GOVERNANCE: CHANGES TO UK INSOLVENCY LAW COULD IMPACT SECURED AND UNSECURED BANK DEBT (UK)

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Legal Briefings

Update; The Corporate Insolvency and Governance Act 2020 commenced into effect on 26 June 2020. While the final provisions of the Act largely reflected the drafting of the original Bill, certain amendments were made including to: (i) improve the information available to certain pensions creditors in relation to a moratorium and restructuring plan; and (ii) prevent certain non-holidayed debts (including accelerated debts due under a financial services contract) from obtaining super priority in an insolvency process following within 12 weeks of the termination of a moratorium. The below update is based on the Bill's original drafting. Our team will soon be publishing short videos considering each of the finalised Act's reforms, as well as its likely impact on particular sectors.

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 and, potentially, the balance between secured and unsecured financial creditors, including via a new restructuring plan in which a cross-class cram down is available.

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.

The focuses of this briefing are what appears to be an unintended consequence of the new debtor-in-possession insolvency procedure and the new restructuring plan being introduced into the Companies Act 2006, which includes a cross-class cram down ability. The unintended consequence is that the draft legislation 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 other debts (including potentially financial debts secured by a floating charge) where a company enters into administration or insolvent liquidation within 12 weeks of a new moratorium ending.

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 OF THE NEW MORATORIUM ON FINANCIAL INDEBTEDNESS

By preventing lenders from issuing statutory demands and winding-up petitions and by allowing companies to enter a pre-insolvency moratorium, this Bill may make it more difficult to recover unpaid debts. However, it is generally rare for banks to issue winding-up petitions, at least where they have the benefit of floating charge security.

It is the new moratorium which is more likely to impact banks. In Chapter 4 of a new Part A1 to the Insolvency Act 1986, the moratorium imposes "restrictions on the enforcement or payment of" certain debts. The draft legislation then refers to a "payment holiday" in relation to certain debts or other liabilities, including most pre-moratorium debts but not those arising under a contract or other instrument involving financial services. Financial services contracts include those for lending, financial leasing, guarantees, futures or forwards, swaps and derivatives.

However, this is *not* limited to contracts entered into between a company and a financial institution. It appears that lending arrangements which are intra-group or between related parties (including shareholder loans) will also constitute contracts or instruments involving financial services. In this note, as in the legislation, we characterise a financial services contract by reference to the services provided under it, not by the nature of the institution providing them.

Though debts due under financial services contracts are excluded from the scope of the payment holiday, other aspects of Chapter 4 appear to suggest that the moratorium does affect these debts. A financial services creditor cannot commence legal proceedings against the company during a moratorium, though they can seek permission to sue (whereas those creditors whose debts *are* subject to the payment holiday cannot seek such permission).

During the moratorium, an uncrystallised floating charge cannot be crystallised. There is no express distinction between floating charges granted to secure obligations due under a contract or other instrument involving financial services and those that do not.

The short point is that Chapter 4 creates restrictions on the enforcement of debts owed to financial institutions, but nevertheless also appears to suggest that those debts will not be holidayed. It is therefore unclear what, precisely, a “payment holiday” is. It would appear that whether or not a debt is subject to a “payment holiday” is a separate question to whether the new moratorium creates restrictions on the enforcement or payment of that debt.

Chapter 4 also appears to create additional restrictions on enforcement of debts due under financial services contracts secured by a floating charge compared to those which are not or those which are secured by a fixed charge. Could floating charge secured financial services debts be holidayed for the purposes of the Bill when unsecured bank debts are not? It does not appear that this is the intention of the draft legislation because the question of a “payment holiday” is distinct from the restrictions which apply under the new moratorium. Put another way, all financial services debt no matter how secured would appear to be holidayed, but also subject to various restrictions on enforcement depending on how (if at all) it is secured.

UNINTENDED CONSEQUENCES OF THE NEW MORATORIUM?

Precisely which debts are holidayed is very important because the Bill appears to grant super-priority to certain pre-moratorium debts 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), unsecured debt and even ahead of a liquidators’ or administrators’ own remuneration.

The relevant pre-moratorium debts are those for which the company did not have a payment holiday. If, as appears to have been intended under the draft legislation, financial services debts are not holidayed, they will effectively obtain super-priority.

Creditors who are owed financial services debts will therefore overtake all other creditors in any administration or insolvent liquidation which commences shortly after a moratorium.

This has a number of important consequences.

First, if they overtake any liquidator or administrator’s fees, it is difficult to see why any liquidator or administrator would be willing to take an appointment.

Second, if it is not possible during the moratorium to rescue the company, creditors who are owed financial services debts will be incentivised to cause the company to enter administration or insolvent liquidation within 12 weeks of the moratorium ending, precisely so as to take advantage of the super priority status. It is possible that creditors which are owed financial services debts will completely change their approach to restructuring, requiring a company first to file for a new moratorium before entering a subsequent insolvency process, simply to produce this super priority result. That could frustrate any longer term rescue of a company.

But even then, creditors owed financial services debts will not be the only creditors taking super-priority. The most significant other class of debts which will enjoy super priority are employees, whose wages and salaries (including pension contributions) will then rank equally with all financial services debts.

Third, all financial services debts will rank equally. That will put banks holding floating charges on an equal footing with unsecured banks and also other lenders to the company, including related parties or shareholders. Intra-group lending is often permitted under facility agreements so third party lenders may not have the ability to prevent the creation of such debt, which will rank alongside them and dilute their returns in an insolvency which quickly follows a new moratorium. This also gives rise to the curiosity that, for financial services debt which is secured by a floating charge, the debt itself will rank ahead of the floating charge in that subsequent insolvency process.

Fourth, super priority will disproportionately benefit accelerated and on demand financial services debts. That is because there is nothing to prevent a creditor which is owed a financial services debt from accelerating the debt or demanding its payment even after the moratorium has commenced. Whereas in the usual course a bank may only be entitled to periodic repayments, if the debt is accelerated all of the amounts due to the bank will become due and be paid at the top of the insolvency waterfall.

It is uncertain whether this is the intended effect of the draft legislation and, if not, whether the draft legislation will be amended to make the position clear before it goes onto the statute book. Further analysis will be required when the Bill is enacted.

APPROVAL OF RESTRUCTURING PLANS OVER FINANCIAL CREDITORS' DISSENT

The approach of financial services creditors to restructuring is also likely to be impacted by the new restructuring plan which, unlike the other measures under the Bill, is characterised as a permanent amendment to the insolvency framework. The new restructuring plan is in many respects similar to a scheme of arrangement (so will appear in the Companies Act, not the Insolvency Act) but includes a cross-class cram down mechanism. Like an 'ordinary' scheme of arrangement, a compromise with creditors under the new restructuring plan will require votes of each class of affected creditors. A vote will be passed on a 75% majority by value. However, unlike a scheme of arrangement, a new restructuring plan can be approved by the court even if not all classes of creditors vote to approve it.

This gives rise to the risk that dissenting bank creditors could be bound by an arrangement between the company and its creditors even if they have not voted in favour of it. The court will only be able to sanction the arrangement in the face of a dissenting class if at least one class has approved it and if the court is satisfied that none of the members of the dissenting class would be any worse off under the arrangement than the alternative if the arrangement were not approved. The relevant alternative is whatever the court considers would be most likely to occur in relation to the company absent the arrangement.

It is possible that dissenting creditors will only be no worse off under the arrangement if the alternative were a formal insolvency process, and it is likely that in most cases the relevant alternative will be insolvency. However, the relevant comparator for most non-financial services creditors may be insolvency within 12 weeks of a moratorium, in which case financial services creditors (and other non-holidayed creditors) will have super priority as described above. If the effect of that super priority would be to give the other unsecured creditors no payment in respect of their claim, it is difficult to see how they could be any worse off under the arrangement. As a result, those other unsecured creditors face a double penalty – first, by the financial services super priority and second by the effect this will have on consideration by the courts of the approval of any arrangement despite those unsecured creditors' dissent.

Where a restructuring plan is proposed within 12 weeks of the conclusion of a new moratorium, an arrangement cannot be approved in the face of dissent by a creditor in respect of a moratorium debt (being a debt which became due during the moratorium) or a pre-moratorium debt which was not holidayed (including a financial services debt). In these circumstances, any arrangement which makes provision in relation to that moratorium debt or pre-moratorium debt must be approved by all relevant creditors. The court cannot sanction the arrangement if a single such creditor has not agreed to it, even if that class of creditors had given 75% approval. Again, therefore, financial services creditors may be incentivised to ensure that a company seeks a new moratorium in order to ensure that a subsequent restructuring plan cannot be imposed on that creditor absent its express agreement.

FURTHER ANALYSIS

We intend to publish more detailed analysis of each of the proposed reforms in the coming days and weeks, including more on the potential unintended consequences that might arise. It is possible that certain aspects of the Bill, including in particular those which appear to produce results which were not intended by Government, will be amended before the Bill is enacted.

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 banks to be aware of the proposed changes to the UK insolvency regime and to understand how they may impact their borrowers and other counterparties. If you wish to discuss these changes further please contact our experts below or speak to your usual Herbert Smith Freehills contact.
More on Catalyst //

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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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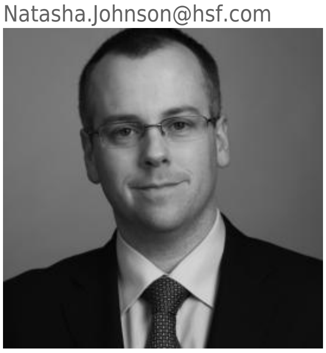

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