PRESSURE POINTS: TRUSTEES BEWARE – CHANGES TO UK INSOLVENCY REGIME ARE NOW IN FORCE (UK)

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Legal Briefings – By **Rachel Pinto, John Whiteoak and Tim Smith**

The Corporate Insolvency and Governance Act 2020 received Royal Assent and is now in force.

The Act contains the most far-reaching reforms to UK insolvency law in over 30 years. The Act 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, the Act undermines the protection afforded to defined benefit (DB) pension schemes and the Pension Protection Fund (PPF) where a corporate sponsor experiences financial distress. It could also upset the delicate balance between debtors and creditors under UK law.

The position of DB pension schemes (and the PPF) has been weakened through the introduction of:

- a new company moratorium, which may last for up to a year

- restrictions on creditors issuing statutory demands and winding-up petitions and enforcing floating charges during a moratorium, and

- a new restructuring process by which a restructuring plan can more easily be imposed on dissenting creditors.

The legislation also grants super-priority to certain pre-moratorium debts (including certain secured and unsecured banking and finance arrangements and intra group loans) 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.

For suppliers, the legislation increases the risk that customers and clients will not make payments when due – as a creditor’s threat to serve a winding up petition has been weakened – which may push liquidity issues through supply chains. Other reforms affect the balance between creditors and other stakeholders, with which the legislature has previously been cautious about interfering.

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 Act introduces a debtor-in-possession insolvency procedure for the first time in English law. Introducing such sweeping reforms during a crisis risks unintended consequences.

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. It may also alter the approach of banks and other lenders where a company is in financial distress.

It is vital that businesses understand the potential impact of these changes on their supply chains. Trustees of DB schemes should also take immediate steps to assess the impact of these changes on their scheme and, in particular:

- on the amount that the scheme might stand to recover in the event that a sponsor becomes insolvent, and

- on the protection afforded by any contingent security that the scheme has the benefit of.

KEY REFORMS

In summary, the key reforms to the UK insolvency regime (which are all now in force) include:

New company moratorium: A novel, free-standing moratorium (unconnected to any other insolvency process) giving up to 40 business days of protection (or up to one year with 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 suppliers under financial services contracts and instruments, whether or not that is the suppliers' business (so that lending from related parties, such as other group companies, falls within the excepted category)). The moratorium restricts 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, this 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, significantly, the court can override rejection by one or more class).

Super-priority for bank debts and other lending: In a significant change to the existing priority order for the payment of debts where a company becomes insolvent or enters administration, the Act grants super-priority to certain pre-moratorium debts (including unsecured banking and finance arrangements and intra-group loans) where a company enters into administration or insolvent liquidation within 12 weeks of a moratorium ending. These super-priority debts would rank ahead of all other unsecured debts and floating charge security (albeit not any fixed security) and even ahead of a liquidators' or administrators' own remuneration.

As a result, these debts will jump above debts due to a DB scheme (even where these debts are secured by a floating charge) where an insolvency process follows shortly after a moratorium ends (which will almost always be the case where a corporate rescue is not possible).

Although some amendments have been made to the legislation as it made its way through Parliament to try to prevent pre-moratorium debts from being accelerated during a moratorium (a mechanism that could otherwise have been used by lenders to secure super-priority status for their entire finance debt), these changes will not prevent banks and other lenders from accelerating their debts (where they have the contractual right to do so) before a moratorium begins. It is also doubtful whether the restriction will prevent lenders from calling in 'on demand' debt during a moratorium so that the entire debt gains super-priority.

In any event, by prioritising a company's finance arrangements (whether with its bankers or related parties) over its pension and other unsecured debts and over obligations secured by way of a floating charge, the Act will reduce the amount that DB schemes and the PPF can expect to recover in a liquidation or administration.

Winding up petitions: Winding up petitions cannot be presented if based on statutory demands dated 1 March 2020 to 30 September 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 automatically void unless specifically validated by an order of 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 September 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 legal 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 and statutory duties becomes ever more important to avoid personal liability.

IMPACT ON DB PENSION SCHEMES AND THE PPF

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 which ranks higher in the priority order (such as 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 is likely to fall into the PPF, which will then take on a responsibility for paying compensation to the scheme's members.

The changes to the UK's insolvency regime made by this Act reduce the protection afforded to DB schemes and the PPF where a corporate sponsor is in financial distress by:

- allowing companies to enter a pre-insolvency moratorium and preventing DB schemes (and most other pre-moratorium creditors) from taking steps to recover existing debts or enforce existing security for up to a year while the moratorium remains in force

- reducing the amount that DB schemes and the PPF stand to recover on a corporate insolvency where a company makes use of the new moratorium before it enters into insolvent liquidation or administration

- undermining the protection afforded by floating charges (which many schemes currently have the benefit of)

- introducing a new restructuring process which could remove any say that the PPF would otherwise have over the terms of any restructuring plan that may be drawn up, and

- severely limiting the scope for schemes (and other creditors) to issue statutory demands and winding-up petitions prior to 30 September 2020 making 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.

Several of these issues were raised by MPs and peers as the legislation went through Parliament. Some amendments were made, for example, to give the PPF and the Pensions Regulator rights to be notified where a moratorium comes into force or ends and introducing powers which may be used to give the PPF the ability to exercise certain creditor rights on behalf of trustees (although, this is reliant on secondary legislation). However, these (together with the restriction on accelerated debts gaining super priority) do not go far enough to prevent the Act significantly eroding the protection and rights afforded to DB schemes and the PPF where a company is in financial distress.

WHAT SHOULD TRUSTEES DO NOW?

In light of these changes to the UK insolvency regime, trustees should take immediate steps to:

- understand these changes and what they mean for their scheme

- assess the impact of these changes on the strength of their employer covenant and, in particular, on the amount that their scheme might stand to recover on a corporate insolvency, and

- assess the impact of these changes on the protection afforded by any contingent assets, including floating charges and company guarantees, that their scheme currently has the benefit of.

These changes will also be an important factor for trustees to consider if they receive a request to defer or reduce deficit reduction contributions or payments to cover scheme expenses or if they receive a request to extend a deferral that has previously been granted.

COMMENT

All in all, these changes are not good news for DB schemes or the PPF. 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 in the form of fixed charges or letters of credit (which fall outside of an insolvent company's estate) 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.

CONTACT US

Directors and trustees need to understand these changes to the UK insolvency regime and 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.

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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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