COVID-19: GOVERNANCE: CHANGES TO UK INSOLVENCY LAW UNDERMINE POSITION OF DB SCHEMES AND THE PPF (UK)

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Legal Briefings

The Government on 20 May 2020 published the Corporate Insolvency and Governance Bill, which contains the most far-reaching reforms to UK insolvency law in over 30 years. The Bill has been introduced on an emergency basis in an attempt to ensure that otherwise financially viable companies survive during a period of unprecedented interruption and turmoil. However, it could upset the delicate balance between debtors and creditors under UK insolvency law. It will also leave defined benefit (DB) pension schemes with distressed sponsors in an even more perilous position.

Many of the proposed reforms could have been achieved with less radical amendments to the Insolvency Act 1986. Consultation with industry, practitioners or policy makers has been limited. Most fundamentally, the Bill introduces a debtor-in-possession insolvency procedure for the first time in English law. Introducing such sweeping reforms during a crisis risks unintended consequences. For suppliers particularly, the legislation increases the risk that customers and clients will not make payments when due – a creditor's threat to serve a winding up petition has been weakened – which may push liquidity issues through the supply chain. Other reforms affect the balance between creditors and other stakeholders, with which the legislature has previously been cautious about interfering.

The position of DB pension schemes (and the Pension Protection Fund (PPF)) will also be weakened through:

- the introduction of a new company moratorium
- the proposed restrictions on creditors issuing statutory demands and winding-up petitions and enforcing floating charges during a moratorium, and
- the introduction of a new restructuring process by which a restructuring plan can more easily be imposed on dissenting creditors.

In what appears to be an unintended consequence, the draft legislation also appears to grant super-priority to certain pre-moratorium unsecured debts (likely including unsecured banking and finance arrangements) which means that they will rank above pension debts (including those secured by a floating charge) where a company enters into administration or insolvent liquidation within 12 weeks of a moratorium ending.

These reforms are likely to impact all companies, whether in financial distress or not, and may well alter the relationship between contractual counterparties as companies attempt to trade through this crisis.

PROPOSED REFORMS

In summary, the proposed reforms will have effect as follows:

New company moratorium: A novel, free-standing moratorium (unconnected to any other insolvency process) giving up to 40 business days of protection even without court or creditor approval during which a payment holiday will apply to all pre-moratorium debts except certain limited categories (principally for liabilities to employees and financiers). The moratorium prevents legal processes against the company, including commencing a claim, commencing insolvency proceedings, crystallising a floating charge and forfeiture. Directors retain management control. An insolvency practitioner will be appointed as moratorium monitor, responsible for ensuring that the moratorium is at all times likely to result in rescue of the company as a going concern. The monitor’s consent will be required for many company payments. Liabilities incurred during the moratorium will be payable as expenses, and therefore effectively prioritised. Fixed and floating charge assets will be capable of disposal subject to certain limitations.

Restructuring plan: Effectively an enhanced scheme of arrangement with similar broad scope, the reform allows the court to impose a compromise on a company's creditors and shareholders, including a cross-class cram-down. The compromise would need approval by the court and 75% of the creditors in each class (although the court can override rejection by one or more class).

Winding up petitions: Winding up petitions cannot be presented if based on statutory demands dated 1 March 2020 to 30 June 2020. Creditors will also be prevented from winding up a company unless the creditor has reasonable grounds to believe that coronavirus has not had a financial effect on the company or that the company would have become insolvent even absent coronavirus’ effect, which will be a significant hurdle for most creditors. Winding up will now commence from the date of the order, meaning that transactions entered into between the petition and the order will no longer be void unless validated by the court.

Ipso facto (termination) clauses: Contractual clauses permitting a supplier of most goods or services to terminate supply as a result of the customer’s entry into an insolvency procedure will cease to have effect. The supplier will not be able to exercise any pre-existing right to terminate either. Suppliers will also not be able to withhold supply to the company in insolvency until pre-insolvency debts are paid, preventing ransom payments being sought.

Suspension of wrongful trading: When determining what contribution, if any, a director should make to a company's assets following a finding of wrongful trading, the Court must assume that a director is not responsible for any worsening of the financial position between 1 March and 30 June 2020. While otherwise directors may feel compelled to cease trading so as to take every step to minimise loss to creditors once they believe that there is no reasonable prospect of avoiding insolvency, directors can now take some comfort that they will not be liable for any deterioration since 1 March 2020. This reform may allow directors to continue trading though other duties of directors will continue to apply, including the common law duty to have regard to creditors’ interests when a company is likely to become insolvent. Given the purpose behind the reforms is to ensure that companies continue to trade even when they are insolvent or in financial distress, the need for directors to consider these common law duties become ever more important to avoid personal liability.

IMPACT ON DB PENSION SCHEMES

DB pension schemes are unsecured creditors, which means that, generally speaking, any debts owed to the scheme are among the last to be paid out in an insolvency situation unless the scheme has the benefit of some form of contingent security (such as a letter of credit or a charge over company assets). Consequently, where a scheme is in deficit and the sponsor becomes insolvent it is almost certain that most of the deficit will remain unpaid meaning the scheme will fall into the PPF, which will then take on a responsibility for paying compensation to the scheme’s members.

By preventing schemes from issuing statutory demands and winding-up petitions and by allowing companies to enter a pre-insolvency moratorium, this Bill will make it even more difficult than it already is for schemes to recover unpaid contributions from distressed sponsors and by the time action can be taken, it may be too late. It may also make it more difficult for schemes to enforce any contingent security that they do get the benefit of, particularly where this is granted by way of a floating charge. In addition, the introduction of the new restructuring process may remove any say that the PPF would otherwise have over the terms of any restructuring plan that may be drawn up.

UNINTENDED CONSEQUENCES

In what appears to be an unintended consequence of the new company moratorium, the draft legislation also appears to grant super-priority to certain pre-moratorium unsecured debts (likely including unsecured banking and finance arrangements) where a company enters into administration or insolvent liquidation within 12 weeks of a moratorium ending. This super-priority debt would rank ahead of floating charge security (albeit not any fixed security) and even ahead of a liquidators' or administrators' own remuneration.

These debts would also jump above debts due to a DB scheme in the subsequent insolvency process (even where these are secured by a floating charge), meaning DB schemes and the PPF would stand to recover even less than they currently would in a liquidation or administration. This is compounded by the fact that finance parties would not be prevented from accelerating their debt during a moratorium (if they were contractually entitled to) and therefore the entire finance debt may well be subject to this super-priority. This prioritising of a company's finance arrangements over its pension and other unsecured debts and over obligations secured by way of a floating charge cannot have been the intention of the drafters of the Bill.

Even without this anomaly, the legislation nevertheless risks upsetting the delicate balance that exists between debtors and creditors under UK law. This could send shockwaves through supply chains leading to more corporate distress, not less.

COMMENT

All in all, these changes (if implemented as currently drafted) will reduce the protection and rights afforded to DB schemes and the PPF where a company is in financial distress. It is not yet clear how schemes or the PPF will respond to this, but it may force trustees to take pre-emptive action in order to protect their scheme's position. It is also likely to lead to more demands from trustees for contingent security from corporate sponsors.

To date during this crisis, the Pensions Regulator has adopted a pragmatic approach encouraging trustees to give sponsors of DB schemes breathing space by agreeing to defer deficit reduction contributions, provided the scheme is treated fairly and its interests are appropriately safeguarded. However, the scope of these changes may force the Pensions Regulator to adopt a tougher approach, which may be to the detriment of distressed DB sponsors. Therefore, it will be important to look out for any reaction or change in approach from the Pensions Regulator.

FURTHER ANALYSIS

We intend to publish more detailed analysis of each of the proposed reforms in the coming days, including more on the potential unintended consequences that might arise. To receive these updates subscribe to our UK pensions blog.

Our restructuring and insolvency team's initial analysis of the proposed reforms when they were first announced at the end of March can be found here.

We strongly advise companies and trustees to be aware of the proposed changes to the UK insolvency regime and to understand how they may impact their business/scheme. If you wish to discuss these changes further please contact any of our experts below or speak to your usual Herbert Smith Freehills contact.

More on COVID-19

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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