# International Corporate Rescue

*Published by:*
Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

*Annual Subscriptions:*
Subscription prices 2008 (6 issues)
Print or electronic access:
EUR 665.00 / USD 799.00 / GBP 465.00
VAT will be charged on online subscriptions.
For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 114 255 9040 or sales@chasecambria.com

*International Corporate Rescue* is published bimonthly.

ISSN: 1572-4638

© 2008 Chase Cambria Company (Publishing) Ltd

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, mechanical, photocopying, recording or otherwise, without prior permission of the publishers.

Permission to photocopy must be obtained from the copyright owner. Please apply to:
E-mail: permissions@chasecambria.com
Website: www.chasecambria.com

The information and opinions provided on the contents of the journal was prepared by the author/s and not necessarily represent those of the members of the Editorial Board or of Chase Cambria Company (Publishing) Ltd. Any error or omission is exclusively attributable to the author/s. The content provided is for general purposes only and should neither be considered legal, financial and/or economic advice or opinion nor an offer to sell, or a solicitation of an offer to buy the securities or instruments mentioned or described herein. Neither the Editorial Board nor Chase Cambria Company (Publishing) Ltd are responsible for investment decisions made on the basis of any such published information. The Editorial Board and Chase Cambria Company (Publishing) Ltd specifically disclaims any liability as to information contained in the journal.

ARTICLE

# More Litigation in the Next Downturn in Europe? – Part Two

Peter J.M. Declercq, Partner, Bankruptcy & Corporate Restructuring group, and Neill Shrimpton, Senior Associate, Litigation group, Brown Rudnick Berlack Israels LLP, London, UK

*As the credit crunch intensifies and, as a result, the European debt market continues to see less liquidity, litigation may play an increased role in the next downturn. This two-part article explores the potential for investors to resort to litigation to protect or improve their positions. Part One, which was published in Volume 4, Issue 6 of* International Corporate Rescue, *examined some of the insolvency/restructuring cases that have come before the English Courts in recent years. Based in part on those cases, Part Two in this issue addresses which other litigation angles may be considered by whom in the next downturn.*

## 2. Possible angles of litigation in the next downturn

As is clear from the case summaries set out in Part One of this article which appeared in Volume 4, Issue 6 of *International Corporate Rescue*, the early tentative steps of hedge funds and other investors to challenge the process of restructurings in the English courts have been met with mixed levels of success.

Some of their arguments have been dismissed (e.g. Highberry's attempt to challenge the valuation of Colt Telecom and Sisu Capital c.s.'s argument that the CVA in the restructuring of the TXUEL group was unfairly prejudicial). However, these arguments were rejected on the facts rather than in principle. It is possible to envisage circumstances in which either may be successful in the future. Indeed, the Powerhouse case demonstrates that, given the right factual circumstances, it is possible to set aside a CVA on the basis that it is unfairly prejudicial.

The other cases were either not decided (British Energy) or are not binding authority for future cases (MyTravel). The argument considered by Mr Justice Mann in MyTravel as to whether a category of creditors had a sufficient economic interest to merit consultation about the CVA will almost inevitably be revisited.

The British Energy case contains a word of warning for hedge funds and other activist investors. Any attempts to undermine existing schemes of arrangement or similar arrangements are likely to be met by claims of tortious interference with contract by the company and/or any of the other parties to the arrangements.

In addition to the above arguments which may be seen again, there are some further issues which may arise in litigation relating to insolvency/restructuring cases. These are briefly set out below.

### *2.1 Companies Act 2006*

Sections 170 to 181 of the new Companies Act 2006 contain a codified statement of directors' duties. The main duties include obligations to 'act in accordance with the company's constitution', to 'only exercise powers for the purpose for which they are conferred'[1] and to 'exercise independent judgment.'[2]

In addition, directors must act with 'reasonable care, skill and diligence'[3] taking account of 'the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company'[4] and 'the general knowledge, skill and experience that the director has.'[5]

One of the most significant provisions in the Companies Act 2006 is section 172 which imposes an obligation on directors to promote the success of the company. The director must act in a way which he 'considers, in good faith, would be most likely to promote the success of the company for the benefit of

Notes

1 Section 171 of the Companies Act 2006.
2 Section 173 of the Companies Act 2006.
3 Section 174(1) of the Companies Act 2006.
4 Section 174(2)(a) of the Companies Act 2006.
5 Section 174(2)(b) of the Companies Act 2006.

its members as a whole, and in doing so have regard (amongst other things) to – (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationship with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct and (f) the need to act fairly as between members of the company.'[6]

It is easy to see how this particular duty could be used by shareholders against directors where, for example, a series of decisions produce a short term profit but lead over time, to the company acquiring a poor reputation and being shunned by its former customers, causing significant losses, leading to insolvency.

In addition to producing a comprehensive set of directors' duties, the Companies Act 2006 also places on a statutory footing the ability of a shareholder to bring a claim in respect of a cause of action vested in the company in which he holds shares. Section 260(3) provides that the derivative claim will be available in respect of a 'cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company.' An important change in the law which has been brought about by this provision is to make clear that an action can be brought in relation to the mere negligence of a director and possibly also in respect of a breach of the rule against conflicts of interest. These claims may also be brought against a former director or shadow director so may interest aggrieved shareholders where the business of a company has been conducted in accordance with the directions of a major shareholder, other investor or even a lender.

### 2.2 Wrongful trading

The law relating to wrongful trading will not be affected by the introduction of the Companies Act 2006. Section 214 of the Insolvency Act 1986 states that, if the directors of a company allow it to continue trading when they knew or ought to have known that there was 'no reasonable prospect' of the company avoiding insolvent liquidation, the directors can be made personally liable to make a contribution to the company's assets.

The law on wrongful trading is, to a certain extent at least,[7] the English equivalent of the US concept of 'deepening insolvency' which has existed in the US jurisprudence for a number of years without its status ever being wholly clear. The phrase 'deepening insolvency' first appeared in 1983[8] since when the US courts have consistently struggled with whether and how to apply the concept. They have been split over whether to treat deepening insolvency as an independent cause of action, or as a measure of damages for a separate tort. One of the most recent decisions on deepening insolvency[9] has called into question the continued existence of the theory, holding both that deepening insolvency is not a valid theory of damages for an independent tort and that negligence is not the proper basis for a deepening insolvency claim.

### 2.3 Shadow directors

For the purposes of the wrongful trading concept set forth in section 214 of the Insolvency Act, the word 'director' includes both executive and non-executive directors as well as shadow directors.[10] A shadow director is a person or entity in accordance with whose directions or instructions a governing majority of the directors of the company are accustomed to act.[11] However, even though the directors may act in accordance with the directions or instructions of a professional adviser, that professional adviser, acting as such, will not become a shadow director of the company as a result.

Where a company becomes insolvent, it is unlikely that any individual director will have sufficient assets to be able to make a meaningful contribution towards the assets of the company, even if either a breach of the new duties contained in the Companies Act 2006 or wrongful trading could be proved. However, the position may be different in the case of a shadow director. A shadow director does not have to be an individual. For example, any of a company's lenders, institutional shareholders or holders of a significant amount of the company's debt instruments could all end up becoming a shadow director if they seek to use their position to influence the actions of the board.

**Notes**

6 Section 172(1) of the Companies Act 2006.

7 Compare William A. Brandt, 'Deepening Insolvency and the United Kingdom's Wrongful Trading Statute: A Comparative Discussion', *Insolvency Intelligence*, vol. 19, no. 10, November/December 2006.

8 *Schacht v Brown*, 711 F.2d 1343 (7th Cir. 1983).

9 *Seitz v Detweiler, Hershey & Associates PC* (*In re CitX Corp Inc.*), No. 05-2760, 2006 WL 1453117 (3d Cir. May 26 2006).

10 Section 214 (7) of the Insolvency Act 1986.

11 Section 741 (2) of the Companies Act 1985; section 251 of the Insolvency Act 1986. *Ultraframe (UK) Ltd v Fielding and others* [2005] EWHC 1638 (Ch) at para. 1272. A shadow director should be distinguished from a *de facto* director which is a person who undertakes the functions of a director, even though not formally appointed as such. See *In Re Hydrodam (Corby) Ltd* [1994] BCC 161.


© 2008 Chase Cambria Publishing

In a market with companies' leverage increasing, and covenant-lite loans being extended to borrowers or private equity houses for yet another LBO financing[12] it may seem unlikely that lenders could qualify as shadow directors. However, following the recent credit crunch and, when the music stops and yet another refinancing is attempted to avoid an almost inevitable restructuring, the lenders may seek to exercise greater control over the activities of the company than would otherwise be the case for a 'normal' lender. In this context, such greater controls could include prior lenders' approval of the company's business plan and prior lenders' approval to the entry into any significant commitment by the company in the ordinary course of its business or the sale of substantial assets. If subsequently, the company does default and certain creditors are worse off now than they were prior to the last refinancing, they may seek to argue a wrongful trading claim. Could they then also argue that the lenders providing the refinancing qualify as shadow directors? How much influencing of the running of the company by the lenders is required for them to qualify as shadow directors?

In *Ultraframe (UK) Ltd v Fielding and others*,[13] Mr Justice Lewison broadly accepted that there was a need to distinguish between a person exercising legitimate, albeit strong influence, for example in his capacity as a lender or other creditor, and someone with effective control over the running of the company in the sense required to become a shadow director. The judge held that a creditor of the company is entitled to protect his own interests as creditor without necessarily becoming a shadow director.[14]

A lender is entitled to keep a close eye on what is done with his money, and to impose conditions on his support for the company. This does not mean he is running the company or is emasculating the powers of the directors, even if (given their situation) the directors feel that they have little practical choice but to accede to his requests. Similarly with customers who may, because of their buying power, be able effectively to dictate conditions to their suppliers (or the other way around).[15] In other words a position of influence (even a position of strong influence) is not necessarily a fiduciary position.

It seems therefore that third parties who are pursued as shadow directors are likely in their defence to point to their own legitimate commercial interests in the way the company's affairs are conducted. However, there is undoubtedly a line which must not be crossed. Beyond that line, a lender or other third party places itself at risk of becoming a shadow director and incurring potentially significant liabilities to creditors in the event of the company becoming insolvent. The judge in the Ultraframe case did not decide the question of shadow directorship (deciding instead that a de facto directorship had arisen).[16] Therefore, it is not possible to draw any conclusions based on the facts of the Ultraframe case as to where this line will be drawn.

We believe that the question of whether a particular lender has crossed that line in any given factual situation is likely to require a consideration of a number of factors including: (1) the lender's legitimate interest in protecting its own position; (2) the extent to which the lender seeks to influence the company's affairs; and (3) the impact of the lender's influence on the legitimate interests of others.

### *2.4 Misrepresentation*

There are various circumstances in which a claim for misrepresentation may arise. A significant one arises where a corporate restructuring is proposed and a circular is published setting out the terms on which the restructuring is going to proceed.

In reliance on the contents of the circular (and related representations made), both existing shareholders or investors and potential new investors are likely to make various decisions regarding their investments. This may include a decision by an existing investor or shareholder whether to sell or retain their investment/shareholding. Equally, it may include a decision by a new investor to buy into the company in the expectation that, following the proposed restructuring, the value of the company (and therefore their investment) will recover/increase. If the restructuring does not proceed, or proceeds in a different form to that foreseen by the circular (and the related representations made), both existing and new investors may suffer a loss as a result of their reliance on the contents of the circular (and the related representations made).

The first question that needs to be answered for the purposes of making a misrepresentation claim is against whom is the claim likely to be (i.e. who made the representations)? In addition, in order to make a successful claim for misrepresentation, a claimant must show an unambiguous false statement of fact[17] (or a statement of intention which is not honestly held at the time) which was addressed to him[18] and which

**Notes**

12 Martin Arnold, 'KKR in cov-lite loan milestone', *Financial Times*, 30 May 2007.
13 *Supra*, note 11.
14 *Supra*, note 11 at para. 1267.
15 *Supra*, note 11 at para. 1268.
16 *Supra*, note 11 at paras 1626 to 1630.
17 *Hummingbird Motors Limited v Hobbs* [1986] R.T.R. 276.
18 *Peek v Gurney* (1873) L.R. 6 H.L. 377.


© 2008 Chase Cambria Publishing

was an inducement, possibly a material inducement, to entry into the contract[19] (e.g. the purchase of shares or other instruments issued by the company).

In the case of an existing lender/shareholder in the company, the situation is potentially more straightforward. The circular is addressed primarily to existing lenders/shareholders who will be affected by the restructuring. The intention of the circular is usually clear – i.e. to induce the company's creditors/shareholders to agree to the restructuring. The fact that it induced an addressee to enter into a different contract – e.g. to sell its shares/investment to a third party – would not necessarily prevent a claim.

In the case of a potential new lender/shareholder in the company who, on the basis of comments made in the circular, decides to buy into the company, the question of whether any representation was addressed to him is more difficult. It would be necessary to argue that the representations contained in the circular were not limited to the existing investors in the company but rather were addressed to the world at large. This is likely to prove difficult.

A more significant barrier to such a claim is likely to be the wide-ranging exclusions of liability which are customarily included in such circulars. Almost certainly, it will exclude all liability for misrepresentations except for those which are made fraudulently. The requirement of proving that the representor had the necessary fraudulent state of mind is always going to be an onerous one but, given the right set of facts, it is an option to be borne in mind.

The recent case of *IFE Fund SA v Goldman Sachs International*[20] is an example where language excluding any liability for representations was upheld by the English Court of Appeal. In 2000, Goldman Sachs International ('GSI') acted as arranger and underwriter of syndicated debt facilities for Autodis S.A. to fund its acquisition of Finelist plc. GSI, as arranger, circulated an Information Memorandum in March 2000 to potential investors, including IFE Fund SA ('IFE'). The Information Memorandum contained an explicit statement that GSI was not making any representation, warranty or undertaking, express or implied, in respect of the information contained in the Information Memorandum and did not accept any responsibility for the accuracy or completeness of the information. It also made clear that GSI did not accept any responsibility for updating the information contained in the Information Memorandum or for advising any potential or actual participant of any information which subsequently came to its attention.

At the end of May 2000, IFE purchased EUR 20 million of Autodis bonds from GSI. In autumn 2000 Finelist plc went into receivership following the discovery of accounting irregularities. IFE alleged that by providing to it the Information Memorandum and accountants' due diligence reports on Finelist plc, GSI had impliedly represented that it was not aware of facts which showed that statements about Finelist's financial performance contained in the Information Memorandum or in the accountants' due diligence reports were or might be incorrect in any material way. IFE claimed that the implied representations were continuing ones which it was entitled to and did regard as remaining true until the date on which it purchased the bonds from GSI. IFE alleged that these representations were rendered incorrect following the receipt of further financial information by GSI after the date it had circulated the Information Memorandum to IFE but before IFE had acquired the bonds. IFE also alleged that GSI owed it a duty of care to inform IFE prior to it purchasing the bonds if it became aware of any facts or matters which might cast doubt on the information contained in the Information Memorandum and the accountants' reports.

At first instance, the English court held that if an arranger states in the Information Memorandum that it is not making any representations about its client and states that it is assuming no responsibility for the information contained in the Information Memorandum, the courts will be unlikely to find that any implied representation has been made (other than one of good faith) or that a duty of care arose.[21] The court also held that, in supplying the Information Memorandum, an arranger is making an implied representation that it is acting in good faith.[22] Therefore, if the arranger subsequently becomes aware that information in the Information Memorandum is misleading, it would be under an obligation to inform the other participants (i.e. there is an implied representation not to knowingly mislead).

The Court of Appeal upheld the decision,[23] finding that it was clear from the disclaimer language in the Information Memorandum that GSI was not assuming any responsibility towards IFE or any other proposed participants in the facilities and, therefore, GSI did not owe the duty of care alleged. Also, no implied representations of the kind alleged by IFE about the information contained in the Information Memorandum were made by GSI.

**Notes**

19 *Attwood v Small* (1838) 6 Cl. & F. 232.
20 [2007] EWCA Civ 811.
21 [2006] EWHC 2887 (Comm) [64] and [66].
22 *Supra*, note 21 at [60].
23 *Supra*, note 20.




© 2008 Chase Cambria Publishing

## 3. Conclusions

In this article we have tried to address the question posed in the title – is there going to be more litigation in the next downturn in Europe? Our answer to this question is a cautious 'yes'. Why?

We started this article by describing the current debt market in Europe. We agree with the European High Yield Association ('EHYA'), which in a recent open letter to the Treasury submitted its views on necessary insolvency law reform in the UK by way of a limited addendum to the Insolvency Act 1986,[24] that as a result of the significant growth in leveraged lending in recent years, the next cycle of large corporate debt restructurings is expected to be substantially more complex than the previous cycle. Also, the arrival of US hedge funds into the UK market has influenced the market to adopt a more US-style approach to financial structures. Today, investors hold not only traditional high yield bonds and equity but also mezzanine debt, payment in kind (PIK) notes and second lien debt. The added complexity of the structures and the greater numbers of competing claims in an insolvency situation are therefore likely to lead to a greater number of disputes when it comes to dividing up the assets, particularly if the arrival of US investors and the US-style approach to financial structure brings the US appetite for litigation across the pond.

After describing the current debt market in Europe, we first looked back at some of the more high profile insolvency/restructuring cases that have come before English Courts in recent years. In doing so, we noticed that in most of the cases we identified, the catalyst for the dispute has been the actions of a hedge fund investor. In this article we have briefly addressed the Colt Telecom case, the MyTravel case, the British Energy restructuring (which eventually was settled and did not get decided in Court), the Sisu Capital c.s. case, and the Powerhouse case.

Against the background of the current debt market in Europe and the recent high profile insolvency/restructuring cases we identified and addressed, we went on to consider the possible angles of litigation in the next downturn. Based on the earlier cases, and with the right facts and circumstances present, we believe that the valuation arguments made in the Colt Telecom case and more particular in the MyTravel case, may be used again in the next downturn. The open letter of the EHYA also specifically mentions the judicial resolution of valuation disputes as an issue that needs to be addressed in England.[25]

The same applies to the unfairly prejudicial CVA claim pursued in the Sisu Capital c.s. case and the Powerhouse case. However, both cases in their own way demonstrate that it is not easy, in particular in a complex restructuring which aims to achieve an overall compromise like that of the TXUEL group in the Sisu Capital c.s. case, for such a claim to be successful. The British Energy case serves as a warning for activist investors aiming to undermine existing restructuring arrangements. They may be faced with claims of tortious interference with contract.

Other litigation angles we have explored in this article are claims based on the extensive directors' duties codified in the new Companies Act 2006, claims based on wrongful trading, which together with the English concept of shadow director bear, to a certain extent and in certain circumstances, resemblance to the US concept of deepening insolvency, and claims based on misrepresentation.

Our overall conclusion is that legal tools for litigation exist and are available in England and that the current debt market in Europe seems to support an affirmative answer to the question asked in the title of this article. However, without the appropriate appetite of interested parties and the right facts and circumstances of the case at hand, there may not be a substantial increase in litigation during the next down cycle in Europe. We, nevertheless, strongly believe that in the restructuring processes and the related negotiations amongst the interested parties during the next down cycle in Europe, litigation scenarios are likely to play a prominent role.

*Notes*

24 European High Yield Association letter to the Treasury dated 23 April 2007.
25 *Supra*, note 24, at page 4.


© 2008 Chase Cambria Publishing

## International Corporate Rescue

*International Corporate Rescue* addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

Alongside its regular features – Editorial, The US Corner, Economists' Outlook and Case Review section – each issue of *International Corporate Rescue* brings superbly authoritative articles on the most pertinent international business issues written by the leading experts in the field.

*International Corporate Rescue* has been relied on by practitioners and lawyers throughout the world and is designed to help:

- Better understanding of the practical implications of insolvency and business failure – and the risk of operating in certain markets.
- Keeping the reader up to date with relevant developments in international business and trade, legislation, regulation and litigation.
- Identify and assess potential problems and avoid costly mistakes.

Editor-in-Chief: Mark Fennessy, Hunton & Williams, London

John Armour, Oxford University, Oxford; Stephen Ball, Mourant du Feu et Jeune, Jersey; Samantha Bewick, KPMG, London; Geoff Carton-Kelly, Baker Tilly, London; Sandie Corbett, Walkers, British Virgin Islands; Stephen Cork, Smith & Williamson, London; Ronald DeKoven, 3-4 South Square, London; David Dhanoo, Qatar Financial Centre Regulatory Authority, Qatar; Hon. Robert D. Drain, United States Bankruptcy Court, Southern District of New York; Nigel Feetham, Hassans, Gibraltar; Stephen Harris, Ernst & Young, London; Jens Jantzen, Bear Stearns, London; Matthew Kersey, Henry Davis York, Sydney; Joachim Koolmann, Bear Stearns, London; Ben Larkin, Berwin Leighton Paisner, London; Guy Locke, Walkers, Cayman Islands; Professor John Lowry, UCL, London; Lee Manning, Deloitte, London; David Marks, 3-4 South Square, London; Riz Mokal, 3-4 South Square, London; Lyndon Norley, Kirkland & Ellis, London; Rodrigo Olivares-Caminal, University of Warwick, Coventry; Wayne Porritt, Bank of America, Tokyo; Susan Prevezer Q.C., Bingham McCutchen, London; Peter Saville, Kroll, London; Daniel Schwarzmann, PricewaterhouseCoopers, London; Professor Philip Smart, University of Hong Kong, Hong Kong; Richard Snowden Q.C., Erskine Chambers, London; Dr. Shinjiro Takagi, The Industrial Revitalisation Corporation, Japan; Lloyd Tamlyn, 3-4 South Square, London; Stephen Taylor, Alix Partners, London; William Trower Q.C., 3-4 South Square, London; Mahesh Uttamchandani, The World Bank, Washington, DC; Robert van Galen, NautaDutilh, Amsterdam; Miguel Virgós, Uría & Menéndez, Madrid; Professor Sarah Worthington, London School of Economics, London.

**For more information about *International Corporate Rescue*, please visit www.chasecambria.com**