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WHITE PAPER

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Key Implications of the UK's Corporate Insolvency and Governance Act

On 25 June 2020, the new Corporate Insolvency and Governance Act (the "Act") received Royal Assent. We anticipate that the changes introduced by the Act will have a significant impact on the future direction of the UK restructuring market.

The purpose of the Act is to promote a stronger rescue culture in the UK, providing companies in financial distress with a better chance of being restructured on a going concern basis (in a similar way to a U.S. Chapter 11). The changes introduced by the Act were initially put forward by the Government in 2016, and were subject to consultation in 2018. A new restructuring regime for the UK had therefore been anticipated. However, in response to COVID 19, the timing of the implementation of the Act was accelerated and certain provisions have been revised (as compared to the Government's proposals announced in 2018), in order to ensure that the Act is more responsive to current economic conditions.

In this *White Paper*, we highlight the main changes introduced by the Act and discuss the key implications for stakeholders.

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KEY FEATURES OF THE ACT:

- A new standalone statutory moratorium;
- A new restructuring plan; and
- Certain restrictions on the use of insolvency termination clauses in contracts for the supply of goods and services.

In addition, directly in response to COVID-19, the Act includes certain temporary measures relating to (i) the suspension of liability for wrongful trading; and (ii) restrictions on the issuing of statutory demands and the presentation of winding up petitions where the underlying financial distress is directly related to COVID-19.

THE MORATORIUM

The Act introduces a new standalone statutory moratorium available for companies in financial distress. Access to the moratorium is not conditional upon the company accessing any other insolvency proceeding. The purpose of the moratorium is to provide companies with breathing space to restructure their liabilities.

Eligibility: The moratorium may only be accessed by a company (i) which is, or is likely to become unable to pay its debts; and (ii) in circumstances where a proposed monitor (an independent insolvency practitioner) confirms that, in the view of the proposed monitor, it is likely that the moratorium would result in the rescue of the company as a going concern.

Exclusions: The moratorium may not be accessed by a company which is or has been subject to an insolvency proceeding (or has had the benefit of a moratorium) in the previous 12 months. In addition, certain financial institutions are excluded together with any company which is a party to a capital markets arrangement. The capital markets exception in particular will exclude a large number of companies with more complex capital structures, which include bond financings, from accessing the moratorium.

Process: The process to access the moratorium is straightforward and requires the company to file certain documents at court (similar to the appointment of an out-of-court administrator), save where a winding up petition is outstanding or an application is made by an overseas company—in both of these circumstances, an application to obtain a moratorium must be made out of court.

THE MONITOR

The monitor is an independent insolvency practitioner appointed by the company. The role of the monitor is to act as a supervisor monitoring the company's affairs. Following the commencement of the moratorium, if the monitor forms a view that the moratorium is no longer likely to result in the rescue of the company, the monitor is required to bring the moratorium to an end. The monitor is also required to approve the making of certain payments and the entering into of certain transactions by the company during the course of the moratorium.

EFFECT OF THE MORATORIUM

Broadly speaking, the moratorium has substantially the same effect as the moratorium in administration. In particular, during the moratorium period:

- No insolvency proceedings can be commenced against the company;
- No legal proceedings can be commenced or continued by or against the company (with limited exceptions);
- No landlord can exercise rights of forfeiture by peaceable reentry; and
- No security holder is permitted to enforce its security in respect of the assets of the company (save for financial collateral or security granted with consent of monitor during the moratorium period).

In addition, during the moratorium, the company is not permitted to enter into certain transactions *without the consent of monitor*. In particular, the company is unable to:

- Sell or otherwise transfer its assets, other than in the ordinary course;

- Grant any security in respect of its assets; and
- Pay any person any premoratorium liability in excess of £5000 or 1% of liabilities of the company.

PAYMENT HOLIDAY

During the moratorium period, the company shall benefit from a payment holiday on all premoratorium debts save for certain excepted payments including:

- Monitor's expenses and remuneration;
- Rent in respect of the moratorium period;
- Wages or salary arising under a contract of employment or redundancy payments;
- Goods and services supplied during the moratorium; and
- Debts or other liabilities arising under a contract or other instrument involving financial services.

The company is also permitted to pay moratorium debts, that is liabilities of the company which arise during the course of the moratorium.

In the event that the company is placed into administration or liquidation within 12 weeks of the moratorium, any moratorium debts and premoratorium debts are provided with super priority status in that subsequent insolvency proceeding, payable ahead of both floating charge and preferential creditors and in priority to the remuneration of the monitor.

On application to the court, the company may dispose of assets subject to fixed charge security—but the court will only grant consent where it will assist in rescuing the company as a going concern.

DURATION

The moratorium is available for an initial period of 20 business days subject to a further extension of 20 business days.

The moratorium can be extended for up to *one year* with the consent of a majority in value of both (i) *'premoratorium' secured creditors; and (ii) 'premoratorium' unsecured creditors.* The majority of either the 'premoratorium' secured creditors or the 'premoratorium' unsecured creditors must be unconnected to the company.

In this context, 'premoratorium' creditors means creditors in respect of which the relevant liability was incurred by the company prior to the commencement of the moratorium and for which there is a payment holiday. Accordingly, creditors who may be paid during the moratorium, such as financial creditors and suppliers of goods and services provided the moratorium period, will not be permitted to vote on the extension.

If a Company Voluntary Arrangement ("CVA") is proposed prior to the expiry of a moratorium, the company will benefit from an automatic extension of the moratorium until the outcome of the CVA is determined. Similarly, where a company proposes a scheme of arrangement or restructuring plan during the moratorium, the court has a discretion to extend the moratorium at the convening hearing.

TERMINATION OF THE MORATORIUM

As noted above, if at any time during the moratorium the monitor comes to a view that the moratorium is no longer likely to result in the rescue of the company as a going concern, the monitor is required to bring the moratorium to an end. Further, if the monitor forms a view that the company is or is likely to become unable to discharge its liabilities during the moratorium period, the monitor is again required to bring the moratorium to an end.

Challenges: Creditors, directors, shareholders, or persons affected by the moratorium can challenge the actions of the monitor and/or the directors during the moratorium. In these circumstances, the court may give directions but will not require the monitor to contribute towards to the assets of the company. The remuneration of the monitor can be challenged by a subsequent administrator or liquidator. This right of challenge may also be assigned by any subsequent officeholder appointed to the company.

Commentary: While the moratorium is intended to be a standalone procedure, in practice it is likely to be used as a runway to implementing another procedure such as a CVA, a prepack administration, scheme, or arrangement, or restructuring plan. Insolvent companies can in theory access the moratorium. However, the scope of creditors excluded from the payment holiday means that the company will, absent agreement to the contrary with the relevant creditors, need to have sufficient liquidity available to pay such amounts during the moratorium period which may not be feasible in many situations.

Given the limited period of the moratorium, we anticipate that 'freefall' moratoriums will be relatively uncommon. In order to maximise the utility of the moratorium, we will likely see restructuring strategies agreed in advance between the company and its key stakeholders. In these circumstances, a moratorium will most likely be used as a tool to implementing the agreed restructuring strategy.

THE RESTRUCTURING PLAN

Entirely independent of the moratorium, the UK now has an additional restructuring tool available in the form a new restructuring plan.

The structure and framework for the plan is based on the existing UK scheme of arrangement (the "UK Scheme") and case law relating to schemes will, to the extent possible, be used to analyse and determine restructuring plan issues.

However, unlike a UK Scheme which is typically used to restructure financial indebtedness at a holding company level, the intention is that the new plan may also be used to implement an operational restructuring as an alternative to a CVA or administration.

Eligibility: In order to access the plan, the company must (i) have encountered or be likely to have encountered financial difficulties that are affecting or will or may affect its ability to carry on business as a going concern; and (ii) the compromise or arrangement must be proposed between the company and its creditors or members and the purpose of which must be to eliminate, reduce, prevent, or mitigate the effect of any of the financial difficulties the company is facing.

Like the UK Scheme, the plan is available to UK companies together with any other company with a 'sufficient connection' to the UK, which could include overseas companies.

Process: The plan can be proposed by the company, any creditor, or member, a liquidator, or an administrator of the company. However, in practice, given the extensive information required to be prepared and disclosed to creditors and the court in connection with the plan, it is anticipated that only the debtor company will be in a position to propose a plan.

Voting: For the purposes of voting on the plan, creditors/members are divided into classes. In relation to any out-of-the money creditor or member, the company may seek court approval to exclude any such class from voting on the plan. Creditors will typically vote in the same class where their respective rights are 'not so dissimilar as to make it impossible for them to consult together with a view to their common interest'. As a starting point, secured and unsecured creditors will vote in separate classes.

Approval threshold: 75% in value of creditors voting (in person or by proxy). Unlike the UK Scheme, there is no numerosity test.

Cross-class cram down: The UK Scheme requires each voting class of creditors to vote in favor of the proposed scheme. However, in the case of a plan, a court may sanction a plan, even if one or more class of creditor or member has voted against the plan (a cross-class cram down). A cross-class cram down may be sanctioned by the court provided that (i) one class of creditors (and/or members) who would receive a distribution on the insolvency of the company (or has a genuine economic interest in the company) has voted in favor of the plan; and (ii) the class or classes to be crammed down must receive a distribution equivalent to that which would be available in the next best alternative.

An additional feature of the plan is that there is no requirement for the plan to observe the 'absolute priority rule'. The absolute priority rule, a key feature of U.S. Chapter 11, provides that a junior class of creditor is not permitted to receive any distribution until a more senior class of creditor is paid in full. In practice, this means that where, for instance, value breaks in the mezzanine debt, unsecured creditors or equity could

still receive a distribution under the plan even if the mezzanine creditors are impaired. The absence of the absolute priority rule will provide greater flexibility to the company proposing the plan to enable it to make payments to key stakeholders, such as trade creditors or landlords, whose support is likely to be required to enable the business to continue trading on a going concern basis.

Safeguarding: Ultimately, as with the UK Scheme, the court has a discretion as to whether to sanction a plan on the basis of fairness. So if any class is being unfairly treated, in practice the court could refuse to sanction the plan.

Commentary: The new plan is a welcome addition which will provide greater flexibility to companies in proposing restructuring solutions. However, greater flexibility may also give rise to potential challenges—valuations are likely to be a particular focus. Where a cross-class cram down (or cram up) is being proposed, what constitutes the 'next best alternative' will also be a key issue and a fertile ground for disputes. In most restructuring schemes, the scheme company will advise creditors that the next best alternative if the scheme is not approved is administration or liquidation. In these circumstances, the return to creditors is likely to be significantly less than the going concern value which could be achieved through the scheme or an alternative restructuring proposal. In the context of COVID-19, where business and asset valuations are likely to be particular contentious, these are likely to be challenging issues to navigate for all stakeholders.

INSOLVENCY TERMINATION CLAUSES

When a company goes into an insolvency proceeding, such as administration, suppliers of goods and services to the company typically rely on insolvency termination clauses to enable them to stop supplying the company in administration. If the administrator requires the continuity of supply, the administrator is forced to make 'ransom payments' to creditors which it may or may not be able to pay. In some circumstances, this can make it more difficult for the insolvency officeholder to achieve a rescue of the company on a going concern basis.

In order to address this issue, the Act provides that suppliers of goods and services will no longer be entitled to rely on insolvency termination clauses (also known as *ipso facto* clauses) to terminate contracts (or 'do any other thing') for the supply of goods and services where a company has the benefit of the moratorium, or is subject to an insolvency proceeding (including a CVA, administration and liquidation). This will be the case even if there are premoratorium or preappointment arrears and the supplier will be prevented from requiring the payment of such amounts as a condition of continued supply. Suppliers will also be prevented from, for instance, increasing prices, charging default interest or changing payment terms.

Further, where a right of termination (on any basis) has arisen prior to a company entering into the moratorium (or any insolvency proceeding), the supplier will not be permitted to exercise a right of termination while the company is subject to the moratorium or relevant insolvency proceeding.

Safeguarding: In order to protect companies who are forced to continue supplying a company during the moratorium or in an insolvency proceeding there are safeguarding provisions.

The Act provides that during the moratorium, a company is permitted to pay for the supply of goods and services during the moratorium. In the event that the company fails to pay such amounts and the company enters into an insolvency proceeding within 12 weeks of the moratorium coming to an end, the supplier will be paid on super priority basis, behind fixed charge holders but in priority to floating charge holders. In practice, if it appears likely that the company will be unable to discharge such amounts, the monitor is required to bring the moratorium to an end. Further, where a company subsequently proposes a CVA, the CVA is unable to compromise the claims of such creditors without their consent.

Where a company is already in administration or liquidation, such amounts due to suppliers will be paid as an expense in the relevant proceeding. Again, payable on a super priority basis behind fixed charge holders but in priority to floating charge holders.

Challenges: A supplier may cease supply with the consent of the company or on application to court in the case of hardship. No further guidance has been provided at this point as to what hardship means. However, in consultation, the Government advised that it intended this to be a high threshold meaning that the solvency of the supplier had to be in doubt as a result

of it being forced to continue supplying the company in order for relief to be granted.

The new provisions are intended to sit alongside the existing regime relating to the supply of essential services which will continue to apply when a company enters into administration or liquidation[1].

Commentary: At this point, no further guidance has been provided with regard to the scope of goods and services to be captured by the new provisions. In consultation, the Government indicated that licenses, such as those relating to patents and software would be included, but licenses issued by public authorities would not. Financial service entities are excluded as are contracts involving the provision of financial services (e.g. loans and ABL facilities).

Notwithstanding the above provisions, suppliers will remain entitled to rely on termination clauses, not related to insolvency. For instance, where a contract may be terminated on notice or on the basis of any other default. This means that in practice we anticipate that suppliers will amend their contracts in order to ensure that they maintain maximum flexibility in the event of counterparty insolvency. While the new provisions will therefore undoubtedly assist companies in certain circumstances, the permitted exceptions will likely compromise the utility of these provisions in practice.

TEMPORARY MEASURES

In addition of the measures outlined above, the Act includes a number of temporary measures including:

Wrongful trading: A temporary suspension on liability for wrongful trading which will expire on 30 September 2020.

Statutory demands and winding up petitions: No winding up petition can be presented on the basis of a statutory demand served on the company between 1 March 2020, and 30 June 2020. These provisions are effective as of 27 April. In addition, there is a temporary suspension on the presentation of winding up petitions between 1 March 2020, and 30 September 2020, if the insolvency relates to COVID-19. Where a creditor does issue a petition, the creditor must satisfy the court that inability to pay is not related to COVID19.

A GAME-CHANGER FOR UK CORPORATE RESTRUCTURING?

The moratorium will in certain circumstances provide companies with a useful (and welcomed) breathing space within which to negotiate a restructuring of their liabilities. However, while the moratorium is intended to be a standalone procedure, in most situations, absent a consensual restructuring, the moratorium is likely to be used as a runway to implementing a formal restructuring proceeding, such as a CVA or a prepack administration.

The new restructuring plan will provide companies with greater flexibility when proposing restructurings in the context of complex capital structures and cross-border situations. The ability to cram down and cram up creditors is a significant advancement on the UK Scheme and will undoubtedly help more and more companies drive through a restructuring, even in circumstances where the company does not have the support of all of its key stakeholders. These changes will have a fundamental impact on the future direction of the UK restructuring market and will ensure that from an international perspective, the UK remains a key hub for cross-border restructuring.

Note: For more on corporate insolvency and restructuring, see our previous Jones Day *White Papers*, "All Change In Europe—New Chapter 11-Style Restructuring Regime Is On Its Way!," and "UK's Proposed Corporate Restructuring Regime Follows European-Style Chapter 11 and Debtor-in-Possession Trend."

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ENDNOTES

1 s. 233 and s. 233A of the Insolvency Act 1986.

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