COVID-19: GOVERNANCE: PROPOSED CHANGES TO INSOLVENCY LAW IN RESPONSE TO THE CRISIS ANNOUNCED BY GOVERNMENT (UK)

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Legal Briefings

The Department for Business, Energy and Industrial Strategy ("**BEIS**") over the weekend announced a number of proposed changes to UK insolvency law in response to the COVID-19 crisis.

While the details of these changes are not yet clear – BEIS indicates that it will be introducing legislation to Parliament at the earliest opportunity, which may be its next sitting from 21 April 2020 after the Easter recess – the BEIS announcement cross-refers to previously announced plans to introduce insolvency law reforms which were the subject of a consultation which concluded in August 2018. We participated in that consultation and commented on the proposals arising from it here.

The emergency reforms now announced by BEIS will offer potentially useful tools and increased confidence for directors of companies attempting to deal with the COVID-19 crisis. While we will cover the proposed changes to UK insolvency law more fully when the implementing legislation is published in draft form, we have outlined below some initial observations about what this might mean for directors in the current climate.

In common with all of industry, we welcome the BEIS's announcement responding to the unprecedented COVID-19 crisis and the steps which are being contemplated in order to support UK-incorporated companies and their businesses, both domestic and international. As ever with emergency legislation intended to respond to a particular crisis, the Government will wish to ensure that any legislation does not give rise to unintended consequences, particularly uncertainty for directors which might inhibit their decision-making during these extraordinary times. Any uncertainty and issues for creditors (such as lenders and suppliers) must also be managed so that they do not treat companies benefitting from the new proposals less favourably as a preventative measure.

CHANGES TO PERMIT CONTINUED TRADING

A new moratorium

BEIS's announcement refers to "*breathing space*" for companies affected by the crisis so that they can seek a rescue or restructure. It appears likely that this will be implemented by way of a moratorium, modelled on the interim moratorium which applies when directors file a notice of intention to appoint an administrator at court. That was the approach preferred by BEIS in 2018 following its consultation with stakeholders.

The precise scope of creditor actions which will be prevented by the moratorium is not yet clear. However, it has been suggested by stakeholders that the moratorium would, like the interim moratorium, prevent a creditor from seeking to commence a winding up of the company and from commencing civil proceedings, enforcing security and exercising certain rights against the company's goods.

Though we expect the eligibility criteria for the moratorium to be updated from those which had been suggested in the 2018 consultation so as directly to address the COVID-19 crisis, were the proposals under the previous consultation to be adopted without modification, a company would be eligible to seek a moratorium if:

- the company will become insolvent if no action is taken but it is not already insolvent;
- it is more likely than not that a rescue will be successful; and
- the company has sufficient funds to carry on its business during a moratorium and to meet current obligations when they fall due as well as any new obligations incurred during the moratorium.

The moratorium monitor

It would be for a moratorium monitor to assess, and certify to the court, whether a company met the eligibility criteria. The monitor is also expected to be responsible for continuing to assess whether those criteria are met throughout the term of the moratorium. A monitor might also be required to sanction major asset disposals or the granting of new security by the company. However, the moratorium monitor would not have management responsibility, which would remain with the directors of the company.

Application for a moratorium will require a filing by the company's directors with the court, similar to the filing of a notice of intention to appoint an administrator. It may not be possible to seek a moratorium without the court's prior permission if a winding up petition has already been issued. It remains to be seen whether the Government proposes any temporary modifications to the current regime for the presentation, hearing and determination of winding up petitions in response to the crisis.

Uncertainties as to eligibility, duration and interaction with directors' duties

Given that the Government's proposals respond to the current crisis, it is possible that emergency measures will modify the eligibility criteria proposed in 2018. For example, the final criterion might be modified so as to provide that, but for the COVID-19 crisis, the company would have had sufficient funds to carry on its business during the moratorium. If that were the case, directors will have to consider carefully the accuracy of their pre-crisis business projections and forecasts.

It is unclear how long any moratorium would last. It is further unclear whether directors' duties will be varied during the moratorium period. Based on the previous consultation, it appears that directors' duties under the Companies Act 2006 and the general law would continue to apply. Directors would therefore be required to continue to act in the best interests of the company (including having regard to the interests of creditors, suppliers, employees and pensioners), particularly given the likelihood of increased scrutiny by both the monitor and creditors.

The need to avoid unintended consequences

The purpose of these changes is clearly to seek to avoid premature filings for insolvency processes by giving directors time, and some comfort as regards actions creditors might take, to seek a rescue (including via Government packages). These changes do, however, represent a fundamental change to English insolvency law given that directors will remain in management throughout the moratorium period and the changes will therefore need to:

- balance protection for the company with the needs of creditors, as well as their desire for certainty; and
- give careful thought to the interaction with general directors' duties, so as to avoid any unforeseen and unintended consequences – given the potential lack of clarity both as to

the emergency measures and the scale and likely duration of the COVID-19 crisis, directors should seek professional advice in relation to the continuing discharge of their duties.

PROTECTING THE COMPANY'S SUPPLIES

Prohibition on exercise of express insolvency termination clauses

The BEIS announcement suggests that there will be protection for a company's supplies so as to enable it to continue trading. Based on the previous consultation, it appears that this measure will be available only in support of the emergency moratorium.

While some stakeholders have called for protection by extending the current regime which applies to essential supplies (such as gas, water, electricity and communications as well as website hosting and data storage) under sections 233 and 233A of the Insolvency Act 1986, the 2018 consultation concluded instead that legislation should be introduced so as to prohibit the enforcement of contractual termination clauses triggered by insolvency events, at least for contracts relating to the provision of goods and services to the company.

It remains to be seen how, if at all, the Government's proposals will affect other contracts (e.g. finance documentation, banking facilities and insurance). Based on the previous consultation, it appears that Government regards licences, memberships and certification for relevant businesses to fall within the scope of services contracts.

Effect on new contracts

The Government's 2018 proposals previously affected only termination clauses in existing contracts and it appears likely that the current reforms will also be so restricted. Companies taking advantage of the emergency moratorium will likely require some certainty as to their ability to enter into new contracts with existing suppliers for the ongoing supply of certain goods and services and counterparties will require certainty of payment when increasing their exposure to the company in this way.

This concern may be mitigated because: (1) the monitor should throughout be assessing whether current liabilities can be met as they fall due, so that creditors should not go unpaid; and (2) a contractual insolvency event may not in any event have been triggered (depending on the contractual wording) because the new moratorium is supposed to be available only to companies which are not actually insolvent. If the concern is nevertheless perceived by counterparties as significant, it is possible that the proposed measures will need also to prevent counterparties 'ransoming' the company, for example by refusing to provide services on an ongoing basis unless all outstanding invoices/liabilities are met immediately or security/collateral is provided.

Which termination rights will be affected?

The reforms will need to balance the protection and attempted rescue of the company with the rights of creditors and the uncertainties they may face in being paid. The scope of the termination rights which may no longer be enforced will also need to be clear, so as to avoid questions about whether termination rights triggered by events related to the same facts which gave rise to the insolvency, but which are not in terms based on an insolvency event, are exercisable.

CHANGES TO THE WRONGFUL TRADING REGIME

BEIS's announcement states that: "*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… Existing laws for fraudulent trading and the threat of director disqualification will continue to act as an effective deterrent against director misconduct.*"

Wrongful trading creates personal liability for a director whose company continues to trade even after the director knew or ought to have known that the company had no reasonable prospect of avoiding insolvent liquidation. Its suspension will give directors a degree of greater confidence to continue trading even where it is very difficult to assess, given uncertainties as to how long the crisis may last and its effect, whether the company has a reasonable prospect of avoiding insolvent liquidation. It will also likely permit directors to continue to incur credit (including the packages offered by Government) with less risk of personal liability. Ultimately, the Government's intention appears to be to ensure that directors do not overreact or put otherwise viable companies into an insolvency process due to concern about their potential personal liability for wrongful trading.

However, the directors' general duties appear to be unaffected such that the directors will still be required to act in the best interests of their company including, as appropriate, the interests of creditors. Further, while wrongful trading may be suspended, that only removes one aspect of a director's personal liability – together with civil claims, directors may still face enquiries into their conduct during the crisis such as in subsequent director disqualification proceedings.

A NEW RESTRUCTURING PLAN?

Finally, the BEIS has announced that its legislation will involve a new restructuring plan capable of binding all creditors (including, potentially, fixed and floating chargeholders). The proposals have not yet been fleshed out but, again based on the Government's previous consultation, it appears that the new restructuring plan procedure would:

- utilise a debtor in possession structure;
- be available only to fundamentally solvent companies dealing with emerging financial distress;

- allow a company to bind all creditors, including junior creditors even if they voted against;
- be available only if bound creditors would be no worse off in liquidation; and
- be court sanctioned, like a scheme of arrangement.

Until draft legislation is published, it will not be possible to consider more meaningfully any proposed new restructuring plan procedure but, as with the changes considered above, it is important to strike the right balance between protection of the company and the rights of creditors and to avoid so far as possible unintended consequences.

We will keep you updated however if you would like to discuss any aspect of the proposed changes please contact us.

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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