished by the new agreement between the parties and a new obligation therefore replaces the old.

98 *Vasco Dry Cleaners v Twycross* 1979 1 SA 603 (A).

99 *Levenstein v Levenstein* 1955 (3) SA 615 (SR).

100 See s 7 of the Companies Act 71 of 2008.

101 Where there is a latent defect in a thing sold and the seller was unaware of such defect upon delivery.

between consensus and the invocation of the *exceptio*.¹⁰² It is true that the use of *exceptio* as a defence entitles the defendant to withhold his or her counter-performance where the contract assertor has rendered unsatisfactory performance.¹⁰³ The Court in the *BP Southern Africa (Pty) Ltd v Intertrans Oil SA (Pty) Ltd* case raised similar issues concerning alterations of agreements.¹⁰⁴

The *exceptio* is the common law defence invoked to compel proper performance from the contract assertor. As Hutchison and Pretorius put it ‘the *exceptio* can be petitioned to secure specific performance from the contract assertor whose performance is unsatisfactory’.¹⁰⁵ Owing to the powers entrusted to the practitioner to suspend and with the court’s approval to cancel any provision considered to be a hindrance to a successful rescue, it is important to understand where the line should be drawn. On the one hand, the creditor can claim that a contract term is fundamental for the rendering of full performance. On the other hand, the practitioner may insist on cancelling the term of the contract to facilitate proper business recovery. In such cases, which right should give way? If the practitioner’s demands were to receive preference, then an affected party can withhold performance, and invoke the *exceptio*. In the context of this article, we need to understand under what circumstances the *exceptio* can be invoked.

The *exceptio* operates in bilateral contracts. In other words, there has to be at least an exchange of performances, that is, the contract has to be reciprocal in nature.¹⁰⁶ The *exceptio* as a defence is restricted to reciprocal contracts where both parties are to perform simultaneously or where it is required that one party performs before the other.¹⁰⁷ Thus, the *exceptio* derived from the existence of a relationship of reciprocity between debts may constitute an impediment to the enforcement of a debt.¹⁰⁸ The Court in *Grand Mines (Pty) Ltd v Giddey NO*¹⁰⁹ held that for the *exceptio* to succeed,

102 If two parties agree that a property has to be delivered on a certain date, and the other party fails to deliver as agreed. The party who has breached the agreement cannot demand payment; he will simply be resisted with *exceptio*. In this instance, breach of contract relates to non-compliance with the terms of the contract. Terms of the contract in many cases relate to the mutual agreement between the parties as to what is to happen and at what time it should happen.

103 M A Fouché (ed), *Legal Principles of Contract and Negotiable Instruments* (2nd edn, 1992), 115–116.

104 *BP Southern Africa (Pty) Ltd v Intertrans Oil SA (Pty) Ltd* 2017 (4) SA 592 (GJ) paras 38–41.

105 D Hutchison and C Pretorius (eds), *The Law of Contract in South Africa* (Oxford University Press, 2017), 328.

106 *Kamaludin v Gihwala* 1956 (2) SA 323 (C) 326.

107 For the concept of ‘reciprocity of obligations’ see Hutchison and Pretorius, n 105 above, 328–9.

108 S W J Van der Merwe et al, *Contract: General Principles* (4th edn, Juta 2012), 487.

109 1998 JOL 4146 (A).

the plaintiff's performance must have fallen due prior to or simultaneously with the performance of the defendant.¹¹⁰ The implication of *exceptio* in terms of reciprocal contracts is that where one party fails to perform as per the contract, the other party who has not performed adequately cannot enforce counter-performance. Depending on who is to perform first, a party may withhold his or her performance until the other party performs satisfactorily or offers to perform satisfactorily. This rule largely affects contracts of sale or those of *locatio conductio operis*.¹¹¹ Provided that the requirements for the *exceptio* are met, it may similarly be entreated in a contract where provision is made for periodic performance or performance in instalments.¹¹² This means that the *exceptio* is a bar to judgment but not a bar to action, therefore it is a defensive remedy. The Court in *Thompson v Scholtz*¹¹³ held that the *exceptio* was a stalemate defence to a claim *ex contractu* and not a remedy for breach of contract. For a party to succeed with a defence of *exceptio* it is not a necessity that the defendant show that the plaintiff has failed completely to perform as per agreement. Instead, all the defendant needs to prove is that the plaintiff has failed to comply with at least one of his obligations.¹¹⁴ Thus, *exceptio* is also available where failure to perform properly is not so serious or material to justify utter rejection of performance or cancellation of the contract.¹¹⁵ Failure to perform must, however, cause substantial or real impediment. Therefore, a trifling failure denies the defendant the invocation of the *exceptio* since the court will not concern itself with trivialities (*de minimis non curat lex*).¹¹⁶

The defendant may even use the incomplete performance rendered by the plaintiff; in this manner the defendant upholds the contract, notwithstanding the defendant can still invoke the *exceptio* to compel complete performance.¹¹⁷ Until the plaintiff has rendered or promises to render adequate performance, the *exceptio* may not be relaxed. This remedy is not temporary in nature because it is hinged on contractual consensus, and it may be invoked until adequate performance is rendered or even in cases where performance is

110 *Ibid* 12, per Smalberger JA.

111 Van der Merwe asserts that the *exceptio* would be applicable in contracts that are reciprocal, which includes the contract of sale, lease, mandate, *locatio conductio operis* and insurance; see Van der Merwe et al, n 108 above, 335.

112 *Grand Mines (Pty) Ltd v Giddey NO* 1998 JOL 4146 (A) 13.

113 1999 (1) SA 232 (SCA).

114 *Motor Racing Enterprises (Pty) Ltd (In Liquidation) v NPC (Electronics) Ltd* 1996 (4) SA 950 (A) 964.

115 *Thompson v Scholtz* 1999 (1) SA 232 (SCA) 241. Material failure to perform could relate to cases of positive malperformance or a significant breach of contract, which would entitle the defendant to *actio redhibitoria*.

116 *Thompson v Scholtz* 1999 (1) SA 232 (SCA) 240.

117 Hutchison and Pretorius, n 105 above, 331.

no longer possible.¹¹⁸ Since in some cases it may create injustice for the court to uphold the *exceptio* where the plaintiff is no longer able to perform and where the defendant has used the defective performance, some measure of fairness may be adopted.¹¹⁹ In this instance, the court may deduct from the contract price the amount that remedies the defect in the performance of the plaintiff. The plaintiff would have to submit evidence that vindicates the reduced price.¹²⁰ Where the plaintiff avoids petitioning the court on contractual grounds, the plaintiff may rely on enrichment for compensation. Thus, the business rescue practitioner may have to engage the alterations of contracts with rules of contract in mind.

The practitioner's possible demands and the exceptio

The courts are hesitant to deny a litigant a right to defend or institute a lawsuit using a valid legal rule. In cases where malperformance of the contract is rendered, the defendant can lawfully ward off a claim with the *exceptio*. Considering this, it could be supposed that there is doubt whether a party whose contract is altered may be compelled to perform since various defences would be available to resist a demand. However, in certain instances, the contract could be altered and continued without the consent of the affected party.¹²¹ In such instances, the *exceptio* will not provide an adequate defence.

The court in *Thompson v Scholtz*¹²² held that the invocation of the *exceptio* for an inconsiderable amount of money is permitted if failure to perform has caused a significant impediment. The Court held that the *exceptio* was a good defence to the plaintiff's claim for occupational interest.¹²³ However, contrary to the trial court, it denied the plaintiff reduced occupational interest because it was of the view that the plaintiff had failed to discharge the onus of proving what it would have cost to remedy the shortfall in his own performance (ie, his failure to vacate the farmhouse).¹²⁴ The appeal was thus upheld. The appeal court was then approached to settle the matter of a defence based on the *exceptio* for the so-called insignificant performance.

118 *Motor Racing Enterprises (Pty) Ltd (in Liquidation) v NPS (Electronics) Ltd* 1996 (4) SA 950 (A) 962 and Van der Merwe et al, n 108 above, 336.

119 Hutchison and Pretorius, n 105 above, 332.

120 *Smith v Van den Heever* 2011 (3) SA 140 (SCA).

121 This would include contract terms that are unlawful, see Hutchison and Pretorius, n 105 above, 187–8.

122 1999 (1) SA 232 (SCA).

123 The court relied on *BK Tooling (Edms) Bpk v Scope Precision Engineering (Edms) Bpk* 1979 (1) SA 391 (A).

124 *Thompson v Scholtz* 1999 (1) SA 232 (SCA) 239.

The Court held that for a defence of *exceptio* to be upheld as illustrated in the *BK Tooling* case,¹²⁵ the defence must be qualified.¹²⁶ First, a plaintiff is barred from recovering any remuneration if his performance falls short of perfection, even when the defendant, notwithstanding its shortcomings, accepts and utilises it. Secondly, the first condition cannot operate without another qualification, which is that corrective measure to the shortfall must be possible.¹²⁷ The word 'corrective' implies that the plaintiff's performance is capable of being restored and quantified so as to award damages for the shortfall in performance.¹²⁸ Since the value of occupation of the farmhouse could not be precisely computed and the occupation of the farmhouse cannot be cancelled out, the *exceptio* cannot be entreated in this instance.

However, the Court relied on other remedies to compensate parties. The case shows that where there is fundamental hindrance, no matter how trivial a matter may seem, the defendant is not precluded from pleading the *exceptio*. Thus, the creditor of the company in distress is not barred from pleading the *exceptio* where the practitioner demands full performance while withholding counter-performance. When considering that the company may not be able to perform fully soon, a creditor may be hesitant to devote itself to a failing entity. In any case, the creditor may argue: why should it suffer on account of the misfortunes or sins¹²⁹ of others? These sentiments may perhaps lend legitimacy to the creditor's rejection to perform where the business rescue plan has been adopted and both parties' performance is still outstanding.

Reflection on the effect of business rescue on creditors' contracts

Business rescue can be undertaken when two possibilities exist: (1) when the company can continue to exist on a solvent basis; or (2) if it is not possible for the company to so continue in existence, business rescue should result in a better return for the company's creditors or shareholders than would result from the immediate liquidation of the company.¹³⁰ Of course, these

125 *BK Tooling (Edms) Bpk v Scope Precision Engineering (Edms) Bpk* 1979 (1) SA 391 (A).

126 *Thompson v Scholtz* 1999 (1) SA 232 (SCA) 241.

127 See *BK Tooling (Edms) Bpk v Scope Precision Engineering (Edms) Bpk* above.

128 See *BK Tooling (Edms) Bpk v Scope Precision Engineering (Edms) Bpk* above.

129 The company could be run in a reckless manner, in which directors could be accountable for much of the loss. In *Rabinowitz v Van Graan* 2013 (5) SA 315 (GSJ) the court held that an affected party is competent to assert a claim for damages against directors who fraudulently abused the company's funds.

130 *Oakdene Square Properties (Pty) Ltd v Farm Bothasfontein (Kyalami) (Pty) Ltd* [2013] 3 All SA 303 (SCA) para 26.

two possibilities should be proven to avoid prejudicing the affected parties, particularly creditors.¹³¹

The author intends to discuss the following alteration of the terms of the agreement: a reduction in interest or principal, a change in maturity, subordination of claims, release of collateral and secured claims exchanged for unsecured claims. These alterations are quite significant and may embolden creditors to refuse to approve the rescue plan of an ailing company. Of course, there cannot be a blanket approach to alteration of contracts. Different categories of agreements should be dealt with in different ways.¹³² The author first discusses instances where creditors have already rendered performance and must decide on the approval of a business rescue plan. Where the creditors approve the rescue plan, they would have obviously consented or agreed to alterations of their agreements. Where there is reluctance or refusal to approve the rescue plan, the practitioner can approach the court to have the vote set aside on the grounds that it is inappropriate.¹³³ The court would consider whether the company has any prospect of operating on a solvent basis, or whether better returns would accrue when the rescue plan is adopted.¹³⁴ The court, when setting aside an inappropriate creditor's vote, devotes much emphasis to the object of business rescue, which, among other things, includes 'the balancing of the rights and interests of all relevant stakeholders'.¹³⁵ The words 'relevant stakeholders' include the employees of the company under distress, whose interests and rights upon determining whether the vote against a business rescue plan is inappropriate are considered.¹³⁶

Once the court sets aside the vote against the approval of a business rescue plan, no fresh rounds of voting shall be conducted, thus the business

131 *Ferrostaal Gmb v Transnet SOC Limited t/a Transnet National Ports Authority and Another (133422019)* 2019 (6) SA 490 (WCC); *Commissioner; South African Revenue Service v Beginsel NO* 2013 (1) SA 307 (WCC) para 62 and *Prospec Investments v Pacific Coast Investments* 97 2013 (1) SA 542 (FB). Also see *Koen and Another v Wedgewood Village Golf & Country Estate (Pty) Ltd and Others* 2012 (2) SA 378 (WCC) para 20, where the following was said: 'Vague and speculative averments in the founding papers will not suffice to provide a proper basis for a court to make the required determination that there is a reasonable prospect, if the company were to be placed under supervision, that the contemplated business rescue objective could be achieved.'

132 Sections 150(2)(a)(ii)–(iii) and (b)(v) of the Companies Act 71 of 2008.

133 Section 153(7) of the Companies Act 71 of 2008.

134 *Ferrostaal Gmb and Another v Transnet SOC Limited t/a Transnet National Ports Authority and Another (133422019)* 2019 (6) SA 490 (WCC) para 15.

135 Section 7(k) of the Companies Act 71 of 2008 states that one of these purposes is to 'provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders'.

136 *FirstRand Bank Ltd v KJFoods CC (In business rescue) (7342015)* 2017 (5) SA 40 (SCA) para 82.

rescue plan would be adopted through the operation of the law.¹³⁷ The practitioner has the option of adopting either of the following approaches. First, the dissenting creditor can be awarded the amount the creditor would have received upon liquidation. In this instance, the rescue plan cannot change the nature of the contract; that is, there would not be a reduction in interest or principal, a change in maturity, subordination of claims, release of collateral, secured claims exchanged for unsecured claims. This means that the rescue plan cannot affect the contracts. However, as the agreements would have to be dealt with in a manner analogous to a liquidation process, the terms and the nature of the contracts cannot remain the same. Secondly, if managing the contracts similarly to a liquidation process defeats the object of the business rescue plan, then the creditor would have to endure the rescue process. In truth, it would make less sense why a creditor would opt to receive a liquidation value while business rescue would be more beneficial to all affected parties, including the dissenting creditor. Perhaps the liquidation process may prove to be a quicker route to receive funds; however, the court has held that if the creditor refuses to approve the rescue plan on such grounds and the creditor would not be placed in a worse off position, the creditor's vote should be considered inappropriate for the purpose of business rescue.¹³⁸ Purely self-interest votes that undermine the interests of others and ignore the purpose of business rescue are considered to be unfair and inappropriate.¹³⁹

Contracts where both parties must still perform prove quite problematic to analyse. It is unclear whether potential creditors are encompassed in the rescue process. Although the contracts of these parties would have been concluded before the initiation of business rescue, the parties remain potential creditors because they would not have performed and are not creditors of the entity in the true sense of the word. Even though the word 'creditors' forms part of the definition of affected parties, there is no precise definition of the word 'creditors' in the statute.¹⁴⁰ It appears that creditors are parties who have claims against the company in distress.¹⁴¹ Similarly, a party would be a creditor if its voting interest (or claim) can be independently appraised and valued.¹⁴² It is true that a voting interest of an outstanding performance can still be valued; however, the statute seems to limit the word 'creditors' to those who have already extended credit to the company.

137 *Ibid* para 88.

138 *Ibid*.

139 *Copper Sunset Trading 220 (Pty) Ltd v Spar Group Ltd* 2014 (6) SA 214 (SCA) para 31 and *Collard v Jatara Connect (Pty) Ltd* 2018 (5) SA 238 (WCC) paras 21 and 27.

140 Section 128 of the Companies Act 71 of 2008.

141 Section 147(1)(a)(ii) of the Companies Act 71 of 2008.

142 Section 145(5)(b) of the Companies Act 71 of 2008.

Potential creditors, accordingly, would not have the right to approve a rescue plan even when contractually tied to the distressed company.

The question then is: does business rescue affect such contracts? And if indeed such contracts are affected, how should they be dealt with in the context of business rescue provided that potential creditors have a myriad of defences at their disposal? It is prosaic that business rescue must be undertaken when the company has the prospect of continuing on a solvent basis; if not, business rescue must provide a better return for creditors than would be the case under liquidation. Well, as potential creditors would only receive a better return when adequate counter-performance is rendered, it appears that alteration of contracts cannot affect the value of the counter-performance that the distressed company must render. The terms of the contract that can be affected could be the following, a change in maturity. This would mean that a counter-performance date could be postponed. This obviously would be in accordance with the purpose of business rescue, which is intended to freeze claims against the company during business rescue. Other alterations could prove problematic to implement. Similarly, a potential creditor's performance could be important in generating profits that could improve the financial position of the distressed company. It would therefore be in the interest of all affected parties that a potential creditor renders performance to an ailing company. As indicated above, there is a myriad of defences the potential creditor can raise to avoid rendering performance where the contract is altered for the purpose of business rescue. This is so even where the alteration is for the postponement of the maturity date. To limit this impediment, perhaps certain rules of the EU Directive could be adopted.

Conclusion

The consequences of the practitioner, with the court's approval, cancelling a contract term and demanding performance in contracts where both parties are yet to perform are uncertain. This article has illustrated the defences the creditor can petition when the company enforces performance without offering immediate counter-performance. The *exceptio* may prove to be a central defence in cases where there is unilateral alteration of contractual terms and where the creditor's and company's performance are due. It is not obvious that the court may find a creditor who is reluctant to accept alteration of its contract to be in contempt of court in cases where the creditor did not have the right to approve a rescue plan.¹⁴³ If, indeed, the

¹⁴³ The impression could be created that the court would find a creditor who refuses to offer performance to be in contempt if the court has sanctioned cancellation.

courts are going to find a reluctant creditor to be in contempt, then that could be problematic.¹⁴⁴ This article does not intend to push a theory that the rules of business rescue are completely inadequate, and that business rescue could lead to failures of entities in distress. It merely intends to illustrate that considering the object of business rescue, it would be permissible for the potential creditor to refuse to perform without the possibility of receiving adequate counter-performance.

To improve this position, it is argued that the rules ought to be much clearer regarding how contracts of potential creditors should be managed during business rescue. The EU Directive appears to provide much insight in this respect. The Directive states that the company in distress should be able to receive additional aid without encumbering such contracts with restrictive business rescue or insolvency rules, except the postponement of counter-performance.¹⁴⁵ This includes executory contract, of which a debtor and one or more creditors still have the obligation to perform at the time the stay of individual enforcement actions is granted or applied.¹⁴⁶ Thus, potential creditors should not withhold performance, where contracts were concluded prior to the rescue proceedings.¹⁴⁷ Of course, the creditor must not be placed in a worse-off position and thus must receive adequate counter-performance. The South African business regime is rather scant concerning the contracts of potential creditors. This of course does not encourage such creditors to participate in the rescue process; instead it is unclear whether the potential creditors can receive adequate counter-performance from a distressed company.

As pointed out earlier, business rescue must be commenced for the economic benefit of all affected parties.¹⁴⁸ In many instances, a potential creditor would be hesitant to perform fully where the terms of their contract are altered and there is no assurance that the party will receive adequate counter-performance in future. Given the issues raised in this article, it is clear that business rescue is mainly formulated for the recovery of the distressed entity and/or to improve the financial positions of affected parties

144 It is necessary to point out that the courts are hesitant to order a person to perform if such order will have the effect of causing that person to be in contempt of court. In any case, if the possibility exists that such a person will suffer hardship, that person should not be compelled to perform; see *National Union of Textile Workers v Stag Packing (Pty) Ltd* 1982 (4) SA 151 (T).

145 Paragraph 66 of the EU Directive (2019/1023).

146 Article 2(1)(5) of the EU Directive (2019/1023).

147 Article 7(4) of the EU Directive (2019/1023).

148 *Oakdene Square Properties (Pty) Ltd and Others v Farm Bothasfontein (Kyalami) (Pty) Ltd and Others* [2013] 3 All SA 303 (SCA) para 26.

even where the company cannot continue as an ongoing concern.¹⁴⁹ The cancellation of terms of continuing agreements, which cancellation does not benefit the creditor, should be avoided. It could be argued that where affected parties do not benefit from the rescue process, liquidation should be commenced.¹⁵⁰

149 *Propspec Investment v Pacific Coast Investment 97 Ltd* 2013 (1) SA 542 (FB).

150 See A Loubser, 'Tilting at windmills? The quest for an effective corporate rescue procedure in South African law' [2013] SA Merc LJ 437.

The Non-Frustration Rule after Brexit

Rojina Thapa*

Background

The UK exited the European Union on 31 January 2020. By virtue of this, the EU Takeover Directive ceased to apply in the UK, and thus there was a need to amend the existing regulatory framework on takeovers for it to operate after the UK's exit from the EU.¹ As a result, the Code Committee of the Takeover Panel published a Public Consultation Paper proposing amendments to the Takeover Code.² A Response Statement was also published by the Code Committee with final proposed amendments.³ Final amendments to the Takeover Code were later published in Instrument 2019/3.⁴ Likewise, the Takeovers (Amendment) (EU Exit) Regulations 2019 made the necessary amendment to the Companies Act 2006.⁵

The Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community, which entered into force on 31 January 2020, however, states that there shall be 'a transition or implementation period, which shall start on the date of entry into force of this Agreement and end

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1 Isidora Tachmatzidi, 'Comparative Analysis of Takeover Defenses in Strong and Weak Economies: The Paradigm of the UK and Greece' (2019) 22 *European Research Studies Journal* 254, 258.

2 Public Consultation Paper, 2018/2.

3 Response Statement, 2018/2.

4 The United Kingdom's withdrawal from the European Union, Instrument 2019/3.

5 The Takeovers (Amendment) (EU Exit) Regulations 2019, SI 2019/217.

on 31 December 2020'.⁶ Such transition or implementation period can be extended 'for up to 1 or 2 years', with the decision regarding the extension needing to be taken 'before 1 July 2020'.⁷ The UK decided not to request the extension of the transition or implementation period and thus the period ended on 31 December 2020.⁸

The first part of this article discusses the Takeover Code and the Takeover Panel. This is then followed by an examination of the rules of the Takeover Code relating to the non-frustration rule. The article then delves into the duties of directors under the company law regime and expounds the desirability of the non-frustration rule. The article concludes by stating that the amendment to the regulatory framework on takeovers does not bring about a substantial change to the current regime and calls for the abolition of the non-frustration rule.

Takeover Code and Takeover Panel

The term 'takeover' is commonly used when one company (offeror) acquires a majority or the whole of the shares of another company (offeree) from its shareholders in exchange for cash and/or securities.⁹ 'Takeovers' includes bids for publicly traded companies. A sale of a public company that is not publicly traded or a private company is executed through private negotiation.¹⁰ The purpose of an offer, also known as a takeover bid, is for the bidder (offeror company) to gain control over the offeree company, and not merely for the transfer of shares.¹¹ A takeover becomes hostile when a takeover offer is launched without the consent of or without communicating to the board of directors of the offeree company.¹²

The emergence of hostile takeovers in the early fifties compelled companies in the UK to adopt defensive measures. The 1960s saw extensive litigation contests regarding takeover defence tactics, which demanded the formulation of an instrument regulating takeover in the UK. The demand materialised with the issue of the City Code on Takeovers and Mergers 1968

6 Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community, Art 126.

7 *Ibid*, Art 132(1).

8 EU-UK Statement following the High Level Meeting on 15 June, Statement/20/1067.

9 Stephen D Girvin, Sandra Frisby and Alastair Hudson, *Charlesworth's Company Law* (London: Sweet & Maxwell 2010), 782.

10 Brenda Hannigan, *Company Law* (Oxford: Oxford University Press 2009), para 26.1.

11 Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy* (Oxford: Hart Publishing 2015), 677.

12 Alexandros Seretakis, 'Hostile Takeovers and Defensive Mechanisms in the United Kingdom and the United States: A Case Against the United States Regime' (2013) 8 Ohio State Entrepreneurial Business Law Journal 248, 253.

(the ‘Takeover Code’).¹³ Since 1968, takeover bids in public companies have been guided by the Takeover Code and administered by the Panel on Takeovers and Mergers (the ‘Takeover Panel’).¹⁴

Any reference in the Takeover Code ‘to “takeovers”, “takeover bids”, “bids” and “offers” include all transactions subject to the Code’.¹⁵ Apart from regulating takeover bids and merger transactions, the Takeover Code also regulates:

‘other transactions (including offers by a parent company for shares in its subsidiary, dual holding company transactions, new share issues, share capital reorganisations and offers to minority shareholders) which have as their objective or potential effect (directly or indirectly) obtaining or consolidating control of the relevant companies, as well as partial offers (including tender offers...) to shareholders for securities in the relevant companies. The Code also applies to unitisation proposals which are in competition with another transaction to which the Code applies.’¹⁶

In addition to providing ‘orderly framework’ for the takeover, the Takeover Code aims to ‘ensure that shareholders in an offeree company are treated fairly and are not denied an opportunity to decide on the merits of a takeover and that shareholders in the offeree company of the same class are afforded equivalent treatment by an offeror’.¹⁷ It aims to provide the market, including shareholders in an offeree company, with information about the strategy of a bidder.¹⁸ The Takeover Code relies on the informal enforcement mechanism rather than on court enforcement.¹⁹ Several changes have been made in the Takeover Code since its formulation but its main principles, most notably the fair and equal treatment of the shareholder, and rules have remained unchanged.²⁰

The Takeover Panel has been entrusted with the responsibility of regulating takeover activity in the UK.²¹ Panel members are appointed

13 Simen H Stokka, ‘Defence Tactics in Hostile Takeovers: An Analysis of the Rules Imposed on the Pursued Target’ (2013) 3 Southampton Student Law Review 1, 1–2.

14 Jonathan Makwiri, ‘The End of History for the Board Neutrality Rule in the EU’ [2019] European Business Organization Law Review, see <https://doi.org/10.1007/s40804-019-00164-w> accessed 14 April 2020.

15 See n 4 above.

16 City Code on Takeovers and Mergers (12th edn 2016), s 3(b).

17 *Ibid.*, s 2(a).

18 See n 12 above, 791.

19 John Armour, Jack B Jacobs and Curtis J Milhaupt, ‘The Evolution of Hostile Takeover Regimes in Developed and Emerging Markets: An Analytical Framework’ (2011) 52 Harvard International Law Journal 219, 258.

20 See n 15 above, 253.

21 See n 12 above, 783.

by several entities such as ‘insurers, investment companies, private and institutional investment management firms, banks, industry, accounting firms, investment banking houses and pension funds’.²² Section 943(1) of the Takeovers (Amendment) (EU Exit) Regulations 2019 requires the Takeover Panel to make rules ‘giving effect to the general principles in Part 1 of Schedule 1C’ and ‘in accordance with Part 2 of that Schedule’.²³ Part 1 of Schedule 1C has stated verbatim general principles as enshrined in the Takeover Code, whereas Part 2 deals with the provisions related to the protection of minority shareholders, the mandatory takeover bid and the equitable price.²⁴ Likewise, section 943(2) authorises the Takeover Panel to make provisions for regulating ‘takeover bids’.²⁵ The Takeover Panel has the power to make rules, to require the disclosure of information and documents, to apply to a court for enforcement orders and to impose sanctions on a person violating the Takeover Code.²⁶

The Takeover Panel did not have statutory power and was self-regulated prior to the implementation of the EC Takeover Directive in the UK.²⁷ Article 4(1) of the EC Takeover Directive required Member States to ‘designate the authority or authorities competent to supervise bids’ and such authority could be ‘either public authorities, associations or private bodies recognised by national law or by public authorities expressly empowered for that purpose by national law’.²⁸ To this end, the Companies Act 2006 provides statutory power to the Takeover Panel, stating that the Panel ‘may do anything that it considers necessary or expedient for the purposes of, or in connection with, its functions’.²⁹ Earlier, when the Takeover Panel did not have statutory power, compliance with the Takeover Code was secured through a process known as ‘cold shouldering’, where the violator was excluded from investment transactions.³⁰

22 Brian E Rosenzweig, ‘Private Versus Public Regulation: A Comparative Analysis of British and American Takeover Controls’ (2007) 18 *Duke Journal of Comparative & International Law* 213, 216.

23 See n 5 above.

24 *Ibid.*

25 Companies Act 2006.

26 See n 13 above, para 26.14.

27 Wan Wai Yee, ‘Enforcing Public Takeover Regulation: Reconciling Public and Private Interests’ (2019) 31 *Singapore Academy of Law Journal* 285, 288.

28 Council Directive 2004/25/EC of 21 April 2004 on Takeover Bids [2004] OJ L142/12 (EC Takeover Directive).

29 See n 28 above, s 942(2).

30 See n 16 above, 2–3.

Non-frustration principle

The regulatory regime of the UK in relation to takeovers has embraced a shareholder-centred approach.³¹ The consent of shareholders is required before taking any defensive measure in the UK.³² As a result, the board neutrality rule or the non-frustration principle, as referred to in the UK, is treated as a central element of the Takeover Code.³³ The non-frustration principle has been enshrined in General Principle 3 and Rule 21 of the Takeover Code. It connotes that directors of the offeree company are prohibited from taking any defensive measures that encroach upon the freedom of the shareholders to decide whether to accept the offer. The non-frustration principle applies when a bona fide offer is imminent.³⁴ Since the 1960s, the boards of publicly traded companies in the UK have been prohibited from deploying defensive measures in relation to takeovers. The reason behind the prohibition was to restrict the board from misusing corporate power, thereby frustrating an imminent or ongoing takeover bid without the approval of the shareholders.³⁵

Buying a large stake in a company at a substantial premium, known as a 'Greenmail' defence measure, and the commonly used defence in Delaware jurisprudence known as a 'poison pill' amount to a frustrating action under Rule 21.³⁶ It also prohibits a restructuring defence, which encompasses the declaration of dividends distribution, an increase in company debt levels, buyback of shares or issuing of a substantial block of shares to a friendly third party.³⁷ Since the Takeover Panel must be consulted to make sure that any action taken by the board of the offeree company does not contradict the Takeover Code, defensive measures are restricted in all circumstances in the UK.³⁸

31 Jennifer Payne, 'Schemes of Arrangement, Takeovers and Minority Shareholder Protection' (2010) Oxford Legal Research Paper Series Paper No 42/2010, 6, see <http://ssrn.com/abstract=1600592> accessed 26 April 2020.

32 John Armour and David A Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why?: The Peculiar Divergence of U.S. and U.K. Takeover Regulation' (2007) 95 *Georgetown Law Journal* 1727, 1736–1737.

33 Matthew Peetz, 'Protecting Shareholders from Themselves: How the United Kingdom's 2011 Takeover Code Amendments Hit Their Mark' (2013) 2 *Penn State Journal of Law & International Affairs* 409, 416.

34 See n 14 above, 696.

35 Chrispas Nyombi, 'A Critique of Shareholder Primacy under UK Takeover Law and the Continued Imposition of the Board Neutrality Rule' (2015) 57 *International Journal of Law and Management* 235, 241.

36 See n 16 above, 7.

37 See n 38 above, 243.

38 See n 16 above, 7.

General Principle 3 of the Takeover Code

The General Principles enshrined in the Takeover Code are the statements of standards of commercial behaviour aimed at achieving their underlying purpose.³⁹ General Principle 3 of the Takeover Code states that ‘[t]he board of directors of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid’.⁴⁰ This principle ensures that it is the holders of the securities who decide for themselves on the desirability or otherwise of the takeover bid.⁴¹

Rule 21 of the Takeover Code

Article 9(2) of the EC Takeover Directive requires the board of the offeree company to obtain the prior approval of the shareholders ‘before taking any action, other than seeking alternative bids, which may result in the frustration of the bid and in particular before issuing any shares which may result in a lasting impediment to the offeror’s acquiring control of the offeree company’, from the time when it receives information that a bid is to be made until the result of the bid is made public or the bid lapses.⁴² Article 12 has made the said Article optional and Member States can opt out of this provision but the UK has opted in since it is consistent with Rule 21 of the Takeover Code.⁴³

Since its origin, the Takeover Code has imposed substantial restriction on the board of the offeree company from applying defensive measures. The most prominent provision in this regard is Rule 21.⁴⁴ It prohibits the board of the offeree company, ‘[d]uring the course of an offer, or even before the date of the offer’, from taking any action, without the approval of the shareholders, which ‘may result in any offer or bona fide possible offer being frustrated or in shareholders being denied the opportunity to decide on its merits’ if in case it has ‘reason to believe that a bona fide offer might be imminent’. In particular, the board of the offeree company cannot:

‘issue any shares or transfer or sell, or agree to transfer or sell, any shares out of treasury or effect any redemption or purchase by the company of its own shares; issue or grant options in respect of any unissued shares; create or issue, or permit the creation or issue of, any securities carrying rights

39 See n 13 above, para 26.41.

40 See n 4 above.

41 See n 12 above, 788; also n 13, para 26.42.

42 See n 31 above.

43 See n 13 above, para 26.63.

44 See n 16 above, 2.

of conversion into or subscription for shares; sell, dispose of or acquire, or agree to sell, dispose of or acquire, assets of a material amount; or enter into contracts otherwise than in the ordinary course of business.⁴⁵

The prohibition is non-exhaustive and it covers other possible ways of deploying takeover defences.⁴⁶ Rule 21, however, only restricts post-bid defences and defences deployed during the takeover offer.⁴⁷

General Principle 3, in this regard, reinforces Rule 21.⁴⁸ The Rule looks to consequences, not to purposes, and thus shareholder approval cannot be given in general and in advance of the bid.⁴⁹ Rule 21, employing a negative obligation, states what the board must *not* do. It does not prescribe an obligation to act positively.⁵⁰

Allowed defensive measure

Rule 21 of the Takeover Code essentially limits pre-bid defensive measures to three options, namely:

1. persuading shareholders to reject the offer and continue their trust with the current management;
2. drawing the attention of the concerned competition authorities towards the public interest grounds of the bid; and
3. encouraging another bidder to make an alternative offer to the shareholders.⁵¹

The prior approval, granted before the board becomes aware of any bid, of the shareholder is nevertheless required for the use of such defences.⁵²

Implementation of the aforementioned pre-bid defensive measures depends on the persuasive power of the board of the offeree company⁵³ and their compliance with the fiduciary duties of the board owed to the offeree company.⁵⁴

45 See n 19 above, rule 21.1(a).

46 David Kershaw, 'Hostile Takeovers and the Non-Frustration Rule: Time for a Re-Evaluation' (2016) LSE Law, Society and Economy Working Papers 19/2016, 5, see <https://ssrn.com/abstract=2875772> accessed 14 April 2020.

47 See n 15 above, 260.

48 See n 16 above, 2.

49 Paul L Davies, *Principles of Modern Company Law* (London: Sweet & Maxwell 2008), 986.

50 *Ibid*, 987.

51 See n 52 above, 987.

52 Carsten Gerner-Beuerle, David Kershaw and Matteo Solinas, 'Is the Board Neutrality Rule Trivial? Amnesia about Corporate Law in European Takeover Regulation' [2015] LSE Research Online, 20, see <http://eprints.lse.ac.uk/39417> accessed 18 April 2020.

53 W Stewart Robinson, 'A Change in the Legal Wind – How a New Direction for Corporate Governance Could Affect Takeover Regulation' (2012) *International Company and Commercial Law Review* 292, 306.

54 David Kershaw, 'The Illusion of Importance: Reconsidering the UK's Takeover Defence Prohibition' (2007) 56 *International and Comparative Law Quarterly* 267, 282.

As per the Enterprise Act 2002, the Secretary of State can intervene in a takeover in certain public interest cases relating to national security, media plurality and financial stability.⁵⁵ Section 42 states that the Secretary of State can present an intervention notice to the Office of Fair Trading if he/she 'believes that it is or may be the case that one or more than one public interest consideration is relevant to a consideration of the relevant merger situation concerned' and the 'public interest consideration is a consideration which, at the time of the giving of the intervention notice concerned, is specified in section 58 or is not so specified but, in the opinion of the Secretary of State, ought to be so specified'.⁵⁶ Section 58 specifies 'national security', 'need for, to the extent that it is reasonable and practicable, a sufficient plurality of views in newspapers in each market for newspapers in the United Kingdom or a part of the United Kingdom' and 'interest of maintaining the stability of the UK financial system' as public interest grounds for intervening in a takeover.⁵⁷ Section 58 also allows the Secretary of State to identify other new considerations that satisfy as public interest considerations.⁵⁸ To this end, section 52 states that the Secretary of State 'may by order modify this section for the purpose of specifying in this section a new consideration or removing or amending any consideration which is for the time being specified in this section'.⁵⁹ Further, section 59, which allows intervention in special public interest cases, states that the Secretary of State can give a special intervention notice to the Office of Fair Trading if he/she 'believes that it is or may be the case that one or more than one consideration specified in section 58 is relevant to a consideration of the special merger situation concerned'.⁶⁰ It is up to the Secretary of State to 'decide whether to make an adverse public interest finding in relation to the relevant merger situation and whether to make no finding at all in the matter'.⁶¹

Directors' duty under company law

The Takeover Code does not cover pre-bid defensive measures and thus the fiduciary duties of directors under the Companies Act 2006 must be looked into.⁶²

55 See n 49 above, 43.

56 Enterprise Act 2002, s 42(2)(3).

57 *Ibid*, s 58(1), (2B), (2D); the Competition (Amendment etc) (EU Exit) Regulations 2019.

58 See n 49 above, 45.

59 See n 59 above, s 58(3).

60 *Ibid*, s 59(2).

61 *Ibid*, s 54(2).

62 Han-Wei Liu, 'The Non-Frustration Rule of the UK City Code on Takeover and Mergers and Related Agency Problems: What are the Implications for the EC Takeover Directive?' (2010) 17 Columbia Journal of European Law 5, 9.

Proper purpose doctrine

Section 171(b) of the Companies Act 2006 incorporates one of the major fiduciary duties of the directors,⁶³ which states that a director must ‘only exercise powers for the purposes for which they are conferred’.⁶⁴ Therefore, directors are required to use their powers only for a proper purpose as per section 171(b) of the Companies Act 2006. The proper purpose doctrine restricts directors from exercising their powers for any collateral purpose.⁶⁵ The doctrine provides that directors can use corporate power to interfere with the takeover offer only in the event that the shareholders have authorised them to do so.⁶⁶ If any action is authorised, other than to interfere in the bid, before the bid then such action can be regarded as lawful.⁶⁷ Several case laws have confirmed that allotting new shares to repel potential takeover does not respect the obligation to use the powers for the intended purposes and to act in the best interest of the company. Byrne J in the case of *Punt v Symons* held that the issue of shares to ward off a takeover was not ‘bona fide for the general advantage of the company’.⁶⁸

Duty of loyalty

The common law duty of loyalty is enshrined in section 172 of the Companies Act 2006.⁶⁹ The section requires a director of a company to act ‘in good faith’ for the promotion of ‘the success of the company for the benefit of its members as a whole’. At the same time, a director should take into consideration ‘the likely consequences of any decision in the long term’, ‘the interest of the company’s employees’, ‘the desirability of the company maintaining a reputation for high standards of business conduct’ and ‘the need to act fairly as between members of the company’ among other matters.⁷⁰ As per this fiduciary duty, directors should exercise the power delegated through the charter document in a loyal manner.⁷¹ If defensive measures are used by directors for their personal benefit then this fiduciary duty is deemed breached.⁷²

63 Chuanman You, ‘The Proper Purpose Rule and the Exercise of Directors’ Power in the Context of a Takeover Battle’ (2017) 38 Business Law Review 2, 3.

64 See n 28 above.

65 See n 38 above, 245.

66 See n 49 above, 8.

67 *Ibid.*

68 See n 12 above, 333.

69 See n 38 above, 245.

70 See n 28 above, s 172(1).

71 See n 55 above, 14.

72 See n 57 above, 282.

Examination of the compliance of a director with section 172 incorporates both the subjective and objective test. The subjective test requires the director to ‘exercise their discretion bona fide in what they consider – not what a court may consider – is in the interests of the company’. Similarly, the objective test involves an examination of ‘whether an intelligent and honest man in the position of a director to the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the interest of the company’.⁷³

Reference to ‘members’ in section 172(1) encapsulates what is traditionally known as shareholders’ primacy to the more recent concept of enlightened shareholder value, which requires the directors to take into consideration the interest of different stakeholders.⁷⁴ The success of the company should be viewed not in the ‘individual interests of members, but their interests as members of an association with the purposes and the mutual arrangements embodied in the constitution’.⁷⁵ Lord Goldsmith in the Grand Committee of the House of Lords stated that ‘for a commercial company, success will normally mean a long-term increase in value, but the company’s constitution and decisions made under it may also lay down the appropriate success model for the company’. Also, investors in companies ‘want a long-term increase in the company’.⁷⁶ Directors of a company ‘should take into account the long term’ and a successful company cannot be planned by ‘looking at short-term gain and short-term popularity, be it on the stock market or in the eyes of members of the company’.⁷⁷ The statutory requirement under the said section is the needs of members as opposed to success in a more general sense.⁷⁸

73 Alan Dignam and John Lowry, *Company Law* (Oxford: Oxford University Press 2012), paras 14.27–14.28; see n 13 above, para 9.3.

74 Collins CAjibo, ‘A Critique of Enlightened Shareholder Value: Revisiting the Shareholder Primacy Theory’ (2014) 2 *Birkbeck Law Review* Volume 37, 46; Blanaid Clarke, ‘Directors’ Duties during an Offer Period – Lessons from the Cadbury Plc Takeover’ (2011) UCD Working Papers in Law, Criminology & Socio-Legal Studies Research Paper No 44/2011, 3, see <http://ssrn.com/abstract=1759953> accessed 24 April 2020; Chrispas Nyombi, Tom Mortimer, Rhidian Lewis and Georgios Zouridakis, ‘Shareholder Primacy and Stakeholders’ Interests in the Aftermath of a Takeover: A Review of Empirical Evidence’ (2015) *International Business Law Journal* 161, 168.

75 *Company Law Review*, ‘Modern Company Law for a Competitive Economy: Developing the Framework’ (URN 00/656, 2000), para 3.51.

76 HL Deb 6 February 2006, vol 678, col 258.

77 *Ibid*, col 237.

78 See n 12 above, 328.

Long-term shareholder value or short-termism

There are divided opinions as to whether takeover or the threat of takeover is boon or bane. Some argue that it disciplines the management of the company and encourages efficiency, whereas others argue, rather, that it forces management of the company to focus primarily in boosting the share price for short-term benefit and to make the takeover futile than to pursue long-term growth through the productive use of assets.⁷⁹

The Companies Act 2006 has not vested much decision-making authority to the board of directors. In UK company law, empowerment of the board of directors is done through the shareholders.⁸⁰ At common law, directors have the fiduciary duty to act bona fide for the interests of the shareholders as a general body. They should balance short-term interests against the long-term interests of shareholders, which is defined primarily in terms of enhancing shareholder value.⁸¹

Section 172 of the Companies Act is also viewed as adopting an enlightened shareholder value approach. The duty clearly establishes the priority of members' interests.⁸² This approach resonates with the approach taken by the Supreme Court of Canada in *People's Department Stores v Wise*, in which the Court stated that acting in the 'best interests of the company required directors to maximise the value of the corporation. This did not mean acting solely in the interests of the shareholders or any stakeholder's interest'.⁸³ However, the Enhanced Shareholder Value principle in section 172 is stated with a high degree of generality, reading very much like a list of good conduct by directors. It is not likely that the principle will act as an agent for change and bring about substantive change in the management of companies in the UK.⁸⁴

Rule 21 prohibits directors from deploying defensive measures that would result in frustration of a takeover bid, unless authorised by the shareholders, even in the case where there is a reason for the board to believe that such a takeover bid is not beneficial for the long-term success of the company.⁸⁵ The board of the offeree company may have an opinion of its own regarding the takeover bid. The takeover may be desired because the board considers it to be in the best interest of the company or undesired because it could

79 See n 13 above, paras 26.6–26.7.

80 David Kershaw, *Company Law in Context: Text and Materials* (Oxford: Oxford University Press 2012), 191–192.

81 See n 13 above, para 9.1.

82 See n 83 above, 382.

83 See n 76 above, para 14.32.

84 Richard Williams, 'Enlightened Shareholder Value in UK Company Law' (2012) 35 UNSW Law Journal 360, 360.

85 See n 77 above, 162.

hamper the business prospects of the company. Directors may as well have a personal vested interest in resisting the takeover.⁸⁶ In case of the latter situation, the threat of a takeover encourages management to concentrate more on shareholder needs, prompting it to promote the short-term interest of the shareholders, which may be detrimental to the long-term development of a company's business.⁸⁷ In such a scenario, the board may assure a return of cash to existing shareholders by way of a special dividend or repurchase of shares, which will have a negative impact on the growth of the company.⁸⁸

Issues related to non-frustration rule

Review of the Takeover Code

Following the much-criticised takeover of Cadbury PLC by Kraft Inc and mounting public pressure, the Code Committee initiated a review of the Takeover Code.⁸⁹ The Code Committee concluded that 'it has become too easy for "hostile" offerors (ie, offerors whose offers are not from the outset recommended by the board of the offeree company) to succeed' and 'hostile offerors have, in recent times, been able to obtain a tactical advantage over the offeree company to the detriment of the offeree company and its shareholders'.⁹⁰ However, it neither questioned nor made any changes in the non-frustration rule.⁹¹

Argument for and against the non-frustration rule

Supporters of the non-frustration rule can argue that:

1. it is the shareholders themselves who should decide on whether to sell their shares or not;
2. in order to avoid the risk of losing a job as a result of the hostile takeover bid, directors can use defensive measures for their own benefit rather than for value-enhancing purpose, thereby creating agency cost problems;
3. the board can potentially exploit collective action problems;

86 See n 12 above, 788.

87 See n 52 above, 985.

88 See n 14 above, 697.

89 Michael R Patrone, 'Sour Chocolate: The U.K. Takeover Panel's Improper Reaction to Kraft's Acquisition of Cadbury' (2011) 8 International Law & Management Review 63, 65; see n 2 above, s 1(a) 1.1.

90 Review of Certain Aspects of the Regulation of Takeover Bids 2010/22, ss 2.5, 2.6.

91 See n 36 above, 429; see n 22 above, 239.

4. any available defensive measure can be implemented with ex post-shareholder approval;⁹²
5. shareholders are at greater risk by investing in companies.⁹³

One argument against the non-frustration rule is that, first, the rule does not serve the interests of rational shareholders having a substantial shareholding in the company. Rational shareholders may want the board to use a defensive measure to ward off the hostile bidder offering a premium for the share of short-term shareholders who will choose a quick gain over the long-term value of the company. Shareholder sovereignty is hence eroded by the prohibition on the use of a defensive measure.⁹⁴ Secondly, as far as agency costs are concerned, the market for corporate control can thwart them. When managers misuse corporate power for personal benefit, it results in a decrease in the company value, which in turn will create an opportunity for the potential bidder, and directors face the risk of losing their job. The scope of agency costs lessens with the more active market for corporate control.⁹⁵ Thirdly, shareholders who do not participate in the corporate affairs of the company pose the threat of approving defensive measures without careful consideration. Even though shareholders have a right to be involved in corporate affairs, they generally do not utilise this right. Not only this, shareholders create free-rider problems, that is, they benefit from the work of active shareholders without contributing anything to corporate affairs.⁹⁶ Fourthly, the non-frustration rule becomes ineffective if ex ante shareholder approval can be invalidated by ex post shareholder approval.⁹⁷ Fifthly, other non-shareholding stakeholders such as employees and creditors also contribute to the company, not just the shareholder. Hence, an act of prioritising shareholders over other stakeholders cannot be justified. In fact, these stakeholders do not have access to the financial condition of the company unlike shareholders and thus are equally at risk on a par with shareholders.⁹⁸

Abolition of non-frustration rule

Evaluating the pros and cons of takeover defences indicates that boards are powerless in the face of a hostile takeover offer and, hence, calls for

92 See n 57 above, 298–306.

93 See n 77 above, 170.

94 See n 38 above, 248–249.

95 See n 57 above, 301.

96 See n 38 above, 250.

97 *Ibid.*, 250.

98 See n 77 above, 171.

changing the balance of power between the offeror and the offeree.⁹⁹ Abolition of the non-frustration rule is appealing for the companies as it provides shareholders with ex ante choice that they do not currently have and it also addresses concerns relating to short-termism and stakeholder investment.¹⁰⁰ Even though the non-frustration rule is abolished, it will not provide the board with the freedom to deploy defensive measures, as in all cases the approval of shareholders is still needed for deployment.¹⁰¹

Abolition of the non-frustration rule will not bring radical change in the power of shareholders as the Companies Act 2006 will continue to keep boards under the command of shareholders.¹⁰² According to section 168 of the Companies Act 2006, a company 'may by ordinary resolution at a meeting remove a director before the expiration of his period of office, notwithstanding anything in any agreement between it and him'.¹⁰³ If shareholders 'representing at least 5% of such of the paid-up capital of the company as carries the right of voting at general meetings of the company' or if the company does not have share capital then shareholders 'who represent at least 5% of the total voting rights of all the members having a right to vote at general meetings' can 'require the directors to call a general meeting of the company' and 'directors are required to call a general meeting once the company has received requests to do so'.¹⁰⁴ Given the multiple stakeholder control in companies, abuse of the power by the boards is unlikely.¹⁰⁵

Conclusion

The amendments made in the regulatory regime relating to takeovers as necessitated by the UK's exit from the EU are technical in nature and do not significantly change the existing regulatory framework. The Takeover Code by virtue of General Principle 3 and Rule 21 continues to prohibit the board of the offeree company from resorting to a takeover defence mechanism once the takeover becomes imminent. These provisions allow the shareholders of a company to decide on the merits of a takeover bid but directors do not enjoy much discretion in influencing the decision of the shareholders, as they need authorisation from the shareholders before taking any action that may frustrate the bid offer. Likewise, company law has entrusted directors to act for the promotion of the success of the company for the benefit of its

99 See n 49 above, 32.

100 *Ibid*, 35.

101 *Ibid*, 33.

102 See n 77 above, 178.

103 See n 28 above, s 168(1).

104 *Ibid*, s 303(1), (2).

105 See n 49 above, 35.

members as a whole. The success of the company is usually defined in terms of a long-term increase in shareholder value. In this situation, directors can be compelled to focus on the short-term profitability of the shareholder to gain their confidence. This phenomenon, in turn, will be detrimental for the long-term success of the company.

Even though the non-frustration rule has been questioned time and again, it has never been reviewed by the Code Committee, and still remains as a central pillar of the Takeover Code. There are arguments both for and against the need for a non-frustration rule but it is recommended that this rule be abolished, as its abolition will not bring radical change in the notion of shareholder primacy in the UK and it is vital in order to change the current balance of power between the hostile bidder and the target company.

CASE COMMENT

***HMRC v Development Securities:* An Unwelcome Development in the UK Corporate Residence Test?**

Jessica Kemp and Joseph Sheldrick*

In *HMRC v Development Securities*, the United Kingdom Court of Appeal ('CA') reinstated the first-tier decision that Jersey-incorporated subsidiaries of a UK parent were UK tax resident by reason of having their central management and control in the UK on the basis that they were simply following the instructions of a UK parent without themselves considering the merits of entering the transaction. This arguably constitutes a widening of the test of corporate residence for UK tax purposes.

Practical application

While this case should be read in light of its unusual fact pattern, and the possibility of appeal to the Supreme Court should be taken into account, there are still some helpful practical lessons that can be taken from it for directors of non-UK subsidiaries or special purpose vehicles (SPVs):

- Directors should ensure that they carefully consider and discuss the merits (or otherwise) of the subsidiary entering into any relevant transaction or proposal.

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- Care should be taken that the correct language and terminology are used in records and minutes (eg, the incorrect use of words such as ‘instruction’, ‘order’ or ‘direction’ should be avoided).
- Detailed and accurate records and minutes should be kept. Draft minutes can be prepared in advance of meetings (as a guide to discussions), but drafts must be updated afterwards to reflect the actual discussions accurately.
- Individuals who are directors, employees or representatives of a UK parent should ideally not be directors of the subsidiary/SPV.
- Corporate governance policies should be reassessed in light of changing working arrangements as a result of the Covid-19 pandemic.

Background and summary of decision

In *HMRC v Development Securities* [2020] EWCA Civ 1705, the UK CA allowed HMRC’s appeal, overturning the decision of the Upper Tribunal (UT), and reinstating the decision of the First-tier Tribunal (FTT) that certain Jersey-incorporated subsidiary companies of a UK parent were UK tax resident by reason of being centrally managed and controlled in the UK.

Very broadly, the case involved some tax planning designed to increase available capital losses for Development Securities plc and its subsidiaries. This relied on Development Securities plc incorporating three new Jersey incorporated companies, which were tax resident in Jersey. To defeat the scheme, HMRC argued that the Jersey subsidiary companies were UK resident on the basis that their central management and control (CMC) took place in the UK and not in Jersey. The FTT held that CMC took place in the UK, but the UT overturned this decision on appeal.

The CA overturned the UT decision on the basis that the UT was not justified in setting aside the FTT decision for the reasons given by the UT. In particular, the CA considered that the UT had mischaracterised the primary reason for the FTT’s decision as being that the directors had failed to decline to do something improper or inadvisable by entering into uncommercial transactions. Instead, the basis for the FTT’s decision was that the directors were acting under what they considered to be an ‘instruction’ or ‘order’ from the UK parent company to carry out the transaction, and that the directors followed these instructions (subject to checking their lawfulness) without engaging with the substantive decision.

For procedural reasons, it was not open to the CA to consider whether the FTT decision might have been wrong for other grounds. However, the CA judges appeared to be divided as to the validity of the FTT’s reasoning. One judge expressed ‘very considerable reservations about the FTT’s reasoning’,

while another judge did ‘not have any concerns about the decision of the FTT or their reasons’.

The UK test for corporate residence

The CA provided a useful overview of the relevant authorities regarding the UK test for corporate residence, including a summary of some of the key points.

- The overarching principle is that a company resides for tax purposes where its real business is carried on, and that is where CMC actually abides.
- The principle applies in relation to subsidiaries, including SPVs.
- It is the actual place of management, not that in which it ought to be managed, which fixes the residence of a company.
- A company may be resident in a jurisdiction other than that of its incorporation not only where a ‘constitutional organ’ (eg, a board of directors) exercises management and control elsewhere, but if the functions of the company’s constitutional organs are usurped, in the sense that management and control are exercised independently of, or without regard to, its constitutional organs, or if an outsider dictates decisions (as opposed to merely proposing, advising and influencing decisions).
- On the other hand, CMC of a subsidiary will not be taken to be in a jurisdiction other than that of its incorporation just because it is following a tax planning scheme propounded by its parent. Nor need it matter that a company’s board takes decisions without full information or even in breach of the directors’ duties.
- Events before or after the particular date in question may be relevant as casting light on the position on that date.
- Where a company is resident is essentially a question of fact.

The CA’s decision in *Development Securities* was limited to overturning the UT’s decision, and it was not open to the CA to consider whether the FTT decision might have been wrong on other grounds. In light of the divided opinions of the CA judges about the reasoning of the FTT, it is therefore questionable to what extent (if any) *Development Securities* extends the scope of the UK test for corporate tax residency (as summarised above). *Development Securities* certainly reiterates the point that CMC is essentially a question of fact, and care should be taken in trying to extract broader principles from the reasoning of the FTT (as applied to the particular facts and circumstances in this case).

If the FTT’s reasoning were to be followed, then the scope of the test could potentially be interpreted as being extended broadly as follows:

Where the directors of a non-UK incorporated subsidiary or SPV:

- (1) act under the ‘instruction’ or ‘order’ from a UK parent (as distinct from an ‘authorisation’ or ‘ratification’), and
- (2) do not consider or discuss the merits (or otherwise) of the company entering into an arrangement (whether from the perspective of the company or the wider group), and merely check the legality of the arrangement, the directors could be regarded as simply administering a decision they were instructed to undertake, without any engagement with the substantive decision, in which case CMC may be regarded as being in the UK (where the UK parent has issued the instructions).

However, it should be noted that one of the CA judges (Nugee LJ) expressed ‘very considerable reservations’ about the FTT’s reasoning, and rejected the apparent extension to the CMC test:

‘I do not think the authorities establish that CMC can only be exercised by “actively engaging” with the decision if that means (as it appears the FTT meant) considering for themselves the merits and demerits of a proposal. The question is not why the directors made the decision they did, or how much thought they gave it, or what they did or did not take, or should or should not have taken, into account. The question is a much simpler one, namely: did they make the decision?’

It is hoped that *Development Securities* will be appealed to the UK Supreme Court, which should provide the opportunity for further guidance in relation to the UK test for corporate tax residence. Pending any such appeal, it is uncertain to what extent the FTT’s reasoning in *Development Securities* can be applied more broadly, but taking a prudent approach it should be assumed that HMRC may seek to apply similar arguments in the future.

What practical lessons can be learned?

While the *Development Securities* CA decision should be read in light of its unusual fact pattern, there are still some helpful practical lessons that can be applied to help prevent non-UK companies being treated as UK tax resident.

HMRC is known to be scrutinising corporate residence more generally, particularly where companies lack real substance in their local jurisdiction. Corporate residence should remain a particular concern for non-UK companies with a UK parent, or which have UK shareholders, directors or some other nexus with the UK. It is important that such companies take steps to ensure that proper corporate governance policies and processes are in place, and are followed in practice, to reduce the risk of HMRC asserting that there is UK CMC.

These corporate governance policies and processes should be revisited in light of any changes or modifications that have been required to be made as a result of the ongoing Covid-19 pandemic. While HMRC has stated that it is 'very sympathetic' to the disruption being caused by the pandemic, its view is that the existing legislation and guidance on corporate residence already provide the flexibility to deal with changes in business activities necessitated by the pandemic. This leaves open the door for HMRC to challenge the tax residency of non-UK companies in the future, at a time when it may be less sympathetic, and motivated to increase tax revenues.

Some particular lessons that can be drawn from the *Development Securities* case are summarised below (but it should be noted that this is not an exhaustive list).

- The directors of non-UK subsidiaries or SPVs should ensure that they carefully consider and discuss the rationale for (and the merits, or otherwise, of) the company entering into any relevant transaction or proposal, and that the directors actively engage with the decision. It is recommended that the board should consider this from the perspective of the subsidiary company only (focusing on the commercial rationale), as well as taking into consideration any benefits to the wider group.
- It should be ensured that the correct language and terminology are used when describing transactions and communications. The use of words such as 'instruction', 'order' or 'direction' rather than 'advise', 'request' or 'recommend' could have a significant impact on the question of CMC, based on the *Development Securities* FTT decision.
- Company records and board minutes should be detailed and accurate. The FTT conducted a very thorough review of all the board minutes and other relevant documents. Companies should be prepared for everything to be scrutinised in minute detail by HMRC (and the FTT). Draft board minutes can be prepared in advance of a board meeting (as an agenda, or guide to discussions), but it should be ensured that the drafts are updated afterwards to reflect accurately the actual discussions at the meeting (including details of any disagreements).
- Care should be taken when determining the scope of the engagement of any local directors, that the local directors are not (in effect) agreeing to follow the parent company's instructions from the outset. It would be advisable for the engagement to be clear that local directors are not pre-agreeing to any such instructions and that their power as directors of the subsidiary company are not being fettered in any way.
- It is recommended that the directors of a non-UK subsidiary/SPV should not include individuals who are directors, employees or representatives of a UK parent. It would also be preferable for no representatives of the UK

parent to be present at the subsidiary board meeting, but if this is necessary then care should be taken to ensure that the observer does not participate in discussions, or otherwise influence the decisions of the board.

Conclusion

While it is hoped that *Development Securities* will be appealed to the Supreme Court, pending any such appeal it would be prudent to assume that the FTT's reasoning could be applied to future cases involving non-UK subsidiaries or SPVs. Particular care should therefore be taken to ensure that non-UK subsidiaries or SPVs do not simply follow the instructions or orders of a UK parent (or other UK persons) without themselves properly considering the merits of entering into any transaction.

BOOK REVIEW

Law Firm Strategies for the 21st Century: Strategies for Success (2nd edn)

Consulting editor: Christoph H Vaagt on behalf of the International Bar Association

Globe Law and Business (2020); 271 pages (hardback)

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Law Firm Strategies for the 21st Century: Strategies for Success ('LFS'), now in its second edition, aims to assist law firms on how to evolve and remain competitive. LFS draws from diverse contributors who pinpoint leading challenges for law firms today. The law firm of a generation ago no longer exists. Today's firms must recruit and retain top personnel, while managing shifting regulations, new and more complicated technology and a changing clientele that has made every firm compete for business. LFS is a must for your law firm library. It lays out concise approaches to developing a viable law firm strategy. Since publishing the first edition in 2013, the contributing authors offer new and revised chapters that address challenges presented by the ever-changing legal landscape.

LFS's overarching theme is a concise how-to on building and maintaining law firm profitability. Embracing strategy as a key element of a law firm's structure and management is crucial. LFS provides insight into law firm management and strategy at a time where technology and the globalisation of providing legal services are uprooting the older concepts of running a law firm. LFS breaks down the different concepts of law firm strategy, discussed by active lawyers, consultants, academics and experts.

LFS begins by introducing the general concepts of law firm strategy. Stated simply, law firm strategy means choice. A more academic approach follows, discussing how a professional service firm needs to sell a 'credible promise', deliver what was promised and learn from the delivery process. All law firms, regardless of size, must continually work to maintain profitability and their

competitive edge. Law firm strategy is not simply a business model, but a long-term, ever-evolving multifaceted thought process. A well thought out discussion of modifications that can be put into practice, and how to implement them, follows. By discussing various ways in which modern firms may choose to focus their efforts, even the least business-savvy lawyers can pinpoint ways in which they can streamline or modernise their practice. What works for a 200-lawyer firm is often unreachable for a sole practitioner, and LFS provides ideas and suggestions that can be tailored to each type of practice.

LFS's second section analyses the resource side strategies. How can a law firm stand out as unique amid its competitors? How can a firm continue to attract and keep clients? The discussion of ethics as a boundary to strategy formulation is an intricate topic but is succinctly summarised by the chapter addressing this issue. This section also takes a deep look at the human resources, systems, structures and procedures in an organisation to determine how a law firm can deliver what a client needs. Research-based practical information is presented in a clear fashion. The authors in this section address aspects of developing and implementing a cohesive law firm strategy and how to overcome the hurdles as they present themselves. This section points out that investing in core competencies is key, but ultimately the goal is to transform individual knowledge to the law firm as a whole. A law firm implementing a clearly defined strategy will learn to be open to and embrace change and thus maintain profitability.

The third and final section addresses market-oriented strategies for law firms. This section goes into detail about legal project management, which are market-oriented strategies available to law firms of all sizes. Reputation management, whether and how to merge, expansion and winning and keeping clients are topics comprehensively covered in this section. The last chapter on pricing and alternative fee arrangements, a complex topic, is wonderfully summarised by the authors. Law firms are continually expected to be cost efficient and the robust discussion in this chapter offers valuable conclusions for even those with little education in the study of business.

LFS is a thorough book that all law firms – small or large – should read and keep handy for reference as needed. Law firm managers and partners must be ready to embrace change and continue to evolve. Living through the year 2020 is an excellent precursor to reading this book. By being thrown into unexpected waters in 2020, law firms now know that law firm strategy is a must, not a concept to work on 'later'. Throughout LFS, there are ample discussions on new avenues to effectuate change and to persuade others that transformation is not only good but necessary to survive and thrive. To convince lawyers and practice managers of the need to be flexible and creative, there must be a clearly defined strategy, which, at its core, will not

be overly difficult. Implementing strategy and continuing to provide a clear sense of direction are crucial to staying competitive.

By combining a renowned group of experts, LFS offers practical ideas and approaches on how best to create a legal strategy based on the values, ethics, cost concerns, size and future goals of any law firm. By accessing the latest research on professional services firms, LFS succeeds in being an extremely useful book for both academics and practising partners alike. LFS will remain a continued source of reference for a law firm and allow those who read this book to stay ahead of the curve when it comes to competition and change.

Meg Strickler

Partner, Conaway & Strickler

The views expressed in this book review are those of the author alone.

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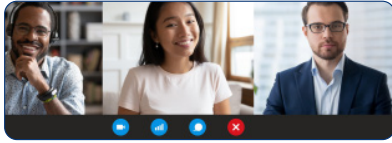
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