

GOVERNANCE: CORPORATE INSOLVENCY AND GOVERNANCE BILL: IMPACT ON SUPPLY CHAINS AND THEIR CUSTOMERS (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 new Corporate Insolvency and Governance Bill, currently expected to be enacted in mid-June 2020, is likely significantly to impact many supplies of goods and services to companies that are or may be in financial distress. However, the effects are sufficiently far-reaching that they could impact the balance of rights in all supply chains and particularly the drafting of supply contracts, with an impact on both suppliers and their customers or clients.

Suppliers may seek to act now to mitigate or address the likely impact of the Bill and to maximise the prospects of obtaining full payment. Since each supplier is likely also to be another supplier's customer or client, any impact on one supplier is likely to have a knock-on impact on its suppliers and so on throughout the supply chain.

How is the law changing?

Once enacted, the key reforms under the Bill which affect supply contracts are that:

1. Temporarily, but with retrospective effect from 27 April 2020 until at least 30 June 2020, winding up petitions must not be served by a supplier on a customer, unless the supplier has reasonable grounds to believe that (a) coronavirus has not had a financial impact on the customer or (b) the company would have become insolvent even absent coronavirus.
2. Where a customer enters an insolvency procedure, contractual rights exercisable because the customer has entered that procedure will become unenforceable. This includes both termination and other rights, including for example price ratchets.
3. Where a supplier had an accrued right to terminate before the customer entered into an insolvency procedure, that right will be suspended.
4. During the insolvency procedure, suppliers cannot make their ongoing supply conditional on payment of outstanding pre-insolvency invoices (though post-insolvency invoices should be paid in priority as an insolvency expense).
5. A customer can apply for a new, short moratorium which prevents suppliers from seeking to take insolvency or other legal proceedings against the customer or its property. Suppliers will be subjected to a payment holiday, whereas financial services creditors and employees will not. If the customer cannot be rescued as a going concern during the moratorium and it subsequently enters into an insolvency process within 12 weeks of the conclusion of the moratorium, pre-moratorium debts which were not subject to a payment holiday (for example, financial services debts) will enjoy super priority, with the result that suppliers are likely to recover less in an insolvency than they would otherwise. During the moratorium, the company will not be permitted to pay its pre-moratorium debts to suppliers if they exceed the greater of £5,000 or 1% of the company's total unsecured debt, unless the moratorium monitor or the court approves the payment.

Our more detailed summary of the Bill's insolvency reforms is [here](#).

What is the potential impact on supply contracts?

As a result of the reforms, two of the most effective threats available to unpaid suppliers – termination and statutory demands leading to winding up – have been removed or weakened. An unpaid supplier will find it more difficult credibly to threaten the defaulting customer with winding up, a relatively quick and cheap threat to make. Other legal proceedings will be more costly to bring and expenditure may be wasted if the customer enters a moratorium which stays legal proceedings.

Compounding this, if the customer's position deteriorates and it enters an insolvency procedure, the unpaid supplier may find itself obliged to continue supply, without payment of prior invoices and on existing terms (potentially without e.g. price ratchet or default interest).

What could suppliers do now?

Suppliers are likely to review their existing contractual arrangements with customers that are, or may become, in distress. Their objective could be to identify means by which to force payment at an earlier stage so as to minimise the impact of any moratorium and reduce the outstanding pre-moratorium invoices if the supplier becomes unable to terminate supply as a result of the commencement of a moratorium.

The rights to which suppliers may look include withdrawing supply or implementing mechanisms to obtain payments in advance or on account. Where money is being held on account, this could be used to pay invoices upon issue and the account topped up regularly by the customer. Extending credit or grace periods to struggling customers may come back to haunt suppliers.

If the supplier already has a termination right (whether for non-payment or not), the supplier may consider exercising it so as to negotiate new terms. Those new terms may include:

- payment in advance or on account;
- a short or rolling term with a fixed termination date so that the supplier will not be 'locked in' to supply for a considerable period in any insolvency procedure;
- an express right to withhold supply for non-payment;
- reservation of title or similar security arrangements; and/or
- guarantees from the customer's affiliates.

Even where suppliers do not wish to terminate immediately, they could consider whether steps need to be taken to prevent the termination right from being lost, so as to preserve the ability to exercise it pre-insolvency. This may involve the sending of reservation of rights letters and/or making clear that ongoing supply should not be taken as acquiescence to the customer's default. If suppliers wait too long and the customer or client enters an insolvency procedure (whether an existing procedure or the new moratorium), the right to terminate will be suspended even if that right was not triggered by insolvency.

If customers do enter an insolvency procedure and suppliers find themselves compelled to continue supply under a contract which has become non-commercial, there is a route for suppliers to terminate the contract with the permission of the court.

Customers resisting any modifications which their own suppliers seek to impose may simultaneously be looking to their own customers to accept similar modifications. For example, if one supplier requires payment in advance or on account, its customer is likely to seek such similar advance payments from its own customers in order to fund this. In this way, the effects on liquidity are likely to flow quickly through supply chains.

Suppliers may also seek more novel routes to insulate themselves from these reforms. As explained above, where a new moratorium fails to rescue a customer and it enters a subsequent insolvency process, certain classes of pre-moratorium debts have super priority. Pre-moratorium debts due under supply contracts would not ordinarily fall within these classes. However, suppliers may attempt to ensure that they do. One way of doing this may be to convert unpaid invoices into loans to the customer, since contracts for lending will benefit from super priority. Suppliers would likely need to negotiate or obtain a contractual right in order to treat the balances in this way, and may seek to do this as part of broader reviews of supply terms. Any such changes must be implemented before the moratorium commences.

Potential lacunae?

The Bill has now entered the House of Lords for debate. It is possible that certain aspects of the Bill will be amended as it proceeds through Parliament, though the Opposition has already signalled that the Bill will be supported and the amendments in the House of Commons were relatively minor. We are aware that representations have been made to Government concerning the “super priority” issue so it is possible that this aspect of the Bill will be amended before enactment.

Potential amendments (if any), whether before the Bill is enacted or by way of secondary legislation where the Bill specifically empowers this, are likely to focus on anomalies in the drafting.

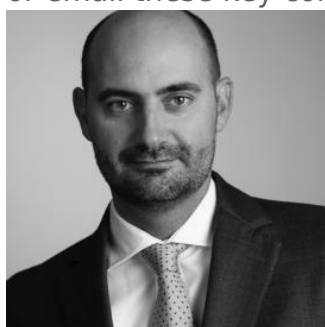
For example, suppliers’ termination rights are only suspended during an insolvency procedure if the rights accrued before insolvency. There appears to be a lacuna where the default occurred pre-insolvency but the consequential right to terminate did not arise until post-insolvency, including as a result of a grace period delaying the right to terminate from becoming exercisable. This could impact the day on which a customer chooses to seek insolvency protection – whereas usually they would seek protection before payment is due, now they may wish to wait until after payment was due and any termination rights become exercisable. We may therefore see a race against time between the supplier seeking to terminate and the customer seeking to file for insolvency as soon as a grace period expires.

We strongly advise you to be aware of the proposed changes to the UK insolvency regime and to understand how they may impact your business and suppliers. 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 //](#)

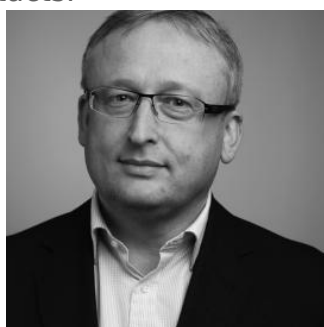
KEY CONTACTS

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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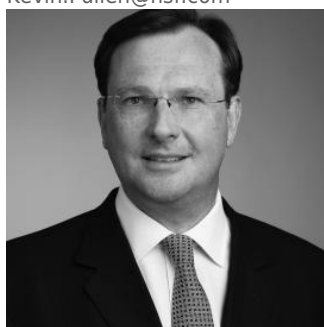
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