Coronavirus update

UK Government proposed reforms to the corporate insolvency regime

9 April 2020

Overview

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.

This note focusses on **a range of major reforms to the corporate insolvency regime,** which are the culmination of a UK government consultation which concluded in 2018. The draft legislation which will implement these proposals is yet to be published, let alone reviewed by Parliament. The details set out below are based on the UK Government's response to the consultation and may not reflect the final form of the legislation once published and approved by Parliament.

For further details on other changes, including the proposed suspension of wrongful trading laws please see our guidance notes on:

- Restructuring and insolvency law reforms – 9 April 2020; and
- Directors' duties in insolvency – 30 March 2020

Both of which are available via TLT's Covid Hub.

What is proposed?

In summary, the proposed corporate insolvency reforms are as follows:

- **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 the 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 of 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 are set out below. This note is 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.

Restructuring reforms in detail:

The Insolvency Service press release of 28 March 2020 notes that the UK Government previously consulted on changes to the corporate insolvency regime and had announced, in August 2018, its plans to introduce new insolvency and restructuring procedures. The consultation was wide-ranging and full details of the Government paper entitled [Government response: Insolvency and Corporate Governance] reviewing the output of the consultation are available on the Insolvency Service website.

Although many concerns have been raised in relation to these reforms, the Government has drawn comfort from evidence that similar reforms have been applied with success overseas and under the [UNCITRAL Legislative Guide on Insolvency Law]. The Government paper indicated that it would seek to implement changes to the corporate insolvency framework to assist financially distressed but ultimately viable companies "*as soon as parliamentary time permits*". Parliament's preoccupation with resolving the turmoil surrounding the UK's decision to cease its membership of the European Union has prevented that legislation from being put forward until now.

The 28 March 2020 press release confirms that the UK Government now intends to implement these plans without delay so as to give a breathing space to companies in difficulty so that they can explore their options for rescue and recovery.

The planned changes are significant and could have far-reaching impacts across sectors and businesses. Some, such as the increase to the prescribed part to £800,000, have already been introduced. Together, the various elements of the proposed reforms to the UK's corporate insolvency regime bear many of the hallmarks of Chapter 11 of the US Bankruptcy Code, known as "debtor-in-possession" proceedings. A number of these elements can already be found separately in existing UK corporate rescue and restructuring procedures: administration, company voluntary arrangements (CVAs) and schemes of arrangement.

The main changes proposed by Government are as follows:

Creation of a new moratorium period for financially distressed (but ultimately viable) companies.

The Government proposes the creation of a statutory moratorium similar to that already available to companies in administration but with the aim of making it available to companies that are merely financially distressed rather than insolvent, so as to encourage early action by management teams.

With reference to the shortcomings of the existing interim moratorium obtained while preparing to implement an administration, the consultation document noted that "*Further efforts to find workarounds to the current absence of a statutory moratorium can be evidenced by the attempted use of repeated notices of intention to appoint an administrator in order to provide breathing space by benefitting from the interim moratorium provisions while a number of possible rescue options are explored. However, the filing of such notices without a settled intention to appoint an administrator has recently been held by the court to be invalid*."

Moratorium Purpose and Effect:

- The moratorium would prevent all creditors (including secured creditors) from taking enforcement action against a company while it makes preparations to restructure or seek new investment;
- Creditors would have the right to apply to court to challenge a moratorium either on the grounds of the qualifying conditions not being met (or the company being ineligible) or unfair prejudice to creditors, at any time during the moratorium.
- Liabilities incurred during the moratorium would have priority ranking for payment in the same manner as administration expenses, with highest priority being afforded to any suppliers prevented from relying on contractual termination clauses.

Qualifying Conditions:

- In order to encourage early action by viable businesses, the standalone restructuring moratorium procedure will only be available to companies that can demonstrate that:
  - they are prospectively insolvent (termed as a company that "will become insolvent if action is not taken") - companies that are either already insolvent (or not "prospectively insolvent") would not be eligible to access the moratorium;
  - it is "more likely than not" that a compromise or arrangement effecting a rescue of the company can be agreed with the company's creditors;

    - they have sufficient funds to carry on their business during a moratorium, meeting current obligations as and when they fall due as well as any new obligations that are incurred in the moratorium; and
    - they do not fall within certain exclusions relating to capital markets, PPP and financial collateral arrangements.
- The procedure will have similar parameters to those provided to companies that are placed into administration but it will be more extensive

Filing Process:

- A company would ordinarily be able to obtain the moratorium by filing the required papers at court in much the same way as currently happens for companies being placed into administration by the out-of-court route;
- No court hearing or order would be required therefore to obtain a moratorium unless the company is the subject of an outstanding winding up petition - modifications similar to those for administration would need to be made to avoid dispositions of assets being void during the moratorium if it was created while a winding up petition was outstanding;

Duration:

- The moratorium would last for an initial period of 28 days during which the company would be protected from creditor action while it develops proposals for a restructuring, refinance or implementation of an insolvency process;
- There is a possibility of extending the moratorium by the company for a further 28 days if the monitor (see below) confirms that the qualifying conditions continue to be met;
- Further extensions would require evidence that a good prospect remains of achieving a better outcome for creditors than might otherwise be possible and either a court order or the approval of over 50% by value of secured creditors and unsecured creditors respectively.

Oversight:

- The company's compliance with the qualifying conditions for the moratorium would be assessed by an authorised moratorium "monitor" who would be a licensed insolvency practitioner;
- The monitor would need to file their consent to act at court with confirmation that they have assessed the eligibility tests and qualifying conditions and are satisfied these have been met;
- Much like the existing CVA procedure, while in force, the company's directors would retain control of the company's affairs (and be responsible for compliance with duties to creditors and related wrongful trading law) with creditors' interests being protected through monitoring by the monitor;
- The monitor would also be required to send notice to all known creditors of the company and register the company's entry into the moratorium at Companies House;
- During the moratorium the monitor would be responsible for assessing and monitoring the qualifying conditions (with information gathering powers to match); terminating the moratorium where the qualifying conditions cease to be met and sanctioning asset disposals outside the normal course of business; and the granting of any new security over company assets;
- Monitors would be officers of the court and will be prohibited from subsequently being appointed the administrator or liquidator of the company (but not a CVA supervisor) for 12 months following the termination of a moratorium;
- Monitors would also have immunity from claims stemming from erroneous termination of a moratorium, providing they acted in good faith.

Outcomes:

- Using a moratorium would not be a pre-requisite for seeking the agreement of creditors to the new restructuring plan proposal;
- Typical outcomes from a moratorium to be that a company agrees an informal restructuring with creditors, or a company enters an insolvency procedure, either a rescue procedure, such as a CVA, or a liquidation procedure;

Contractual insolvency termination clauses (known as ipso facto clauses) will be unenforceable.

The Government has indicated that an essential ingredient to ensuring the success of the new restructuring moratorium procedure and business rescue more generally would be to prohibit the enforcement of clauses which purport to allow the suppliers of goods or services to terminate their contracts with a customer on its insolvency or for other reasons connected with its financial position. This prohibition would prevent third parties from terminating their contracts solely as a result of a company seeking the protection of the new restructuring moratorium, or on its entry into a formal insolvency procedure or the proposal of a new "rescue plan" (see below).

Suppliers would retain the ability to terminate contracts on any other ground permitted by the contract, including termination on notice or for non-payment for liabilities incurred following the commencement of the moratorium, restructuring plan or insolvency procedure. Suppliers facing undue financial hardship as a result of the prohibition would be entitled to apply to court for relief, with the court's decision being based on whether:

- in being compelled to continue to supply, that supplier would be more likely than not to enter an insolvency procedure as a consequence; and
- an exemption is reasonable in the circumstances, having regard to the effect of non-supply on the debtor company and its prospects of rescue.

Certain exceptions to this general rule remain under consideration by the Government, including providers of certain types of financial products and services who would be incentivised to withdraw those products and services much earlier if made subject to the prohibition.

Commercial licences (such as software licences) are to be included in the prohibition but licences issued by public bodies will be exempted.

A new cross-class standalone restructuring plan

A key part of the Government's proposed reforms is the introductions of a new restructuring plan procedure which would allow companies to implement a broad range of restructuring proposals (most likely to involve debt deferral and comprise). The procedure bears a number of the hallmarks of the existing CVA and scheme of arrangement procedures but with greater flexibility and more "teeth" (particularly via a new "cross-class cram-down" process). Adopting and adapting the language of the Government's key conclusions from the consultation, the key features of the new plan procedure are as follows:

Purpose and Effect:

- The restructuring procedure would be a standalone procedure and thus could be implemented with or without a prior restructuring moratorium and as an alternative to existing insolvency procedures (such as a CVA) or a scheme of arrangement;
- The Government intends to avoid an overly prescriptive approach to the types of proposal that may be made to creditors and shareholders under a restructuring plan. The plan may therefore provide for debt write-down or debt postponement as well as other matters such as a change in the management team or selling off lossmaking parts of the company. This will allow maximum flexibility to support the best interests of both the company and its creditors.

Qualifying Conditions:

- The new plan would be available to solvent and insolvent companies (including those in formal insolvency processes) and large or small companies, without financial entry criteria;
- The same capital markets, PPP and financial collateral exemptions as apply in the case of small company CVA moratoria (and as will apply to the proposed restructuring moratorium) will apply to the restructuring plan.

Process:

First Hearing -

- A restructuring plan proposal will be sent to creditors and shareholders and filed at court;
- At a first hearing, the court will examine the classes of creditors and shareholders as defined by the company and apply the established principles regarding class formation developed over time in the context of schemes of arrangement;
- Creditors and shareholders may challenge class formation if they think the company's classes do not accurately reflect the rights and interests of different classes;
- If satisfied, the court will confirm that a vote on the proposal may be conducted on a specified date ahead of a second hearing if required;
- 'Necessary information' would be anything that creditors need in order to make a decision whether or not to support the proposal, with the Government prescribing certain mandatory matters that must be covered in all cases. This may take the form of something like the explanatory statement used in schemes;

Challenges/Counter-proposals -

- If no challenges are brought or no counter-proposals permitted by the court then creditors and shareholders will vote on the proposal.

Voting -

- The Government intends to encourage the use of electronic voting and communication more generally in line with recent legislative initiatives aimed at streamlining and reducing the cost of administering insolvency proceedings;
- For a class to vote in favour, 75 per cent of a class by value, and more than 50 per cent by number, would have to agree to the plan;

Second Hearing -

- Subject to the requisite voting thresholds being met and the rules for imposing a cross-class cram down being complied with (discussed above), the court will then schedule a second hearing at which it will consider if the necessary requirements have been met and will make a decision whether or not to confirm the restructuring plan and make it binding on affected creditors and shareholders;

Court's Absolute Discretion -

- The court can confirm a plan even where dissenting creditors (potentially including secured creditors) will not be satisfied ahead of more junior creditors, provided: this is necessary to achieve the aims of the restructuring; it is just and equitable in the circumstances; and at least one class of creditors who will not be paid in full has voted in favour of the plan;
- The court will thus have absolute discretion over whether or not to confirm a restructuring plan.

Cross-class Cram-Down Provision:

Overview -

- The new procedure would allow a company to bind all creditors, including secured creditors and junior classes of creditors even if they vote against the plan, through the use of a cross-class cram down provision;
- The Government has concluded that a cram-down 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”. This might be the value in administration or liquidation depending on the circumstances. The Government decided against applying a minimum liquidation value as the alternative valuation methodology;

Dissenting Classes of Creditors -

- Dissenting classes of creditors would be bound by the plan if it is in the best interests of all stakeholders. The rescue plan legislation would provide that a dissenting class must be satisfied in full before a more junior class can receive any distribution (under the so-called "absolute priority rule" or APR). However, so as to inject flexibility into the APR, the Government also proposed that the court could confirm a plan even if this requirement is not met, if non-compliance is necessary to achieve the aim of the restructuring and it is just and equitable to do so in the circumstances;
- The Government intends that the restructuring plan will represent a streamlined procedure in which dissenting classes of creditors, most importantly those who are ‘out-of-the-money’ (i.e. those who, under the order of priority for creditor repayment in administration or liquidation, would not receive any dividend), may be bound to an arrangement that is in the best interests of all stakeholders;

Safeguards -

- The Government has stated that protections built into the proposals will safeguard creditors from unfair detriment where their contractual rights are interfered with by the effect of a restructuring plan;
- As an additional safeguard to ensure creditors are adequately protected, the Government intends that at least one class of impaired creditors (that is, creditors who will not receive payment in full under the restructuring plan) must vote in favour of the restructuring plan in order for a cross-class cram down to be confirmed by the court;
- The process will therefore closely resemble that for schemes of arrangement but with the added “advantage” of the APR approach to voting:

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