Coronavirus update

Important changes to insolvency law and creditor enforcement

9 April 2020

The purpose of this note

The profound business and market interruption already caused by the COVID-19 outbreak has introduced insolvency risks for many otherwise healthy businesses.

This note summarises proposed insolvency law reforms announced on 28 March 2020 with some commentary on other recent COVID-19 developments in this area, including:

- the temporary suspension of wrongful trading laws;
- the introduction of a new restructuring regime; and
- other important changes to insolvency law and creditor enforcement.

The law and market practice in this area is undergoing significant and rapid change. This is a general note, for information purposes based on developments as at the time of writing. If you require more detailed advice on your specific circumstances, please contact a member of TLT's UK-wide Restructuring and Insolvency team, whose details are set out at the end of this note.

What is proposed?

In response to the profound market disruption caused by the coronavirus pandemic and to stave off a predicted "tsunami" of corporate insolvencies, the UK Government has announced its plans to enact a series of urgent law reforms, aimed at keeping as many of the affected businesses as possible intact and trading. So far, these comprise:

- **a 3-month suspension of the so-called wrongful trading provisions** in UK insolvency legislation; and
- the introduction of a **suite of restructuring reforms -** incorporating a **moratorium** preventing creditor enforcement action, **prohibiting contract termination for insolvency** against businesses that are undergoing a rescue, restructuring or insolvency process and providing for a **new restructuring plan** procedure with a "cram-down" mechanism to bind dissenting creditors. These changes, were set out in a Government paper entitled Government response: Insolvency and Corporate Governance dated 28 August 2018, which is available on the Insolvency Service website.

Summary details of the proposals are set out below. Further details of the restructuring reforms (as set out in the UK Government's 2018 paper) is available in our guide to the UK Government's proposed reforms to the UK Corporate Restructuring and Insolvency Regime.

A number of other legislative changes have occurred or are planned. The restructuring market is also responding in various ways, including through the promotion of the so-called **light touch administration** approach. For more details, see below under *What other changes are occurring in this area?*

For further details on wrongful trading and directors' duties in insolvency please also see our guide to UK company directors' duties under threat of insolvency during the COVID-19 outbreak.

Why is it being done?

The UK Government is concerned that large numbers of businesses now face insolvency that were previously solvent and financially viable prior to the market disruption and lock-down brought about by the coronavirus pandemic.

The Government hopes to reduce the threat of personal liability for directors trading on in these challenging times and proposes that the new restructuring procedure will provide a much-needed breathing space to many businesses that are undergoing a rescue or restructuring process. Overall, Government aims to allow otherwise viable businesses to continue trading, retain as much of their workforce as possible and to avoid the need to enter a formal insolvency process.

When will this happen?

Some uncertainty surrounds when these changes will be introduced – not least because the coronavirus is presenting challenges around when and how Parliament can now function and pass legislation.

The Insolvency Service press release of 28 March 2020 confirms that: "*Legislation to introduce these changes will be introduced in Parliament at the earliest opportunity.*" We anticipate that this could begin as soon as Parliament resumes after Easter. It is currently scheduled to return on 21 April 2020, although it is of course possible that Parliament could be recalled earlier if the need arises.

Once introduced, the wrongful trading suspension is planned to apply retrospectively from 1 March 2020 to 1 June 2020, although the press release notes that: "*Provisions will be included to enable the changes [to the wrongful trading regime suspension] to be extended if necessary*."

What will be the impact on lenders?

In many respects, the approach by banks and other lenders to customers who are facing financial distress or insolvency will remain unchanged by the reforms. The suspension of wrongful trading is clearly intended to encourage directors of viable businesses not to throw in the towel while real hope of a recovery post-pandemic remains. In many cases, it is the spectre of potential personal liability of wrongful trading which ultimately leads to directors pushing the button on a formal insolvency process. That will often crystallise the position (and potential impairment) of the lenders. Allowing the board to take more time to investigate better solutions outside of a formal insolvency process should operate to lenders' advantage.

However, lenders need to remain alert to the reality that a business trading close to or past the point of no return from formal insolvency is at risk of eroding value for all creditors – not just those with security - that could (and arguably should) be protected through formal action being taken by the directors or the lender. Regular dialogue with the customer's management and advisers and prompt action to stem losses remains key.

The impact for lenders of the proposed restructuring reforms is potentially profound but important gaps remain, pending publication of the draft legislation:

- The proposals make clear that the restructuring moratorium is intended to prevent action by all creditors, including secured creditors. Although checks and balances are included, there is no exception for banks and other institutional lenders and no accommodation in the proposals for the exercise of rights under security, including, for example, to appoint administrators under a qualifying floating charge. The moratorium is only available, however, to companies that can currently (and for the period of the moratorium) pay their debts when due but which anticipate becoming insolvent in the future if no action is taken. Eligibility for the moratorium will be assessed by an Insolvency Practitioner on the current proposals. It may well be that those companies which are in most need of a moratorium, do not qualify for it.
- The prohibition on insolvency termination clauses is intended to be a blanket ban which ensures continuity of supply during any formal restructuring or insolvency rescue procedure. Again, there is currently no carve-out for insolvency triggers in loan documentation. Although mentioned in the proposals, it isn't yet clear what (if any) financial services and products will be granted exemptions under the legislation. However, giving a distressed customer more protection from the effects of insolvency and a better opportunity to save itself, should also operate for the benefit its lenders.
- Banks and other institutional lenders will be reasonably familiar with the process and parameters of schemes of arrangement, many of which are carried through into the new restructuring plan procedure. In broad terms, existing principles of priority of debt and security will be respected under the new procedure. However, unlike schemes, the approved plan will be binding on all creditors (including those who dissent) by virtue of a cross-class cram-down that can be imposed if it can be shown that dissenting classes of creditors will be no worse off than they would be in the "*next best alternative for creditors if the restructuring plan was not to be agreed*".

As noted in the UK Government paper entitled [Government response: Insolvency and Corporate Governance,] reviewing the output of the consultation on proposals to reform the corporate insolvency regime: "*Most insolvency professionals and their representative bodies who responded, supported the first three proposals [listed in the details section below], but questioned some of the detail. Creditor organisations were, broadly speaking, opposed to the proposals, raising concerns about potential abuse and warning of negative impacts, such as increased cost of credit and knock-on insolvencies for creditors affected by the proposals*." With no further details or draft legislation published subsequently, these concerns remain unresolved.

What other changes are occurring in this area?

With so many businesses facing financial distress there is growing pressure for these reforms to be introduced as soon as possible. While understandable, caution is needed. Rushed legislation can lead to gaps and unintended consequences. Indeed, some practitioners have pointed out that the solution already exists in the form of administration. Administration was originally created as a flexible means of rescuing viable companies for the long-term. Regrettably administration has acquired a tarnished image in many quarters as a result of its association with **pre-pack sales** and quasi-liquidation strategies. In an effort to rehabilitate the administration process, the restructuring market is promoting and implementing a process of what is termed **light touch administration**; using existing legislation to allow the company's management team to retain day to day control of the business with minimum involvement (and cost) from the appointed administrators while a plan is developed to resolve the problem of legacy debts free from creditor action. The particular feature of the light touch administration approach is an **agreed protocol** between administrators and directors setting the parameters within which the management team must operate under the ultimate sanction of the administrators. The re-entry of Debenhams into administration appears to be a recent example of this approach being applied in practice - although similar structures have been used in cases such as Turner & Newall and Metronet."

This shift in market focus and the announcement of the restructuring reforms summarised above arrive hot on the heels of other important changes that have already been enacted in this area, including:

- an inflation-linked **increase from £600,000 to £800,000 in the cap on the so-called prescribed part** of realisations that must be set aside from floating charge asset realisations for distribution to unsecured creditors rather than preferential or floating charge creditors, effective from 6 April 2020;
- provisions made in the Coronavirus Act 2020 (which received Royal Assent on 25 March 2020), **preventing landlords from exercising a right of forfeiture** of a relevant business tenancy (under Part 2 of the Landlord and Tenant Act 1954) for non-payment of rent between 25 March and 30 June 2020 (a date which may be extended).

Our experience is that the forfeiture moratorium - which was rushed through to coincide with the March rent quarter day last week - has already resulted in many landlords instead pursuing tenants for the unpaid rent using the formal statutory demand procedure, which if not paid or opposed will, 21 days post-service, permit landlords to present a winding up petition against their defaulting tenant. Winding up is a collective remedy and it is an abuse of process to use that procedure as part of a debt collection exercise. However, there is currently no established coronavirus exception to the test as to whether a debtor can pay its debts as they fall due – although a strong argument could be made out that the pandemic provides a reasonable excuse for non-payment in the current circumstances and this would be in keeping with the change in the law on forfeiture. In many cases there is a serious risk that landlords who successfully obtain the compulsory liquidation of their tenants could bring about the mutually assured destruction of their respective businesses.

After a period of adjournment the Business and Property Courts have begun to recommence work on existing winding up petitions. It is still currently possible to issue them at Court. Questions are therefore being raised widely over whether the Government will also seek to **ban the presentation of any new winding up petitions** to further protect businesses struggling in the face of the pandemic and to ensure that the relief intended to be provided to tenants through the temporary ban on landlord forfeiture cannot be circumvented through the winding up route and debt recovery action.

Other changes currently in train are the **partial reinstatement of HMRC as a secondary preferential creditor** in corporate insolvencies in respect of VAT, PAYE and employee NICs (i.e. HMRC will rank for payment from realisations under a floating charge after primary preferential payments of wages and salary but ahead of the claims of both the holder of the charge and ordinary unsecured creditors). This change is scheduled to be introduced under the Finance Bill 2020 which is currently due to have its second reading before the House of Commons on 22 April 2020 and, if enacted, the preferential creditor changes will come into force on 20 December 2020.

The restructuring and insolvency reforms in more detail

On 28 March 2020, Alok Sharma, the UK business secretary announced that the UK Government would introduce legislation aimed at preventing businesses that are unable to pay their debts as a result of the impact of the coronavirus pandemic from being forced into a formal insolvency process.

The UK Government is yet to release details of the measures but it appears from the Insolvency Service press release of 28 March 2020 that there are two principal changes, one temporary and one an extensive suite of long-term reforms.

The following summarises the proposals in more detail. Many gaps remain but full details of the restructuring reforms (as set out in the UK Government's 2018 paper) can be found in our guide to the UK Government's proposed reforms to the UK Corporate Restructuring and Insolvency Regime.

What is wrongful trading and what is changing?

The more eye-catching of the reforms is temporary; a **3-month suspension of the so-called wrongful trading provisions** of insolvency legislation, retrospectively, from 1 March to 1 June 2020.

Prior to the pandemic, when a company was insolvent and its directors knew (or ought reasonably to have concluded) that it could not avoid insolvent liquidation or administration, they were under a duty to take every step which a reasonably diligent person would take to minimise potential loss to the company's creditors. Failing that, directors risked personal liability for any worsening of the company's financial position. This offence is known as wrongful trading – although the offence is not so much one of "trading" but of the directors causing their company to incur avoidable losses after passing the point of no return from insolvent liquidation or administration.

Although new legislation has yet to be introduced or brought into force to effect this change, the UK Government has clearly signalled its intention to suspend the law relating to wrongful trading retrospectively from 1 March 2020 for three months to 1 June 2020, with the possibility that this may be extended if the exceptional market circumstances continue past that point.

This is a controversial move about which R3 and other commentators have expressed concerns; there is a risk that the change could simply pass the insolvency risk to the debtor's suppliers and customers; and it could be open to abuse by fraudsters.

In its press release, the arm of the UK Government responsible for such matters has said that:

"*Relaxation of these wrongful trading rules will reassure directors that the difficult decisions they have to make about the future viability of their business will not have to be unduly influenced by the exceptional circumstances which are entirely beyond their control."*

"The Government will also temporarily suspend the wrongful trading provisions to give company directors greater confidence to use their best endeavours to continue to trade during this pandemic emergency, without the threat of personal liability should the company ultimately fall into insolvency."

Anticipating the concerns being raised, the Insolvency Service has also noted that:

"*Existing laws for fraudulent trading and the threat of director disqualification will continue to act as an effective deterrent against director misconduct."*

This is a complex and developing area of law and practice and which management teams typically require specialist advice. You can access further details and guidance on the responsibility of directors facing these challenging issues in our practical guide: Compliance with directors' duties under threat of insolvency during the COVID-19 pandemic.

What will the new restructuring reforms involve?

The reforms that, thus far, have received less attention but are potentially much more far-reaching and likely to have a significant market impact are **to the corporate insolvency regime,** including:

- **Creation of a new "restructuring moratorium" –** This is intended to give struggling (but ultimately viable) businesses a 28-day breathing space (extendable), protecting them against enforcement action by creditors (including secured creditors) while they prepare a rescue plan;
- **A prohibition on insolvency termination clauses** - Such clauses (known as *ipso facto* clauses) purport to allow a party to a contract to terminate the contract if specified insolvency events occur in relation to the other party. Under these proposals, such clauses will be unenforceable. The intention is to ensure continuity of supply and thereby to promote the prospects of a business rescue. The Government is yet to publish details of any exemptions but is considering excluding certain financial services and products from the prohibition; and
- **Creation of a new "restructuring plan" procedure -** This procedure would allow companies to implement a broad range of restructuring proposals (most likely to involve debt deferral and comprise) which would be binding on dissenting classes of creditor via "cross-class cram-down" provisions. The proposals incorporate a number of the features of existing corporate restructuring and insolvency procedures (particularly schemes of arrangement and company voluntary arrangements).

In aggregate, the proposals borrow a number of the existing features from similar overseas regimes, particularly Chapter 11 of the US Bankruptcy Code; the debtor company remains in control of its affairs in the ordinary course of trading (albeit subject to monitoring and answerable to creditors via the court) in a legal structure known as "debtor-in-possession" proceedings.

Full details of these measures will be set out in our guide to the UK Government's proposed reforms to the UK Corporate Restructuring and Insolvency Regime. The guide considers the reforms based on the Government's paper entitled Government response: Insolvency and Corporate Governance dated 28 August 2018 and which is available on the Insolvency Service website.

That paper referenced a number of key matters which remained to be considered further. To date the Government has published no further details. We plan to provide a further update when it has.

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