

Arbitrating against a distressed or insolvent party

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Although the challenges brought by the COVID-19 pandemic have, and continue to, put exceptional pressure on supply chains, the reality is that the insolvency of a business partner is a risk even in normal times. When that business partner is on the other side of pending arbitration proceedings, questions arise as to how the insolvency affects the substantive claim as well as the underlying procedure.

This alert will outline some of the challenges of arbitrating against a party who is financially distressed or in insolvency proceedings, explore how the position of the solvent party might be improved by monitoring a distressed business partner, and discuss some alternatives to pursuing claims in arbitration. We will orientate our discussion towards the legal position in England and Wales, but the general principles will apply to insolvency and arbitration in many other jurisdictions.

The risks of arbitrating against a distressed or insolvent party

In the UK, a company will generally be held to be "insolvent" if it is unable to pay its debts. Other jurisdictions have different tests and nuances of when exactly a company is insolvent. It is therefore important to know where a business partner is incorporated and what insolvency laws will apply to it.

In the UK, a company may be factually insolvent some time before formal insolvency proceedings are commenced. Unlike some other jurisdictions, there is no legal requirement for directors to start insolvency proceedings if the company is insolvent. Arbitrating against a financially distressed or insolvent business partner may be a highly unattractive prospect due to the following challenges:

- **Commencing arbitration:** Solvent parties should conduct a thorough risk analysis of whether or not it makes commercial sense to pursue arbitration based on the distressed or insolvent party's financial position. Even where the insolvent party elects not to participate in or actively contest the proceedings, the lack of a "default judgment" mechanism under most arbitration rules means that the solvent party will still have to proceed with the arbitration and establish the merits and quantum of its claim. Many arbitral institutions provide for an expedited procedure that may facilitate a more expeditious disposal of the claim but the

availability of any such expedited procedure depends on the arbitration agreement and the applicable procedural rules.

Even if the solvent party is ultimately able to obtain a favourable award, it will still have to pay the insolvent party's share of the arbitrator fees and it may prove difficult, if not impossible, to enforce the award if the insolvent party has entered into an insolvency process in the meantime. Needless to say, where the insolvent party has already been dissolved, the question of arbitration proceedings becomes largely moot.

- **Interim relief:** The arbitral tribunal, a court, and depending on the arbitration agreement, an emergency arbitrator, may be able to grant urgent temporary relief against distressed and insolvent parties. This is especially relevant when a distressed party is close to entering an insolvency process, as there is a heightened risk that the distressed party may dissipate assets when faced with imminent insolvency proceedings. Where enforcing interim relief granted by an arbitral tribunal or emergency arbitrator may prove difficult, the arbitration proceedings will benefit from being seated in a jurisdiction that enables appropriate relief to be obtained urgently from a court if a risk of dissipation arises.
- **Costs:** In addition to the insolvent party's likely lack of funds, insolvency law may make it difficult and sometimes even prevent distressed and insolvent companies from making payments to a third party. Before entering an insolvency process, distressed parties may be reluctant to make payments to third parties because of the risk that such payments may later be challenged by an insolvency practitioner and clawed back, for example, as a preference. Paying one creditor ahead of others may also raise questions of breach of directors' duties. Once an insolvency process has started, the relevant insolvency practitioner is under strict rules that will determine whether he or she can commence or continue arbitration proceedings and the extent to which costs or an award can be paid. Arbitration institutions generally set an advance on costs before arbitration proceedings can continue, to cover arbitrators' and administrative costs. Each party normally pays half of these costs. If one party cannot pay, then the other party will have to make up the costs before the arbitration can continue. This can pose a significant further cost burden for the solvent party if the distressed or insolvent party either is not able or is not willing to pay.
- **Security for costs:** Most institutional arbitration rules empower the tribunal to order security for costs. Where a party enters an insolvency process during ongoing proceedings, an application for security for costs by a solvent respondent (or claimant facing counterclaims) will not automatically be successful, but will be bolstered. This will require the party in an insolvency process to set aside a sum of money to pay for a potential adverse costs order made against it. Whether such payment is made will depend very much on whether the insolvent entity is willing and able to continue the arbitration.
- **Third-party funding:** Impecuniosity may not be an obstacle to a distressed or insolvent party defending arbitration proceedings if it can enter into a third-party funding arrangement. This will alleviate the financial burden that would otherwise prevent a party from commencing or continuing claims. In assessing potential investment, third party funders usually consider recoverability, the economics of claims (in particular realistic claim value and costs/value ratio), advisory team expertise and the merits of the claim, as well as relevant restrictions imposed by some jurisdictions and arbitration rules. As third party funding can be expensive, funder buy-in is essential, as is considering portfolio options and single case financing.

- **Stays:** Many jurisdictions provide for a stay of proceedings against a company, including ongoing arbitration proceedings, in the event of that party entering into insolvency proceedings. Where a party goes into administration, for example, a moratorium comes into force which prevents the commencement or continuation of proceedings against the company without the consent of the administrator or the court. A similar stay will apply in compulsory liquidation. It is likely that UK insolvency law will shortly include a standalone moratorium, which an insolvent company can apply for, and which will have a similar effect to the administration moratorium. This new process is introduced by the Corporate Insolvency and Governance Bill, which is expected to receive Royal Assent in late June or early July. Arbitrators, however, are generally not bound by the determinations of national courts outside of the seat of arbitration. They may choose to continue with arbitration proceedings even where the national court responsible for the party's insolvency has ordered a stay in proceedings or where a stay has automatically come into force.
- **Enforcement:** In an insolvency process, an arbitral award is an unsecured debt that ranks the same as all unsecured creditors. Exploring the alternatives to arbitration set out below may therefore be the more sensible approach, as incurring costs pursuing a solely monetary claim may be pointless if recovery of the award is impossible or the amount recovered is nominal.

Monitoring a business partner's risk of insolvency

In light of the significant challenges outlined above, it is of critical importance for businesses to identify the weak link in a supply chain and take active measures to monitor its performance. There are several ways in which a party can monitor the performance of a business partner it deems at risk of insolvency:

- Checking the published financial accounts of at the company registry, paying particular attention to the current assets and current liabilities and looking for any charges which will soon become due.
- Collecting as much information as possible from the press, industry contacts and internal records, paying particular attention to counterparties that are settling their invoices erratically.
- Monitoring filings and notices of the most vulnerable counterparties. For a company registered in England and Wales, this can be done at [Companies House](#), the Business and Property Courts and the [Gazette](#).

None of the above methods will paint a complete picture of a company's financial position, but they will certainly provide a valuable insight.

Alternatives to arbitration

If a business partner is at risk of insolvency, there are a number of alternatives to arbitration that may help preserve the status quo and/or secure payment without the challenges of pursuing arbitration.

- **Salvaging the relationship:** Continuing business with a struggling business partner may be preferable to tipping them into insolvency, especially if the relationship with them is valuable and worth protecting. Temporarily reducing or spreading payments over a longer timeframe may not only be a way of renegotiating the agreement but may also provide the distressed party with much needed cash flow assistance and may ensure its survival. Non-binding mediation or expert determination may facilitate the negotiations while still keeping them amicable.

It is nevertheless important for the solvent party to safeguard its own contractual rights to ensure that it is adequately protected for the future. This could be accomplished through the strengthening of termination rights in favour of the solvent party to provide it with more flexibility to terminate the contract. In cases where the party at risk of insolvency is a buyer (and the solvent party the seller), reinforcing retention of title provisions may also be sensible, so that the title to goods delivered does not pass to the seller until payment is received in full. This would allow the seller to repossess the goods from an insolvent buyer. Enforcing retention of title provisions against an insolvent counterparty is, however, not always straightforward. Under the Corporate Insolvency and Governance Bill, for instance, new provisions will be introduced into the Insolvency Act 1986 which will, with exceptions, prevent a supplier from exercising termination rights under a contract for the supply of goods or services where the termination right is triggered by the counterparty going into an insolvency process.

Where the parties have a bank guarantee or on-demand bond or letter of credit in place from a third party, the solvent party may be able to request and receive payment without commencing arbitration. It would then be incumbent on the insolvent party to establish that the solvent party was not entitled to make demand under the credit support document.

- **Using the insolvency:** Presenting, or leveraging the threat of a winding-up petition to the court could be a powerful tool to obtain payment, although winding up petitions should not be used as debt collection tools. However, if there is any dispute as to the existence of the debt, a winding-up petition will usually be dismissed in favour of arbitration where the relevant debt arises in connection with a contract that contains an arbitration agreement. Again, the Corporate Insolvency and Governance Bill will introduce, with retrospective effect, restrictions on the presentation of a winding up petition unless the creditor can show that the debtor's financial difficulties have arisen for a reason not related to COVID-19. Waiting for the beginning of formal insolvency proceedings and submitting a proof of debt may prove less costly than incurring the cost of formal arbitral proceedings. The solvent party will need to balance this against the risk of becoming one of many creditors vying for what is left over after the secured creditors and the costs of the insolvency process have been paid.
- **Risks:** The advantage of these approaches in comparison to arbitration is that they largely avoid the costs that might be difficult to recoup from a party in a weak financial position, especially one that enters into insolvency proceedings during the dispute. The risk involved in the above alternatives is that payments made by a distressed party could later be challenged

as a preferential transaction, potentially allowing the insolvency practitioner to claw back any payments made to the solvent party.

Conclusion

If the actual insolvency of a debtor is just a possibility and not a certainty, commencing arbitration proceedings may still be the best alternative – particularly if the seat of the arbitration is different from the locus of the insolvency proceedings, in which case it may be possible to continue with the arbitration in parallel.

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