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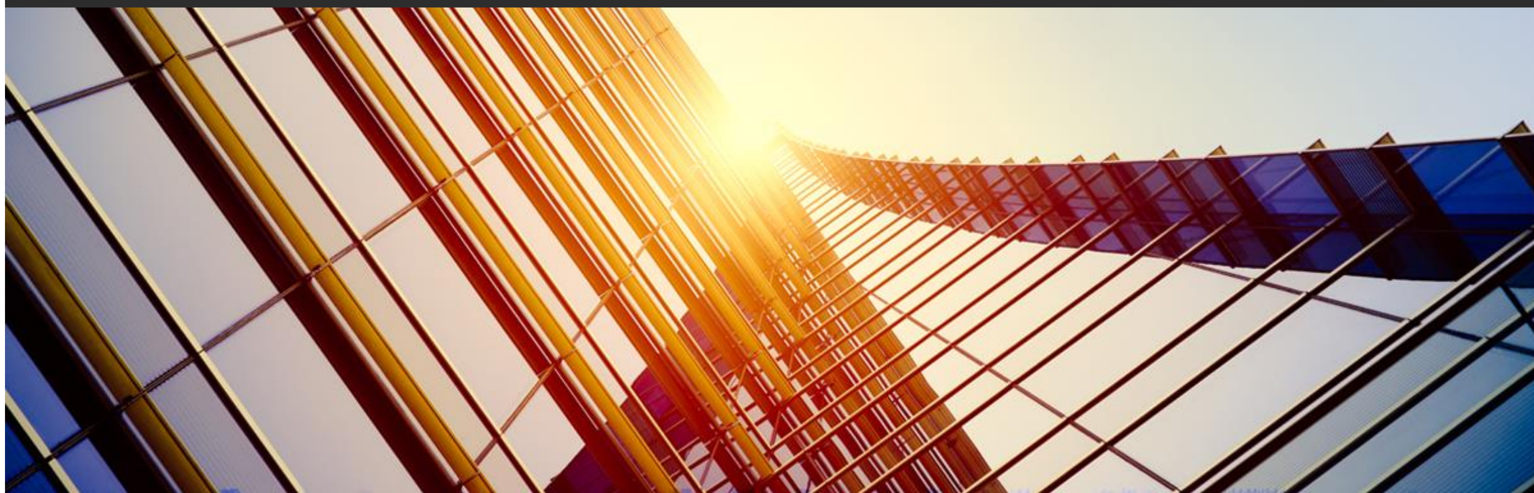

August 2020

The Corporate Insolvency and Governance Act 2020: Changes to UK Insolvency Laws

Background

On 26 June 2020, the Corporate Insolvency and Governance Act (CIG Act) came into force which introduced fundamental changes to the UK's company and insolvency laws which not only provide temporary assistance to companies and their directors during the Coronavirus Disease 2019 (COVID-19) crisis, but on a permanent basis have significantly bolstered the UK's restructuring tool kit. Amongst other matters, the CIG Act implements measures contained in the UK Government's consultation on Insolvency and Corporate Governance which concluded in August 2018.

In summary, the CIG Act makes certain permanent and temporary changes to the UK's laws as follows:

Permanent Changes:

- a new restructuring procedure (Restructuring Plan) that is closely based on the UK scheme of arrangement procedure (UK Scheme) but which has the ability to 'cram-down' entire dissenting classes of creditors and/or shareholders;
- a ban on *ipso facto* clauses which would otherwise permit suppliers of goods and services from terminating or varying supply to a company due to the commencement of insolvency and restructuring procedures; and

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- a new moratorium procedure for companies in financial difficulty.

Temporary Changes:

- a relaxation of wrongful trading rules, reducing the risk that directors will be personally liable for continuing to trade during the period 1 March 2020 through 30 September 2020 with retrospective effect;
- temporary changes to when and how creditors can present statutory demands and winding-up petitions, also with retrospective effect; and
- flexibility on requirements in relation to the holding of shareholders' meetings and extension of time to make certain filings at Companies House.

Whilst the CIG Act came into force following a rapid implementation timetable as a result of the COVID-19 crisis, the reaction of the market to both the permanent and temporary changes has generally been positive.

Further information on some of the key changes is set out below.

A New Restructuring Plan

One of the most significant changes implemented by the CIG Act is the introduction of the Restructuring Plan, which may be utilised by a company which has encountered, or is likely to encounter, financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern. The purpose of the Restructuring Plan must be to eliminate, reduce or prevent, or mitigate the effect of such financial difficulties.

Prior to the Restructuring Plan, the UK Scheme has been used for decades by debtors in both the UK and elsewhere to restructure their debts outside of formal insolvency proceedings. The UK Scheme is a court process pursuant to which a company proposes a compromise or arrangement with its creditors and/or shareholders, or any class of them.

Provided that the necessary majorities of creditors or shareholders in each (and every) affected class voted in favour, a successful UK Scheme could bind dissenting minorities within individual classes. However, one of the limitations of a UK Scheme was its inability for entire dissenting classes to be bound by the vote of other classes, which is referred to as a 'cross-class cram down'.

The Restructuring Plan has addressed this gap in the UK's restructuring tool kit by enabling cross-class cram-down of dissenting junior classes (or even cross-class 'cram-up' of dissenting senior classes). Given the serious impact that such an arrangement may have on entire classes of stakeholders (as well as individual dissenting stakeholders within a particular class), the Restructuring Plan provides for certain protections as follows:

- Like a UK Scheme, a Restructuring Plan is also a court process, whereby
  - an initial court hearing is held to determine class composition and convene meetings of the creditors and/or shareholders which will be subject to the Restructuring Plan; and
  - following the relevant class meetings, there is a second court hearing to sanction the Restructuring Plan (where the court has a discretion to sanction the plan after considering, amongst other

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matters, whether all procedural formalities were complied with and whether the Restructuring Plan is otherwise fair).

- If not all classes have approved the Restructuring Plan at the relevant meetings, it is open to the court to sanction the Restructuring Plan (thereby 'cramming down' the dissenting classes) if:
  - none of the members of a dissenting class would be any worse off than they would be in the event of the 'relevant alternative' (see below); and
  - the Restructuring Plan has been agreed by at least 75% in value of a class of creditors or shareholders, present and voting either in person or by proxy, who would receive a payment, or have a 'genuine economic interest' (see below) in the company, in the event of the relevant alternative.

There is no numerosity test in the voting procedure for a Restructuring Plan, unlike in a UK Scheme (where a majority in number of voting creditors of each class had also to approve).

Notwithstanding the above protections, should a particular class of creditors or shareholders have no 'genuine economic interest' (see below) in the company, they may potentially be excluded from voting in the Restructuring Plan but still be bound by it.

The 'relevant alternative' referred to above is whatever the court considers would be most likely to occur in relation to the company if the Restructuring Plan was not sanctioned. For example, this may be the sale of the business as a going concern in a pre-packaged administration sale, or alternatively a liquidation sale of the business either of which may result in significantly lower returns for all stakeholders. The choice of one relevant alternative over another (resulting in differing valuations of the company and different outcomes for particular stakeholders in relation to being 'worse off' in the relevant alternative) could lead to challenges by dissenting stakeholders who would otherwise be crammed-down in the Restructuring Plan.

Similarly, whether a class of stakeholders has a 'genuine economic interest' (which is not defined in the CIG Act) in the company will likely depend on whether that class is 'in-the-money' or 'out-of-the-money' and will be heavily dependent on valuations of the company and the basis on which those valuations are determined.

In any contested Restructuring Plan, the choice of relevant alternative may be heavily reliant on valuation evidence and may be an area for challenge by a dissenting creditor or shareholder.

Like a UK Scheme, a Restructuring Plan is not restricted to companies which are incorporated in the UK or have their centre of main interests in the UK. In most cases, a 'sufficient connection' to England will be enough for an English court to have jurisdiction to sanction a Restructuring Plan, which may generally be demonstrated by having English law as the governing law of the relevant debt documents that are subject to the compromise or arrangement under the Restructuring Plan. It should also be possible to demonstrate a 'sufficient connection' to England if the company proposing the Restructuring Plan has its centre of main interests in England.

Ban on *Ipso Facto* Clauses (and the Introduction of Related Elements) – Protecting the Supply of Goods and Services

Ipso facto clauses are provisions of contracts which entitle a party to terminate or vary their terms upon the occurrence of an insolvency event relating to the other party. Such clauses may also operate automatically, without any party needing to make an election.

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The rationale behind this batch of changes is to prevent suppliers threatening a company in financial difficulty from requiring cash up front or that their overdue amounts are paid as a condition to continued supply once the company enters into an insolvency procedure, which may be detrimental for the rescue of that company as a going concern.

Prior to the CIG Act, the operation of such clauses under English law (unlike *e.g.,* U.S. law) was generally unrestricted unless they involved essential services (such as certain utilities and communication services in limited circumstances) (the Essential Services Ban) or offended the rule against anti-deprivation (whereby the creditors of an insolvent company are deprived of an asset). The CIG Act has, however, introduced a wide-ranging ban on the operation of *ipso facto* clauses which apply to all contracts for the supply of goods and services (with some notable carve-outs, discussed below).

Pursuant to the CIG Act, any provision in a contract for the supply of goods or services to a company will cease to have effect when a company becomes subject to a 'relevant insolvency procedure' (see below) if and to the extent that, under the provision:

- the contract or the supply would terminate or 'any other thing' would take place (*i.e.*, automatically); or
- the supplier would be entitled to terminate or to do 'any other thing' (*i.e.*, at the supplier's election),

in each case because the company became subject to a relevant insolvency procedure. The reference to 'any other thing' in both limbs is broad and may prevent the operation of contractual provisions which might otherwise be triggered such as price rises or shorter payment terms.

The list of 'relevant insolvency procedures' referred to above is as follows:

- a moratorium comes into force for the company (see below);
- the company enters administration;
- an administrative receiver of the company is appointed;
- a company voluntary arrangement takes effect in relation to the company;
- the company goes into liquidation or a provisional liquidator is appointed; and
- in relation to a Restructuring Plan (see above), an order is made by the court summoning meetings relating to that Restructuring Plan.

A UK Scheme is not included in the above list of relevant insolvency procedures.

In addition to being prevented from terminating supply when a company becomes subject to a relevant insolvency procedure, the supplier is also prevented from terminating supply because of an event occurring prior to the start of the insolvency period (such as non-payment) such that the entitlement to terminate arose before the start of that period but was not exercised at that point. The supplier cannot use that event as a right to terminate during the relevant insolvency procedure. The supplier can however terminate on non-insolvency grounds for other breaches which occur following the commencement of the relevant insolvency procedure (*e.g.*, non-payment).

Furthermore, a supplier cannot make it a condition of continued supply during the insolvency period that any outstanding charges are paid in respect of a supply made to the company before the relevant insolvency procedure.

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Whilst the above summary of the ban on *ipso facto* clauses may indicate a wide application, there are a number of significant exceptions, as follows:

- if the supplier or the company in the relevant insolvency procedure is an insurance company, a bank, or certain other financial institutions, the ban will not apply to the relevant supply contract;
- if the supply contract itself involves certain financial services (including, for example, lending, other financial services, and derivatives), the ban will not apply to it. Combined with the exception referred to immediately above, this will likely limit the application of the ban on *ipso facto* clauses to contracts involving trade creditors rather than many financial creditors;
- there is a temporary exclusion for certain small suppliers, which expires on 30 September 2020 (a small supplier will need to satisfy at least two of the following conditions: (i) turnover of £10.2 million or less, (ii) aggregate assets of £5.1 million or less, and (iii) no more than 50 employees); and
- those contracts for the supply of essential services which would be covered by the Essential Services Ban and will continue to be governed by that existing regime.

If a supplier wishes to terminate a supply contract and one of the above exceptions does not apply, it may request the company's consent (or, if applicable, the consent of the relevant insolvency officeholder). Failing that, the supplier may also apply to the court for permission to terminate on the grounds of 'hardship', which is undefined in the CIG Act but which may be a relatively high hurdle to satisfy.

In some instances, parties will have to carefully consider whether a relevant contract constitutes a supply of goods or services, for example leases under which services are also provided or IP contracts.

In many cases, insolvency related termination events will be exercisable not only on the commencement of the relevant insolvency procedure but also on the 'taking of any step' with a view to the commencement of that procedure. Termination on the basis of preliminary action prior to actual commencement is not banned (provided that the termination itself actually occurs prior to the commencement of the relevant insolvency procedure). It is therefore possible that the introduction of the ban may encourage some suppliers to terminate sooner that than they would otherwise have done because of that.

Finally, the ban on *ipso facto* clauses will not impact the ability of the company itself or its administrator to terminate a contract should there be a right to do so, or impact the right of a liquidator to terminate an unprofitable contract unilaterally by disclaimer as an onerous contract. In the case of an administration or liquidation, this ability to terminate may be important to prevent the creation of expenses of the administration or liquidation (which benefit from priority status in an administration or liquidation (as applicable) and which rank ahead of the administrator or liquidator's own remuneration).

New, Free-Standing Moratorium for Companies in Financial Difficulties

A moratorium is a legal ban which restricts certain creditor enforcement action for a period of time to allow a company in financial difficulty the chance to implement a restructuring. Prior to the CIG Act, this was only available in the UK to (i) companies in administration, protecting the company against creditor action except with the consent of the administrator or by making an application to court; and (ii) for certain small companies who had made a proposal for a company voluntary arrangement.

The new moratorium under the CIG Act (the Moratorium) is available for all companies except for insurance companies, banks, and certain other financial institutions and (after 30 September 2020) companies which were previously subject to a Moratorium or certain formal insolvency procedures in the

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last 12 months. Foreign companies are also eligible provided they can demonstrate a sufficient connection to England.

The Moratorium will last for an initial 20 business day period, but it may be extended without creditors' consent for a further 20 business days. With creditors' consent, the moratorium may be extended for a total period up to 12 months or, upon an application to the court, the Moratorium may be extended beyond 12 months. However, the Moratorium will automatically end if the company enters into a UK Scheme, a Restructuring Plan, or certain other insolvency procedures in the UK.

If the company is not subject to an outstanding winding up petition, the directors of a company may obtain a Moratorium by filing certain documents with the court, including:

- a statement by the directors that, in their view, the company is, or is likely to become, unable to pay its debts; and
- a statement from the proposed 'monitor' (being an insolvency practitioner whose role will be to oversee the Moratorium) that:
  - he/she is qualified to act as monitor and the company is eligible for a Moratorium; and
  - in the monitor's view, it is likely that the Moratorium will result in the rescue of the company as a going concern or (for such statements made until 30 September 2020) would do so if it were not for any worsening of the financial position of the company for reasons relating to COVID-19.

If the company is subject to an outstanding winding up petition, or is a foreign company, it will need to make an application to the court for a Moratorium (which must be accompanied by the same documents referred to above).

During the Moratorium, the company does not need to pay any pre-Moratorium debts (or debts which fall due during the Moratorium in respect of obligations incurred prior to the Moratorium), which is referred to as a 'payment holiday'. For example, where rent for a period ending prior to the Moratorium is paid in arrears (i.e., the payment date occurs after the commencement of the Moratorium), this would be a pre-Moratorium debt subject to the payment holiday.

However, the following pre-Moratorium debts are excluded from the payment holiday, which means they must continue to be paid during the Moratorium:

- debts or other liabilities arising under a contract/instrument involving financial services, including bank lending and other financial transactions (this is a significant exception to the payment holiday);
- goods and services supplied during the Moratorium;
- rent in relation to the Moratorium period;
- employee payments including wages, salary, and redundancy payments; and
- fees and expenses that are payable to the monitor.

During the Moratorium, creditors may not take steps to commence formal insolvency proceedings, enforce security or commence certain other legal proceedings against the company (unless an exception applies). Landlords are also restricted from forfeiting a lease for unpaid rent falling due prior to the Moratorium period without permission of the court.

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During the Moratorium, the directors remain in control of the business as well as the restructuring process, albeit with the close supervision of the monitor (whose primarily role is to ensure the interests of the creditors are protected).

The CIG Act aims to protect borrowers and struggling businesses, however, it is not clear whether it will protect or assist UK creditors who are also struggling as a result of COVID-19. For example, the position of a landlord owed rent by a tenant is materially disadvantaged by the CIG Act. Whilst understandably creditors may be worried that the Moratorium process may be subject to abuse, there are safeguards, for example:

- any pre-Moratorium debts which were not subject to a payment holiday (such as rent in relation to the Moratorium period) will enjoy elevated priority status in any subsequent liquidation or administration of the company which commences within 12 weeks following the end of the moratorium; and
- the insolvency practitioner that acts as the monitor has a degree of control over which debts can be paid and which property can be sold. Creditors can also apply to court if they disagree with the decisions of the monitor.

Temporary Relaxation of Wrongful Trading Laws

Where a company enters into an insolvent administration or an insolvent liquidation, an administrator or liquidator may apply to court for a director to be personally liable to contribute to a company's assets if, prior to the administration or liquidation, that director:

- knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation or administration; and
- failed to take every step with a view to minimising the potential loss to the company's creditors as the director should have done.

The court has wide powers to determine the level of compensation payable by the director, but ordinarily a director could be personally liable to contribute towards any increase in the net deficiency in the amount available to pay creditors during the period of wrongful trading.

The CIG Act introduces a temporary relaxation of the laws in relation to wrongful trading during the period 1 March 2020 to 30 September 2020 (the Relevant Period). Pursuant to the CIG Act, the court is required to assume that a director is not responsible for any worsening of the financial position of the company or its creditors during the Relevant Period.

This reduces, but does not remove, the risk of personal liability for directors in relation to actions taken during the Relevant Period and is intended to give directors additional comfort to continue trading.

In theory, it is possible for directors of companies with no reasonable prospect of avoiding an insolvent administration or an insolvent liquidation to continue trading through the Relevant Period whilst the financial position of the company and its creditors gets worse, without those directors incurring additional personal liability. However, directors should be aware that when the Relevant Period comes to an end, they may face immediate risk (assuming that there is no reasonable prospect of the company surviving at that point). Furthermore, the CIG Act has not changed other areas of liability which could be relevant to a director’s conduct during the Relevant Period, including:

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- fraudulent trading;
- transactions defrauding creditors;
- misfeasance; and
- the general duty of directors to act in the way that would be most likely to promote the success of the company for the benefit of its members or, depending on the circumstances, in the best interests of the company's creditors.

Therefore, whilst administrators and liquidators may be less able to pursue directors for wrongful trading during the Relevant Period, they can pursue directors for these other areas of liability if the directors conduct during the Relevant Period would result in an actionable breach.

The CIG Act also does not amend or relax the director's disqualification legislation in the UK during COVID-19. In connection disqualification proceedings, a court may make 'compensation orders' against directors. It may be anticipated, however, that courts would not impose compensation orders (which are at their discretion) where liability for wrongful trading would be precluded because of the CIG Act.

As is the case with some of the other changes introduced by the CIG Act, the relaxation of the wrongful trading laws does not apply to directors of certain types of companies, including insurance companies, banks, and certain other financial institutions.

Temporary Restriction on Statutory Demands and Winding Up Petitions

Pursuant to section 122(1)(f) of the Insolvency Act 1986 (the Insolvency Act), a company may be wound up by the court if it is unable to pay its debts. Pursuant to section 123(1)(a) of the Insolvency Act, a company is deemed unable to pay its debts if, among other reasons, a creditor, to whom the company is indebted in a sum exceeding £750, serves a statutory demand requiring the company to repay the debt and the company has failed to repay that debt for three weeks thereafter. Under section 124 of the Insolvency Act, the creditor can then apply to court to wind up the company, potentially forcing it into liquidation.

The CIG Act limits the ability to commence winding-up proceedings where COVID-19 has had a financial effect on the company. In the event that COVID-19 has not had a financial effect on the company (or it would be in financial distress regardless of the effects of COVID-19), the company may not benefit from this temporary change to the law.

Briefly:

- Creditors may not present a winding-up petition based on an unpaid statutory demand or an unpaid judgement debt in the 'relevant period' (between 1 March 2020 and 30 September 2020) unless the creditor has reasonable grounds for believing that:
  - COVID-19 has not had a financial effect on the company; or
  - the company's inability to satisfy the statutory demand or judgement debt was not caused by COVID-19.
- Similarly, creditors cannot present a winding-up petition based on the insolvency of a company (i.e., that the company is cash-flow insolvent (being unable to pay its debts as they fall due) or is balance sheet insolvent (where the value of the company's assets is less than the amount of its liabilities, taking

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into account its contingent and prospective liabilities)) unless the creditor has reasonable grounds for believing that:

  - COVID-19 has not had a financial effect on the company; or
  - the company's insolvency would have existed even if COVID-19 had not had a financial effect on the company.

- Furthermore, the CIG Act also provides that creditors cannot present winding-up petitions based on a statutory demand served during the period commencing on 1 March 2020 and ending with 30 September 2020 (regardless of the financial effect of COVID-19).
- The above restrictions apply to winding-up petitions presented on or after 27 April 2020 (i.e., the change in law has retrospective effect) and, if applicable, the court will only wind-up the company based on such petitions if it is similarly satisfied in relation to the effect of COVID-19. Courts are also empowered to reverse winding-up orders granted on or after 27 April 2020 but prior to the commencement of the CIG Act if the orders would not have been made if the law had been in force and the above tests had been applied.
- The relaxation of the provisions relating to statutory demands and winding up petitions apply to all companies. There are no exclusions for certain types of companies as is the case with other changes to the law under the CIG Act.
- These changes to the law do not interfere with default provisions in loan documents. For example, the presentation of a winding-up petition could still trigger a default if the grace period in a loan document expires before the court has rejected the petition (assuming it would). Creditors considering presenting petitions should also be mindful of the considerable processing pressures on the courts given the difficulties in staffing hearings during the COVID-19 crises. The petitions may also require evidence to be adduced (for example, as to whether or not COVID-19 has had a financial effect of the company and how great the effect was) which can take time and might well be open to debate.

So where does that leave creditors? On what bases could creditors still issue a statutory demand or a petition to wind-up a company? The following remain permissible:

- Whilst statutory demands served during 1 March 2020 and 30 September 2020 may not be used as the basis of a winding-up petition, creditors can still sue for their debt and, assuming they receive judgement in their favour, may then use an unsatisfied judgment debt as a basis for a winding up petition. However, the petitioning creditor will have to demonstrate that COVID-19 has not had a financial effect on the company or the failure to pay the amount would have arisen even if COVID-19 had not had a financial effect on the company. This may result in additional time and cost for the creditor in the recovery of the relevant amount from the company.
- The presentation of winding-up petitions based on either (i) an unpaid statutory demand served on the company <u>prior to</u> 1 March 2020 <u>or after</u> 30 September 2020 or (ii) an unpaid judgement debt, in each case are permitted where the petitioning creditor can demonstrate that COVID-19 has not had a financial effect on the company or the failure to pay the amount would have arisen even if COVID-19 had not had a financial effect on the company.
- The presentation of winding-up petitions based on the insolvency of the company are permitted, again where the petitioning creditor can demonstrate that COVID-19 has not had a financial effect on the company or the failure to pay the amount would have arisen even if COVID-19 had not had a financial effect on the company.

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