

UK Insolvency Reforms and Derivatives:

Impact of the prohibition on the operation of termination and certain other provisions

The UK Corporate Insolvency and Governance Bill (**CIGB**) was introduced to Parliament on 20 May 2020 and proposes to support the real economy by introducing certain reforms to give companies increased flexibility to reduce their chances of insolvency during stressed market conditions resulting from the Covid-19 pandemic and beyond.

This bulletin focuses on **the prohibition on the operation of certain termination and other provisions (so called *ipso facto* clauses) and the treatment of those provisions in the context of the derivatives markets** and is not a full and detailed analysis of the legislation (which may still be subject to change).

CIGB proposes to introduce a number of insolvency measures, including a moratorium to allow companies breathing space from creditor action to explore options for rescue. Whilst the impact of the company moratorium on the enforceability of security financial collateral arrangements entered into in connection with derivatives transactions is a relevant consideration, we note that these arrangements are able to benefit from an exemption. For a discussion of the wider proposals (including the company moratorium), please refer to our more comprehensive bulletin *on CIGB* (<https://www.allenoverly.com/en-gb/global/news-and-insights/publications/the-corporate-insolvency-and-governance-bill-the-most-significant-insolvency-reforms-in-the-uk-for-a-generation>).

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Key messages for derivatives markets participants:

- A **prohibition on the operation of termination and certain other provisions** (so called *ipso facto* clauses) in certain contracts for the supply of goods and services is proposed to the extent:
 - (i) those provisions are triggered by a company becoming subject to a **relevant UK insolvency procedure**; or
 - (ii) a right to terminate arises prior to the commencement of a relevant UK insolvency procedure for any reason and an entity wants to exercise that right **during the relevant “insolvency period”**
- The prohibition is proposed to apply to companies which become subject to a relevant UK insolvency procedure on or after the day following Royal Assent is received which, given the intention to fast-track the reforms, is likely to be at the **end of June or beginning of July 2020**
- Termination clauses are typically included in many derivatives contracts where they are a **key component of the close-out netting process** and a **pre-condition to the enforcement of financial collateral arrangements**
- **A number of appropriate carve-outs have been proposed for derivatives markets counterparties and contracts** with the aim of ensuring that close-out netting, set-off and financial collateral arrangements related to those contracts will remain enforceable upon the insolvency of a counterparty
- **We do not expect a significant impact** on the ability of derivatives counterparties to exercise close-out rights or enforce financial collateral arrangements as a result of the prohibition

CIGB proposes to introduce a prohibition on the operation of termination and certain other clauses in contracts for the supply of goods and services

There will be a prohibition on the termination of any contract for the supply of goods and services to a company, or 'doing any other thing' in respect of that contract¹, where a company becomes subject to an "**insolvency procedure**". An "insolvency procedure" includes where:

- (a) a **moratorium** comes into force for the company under the new moratorium procedure;
- (b) the company enters **administration**;
- (c) an **administrative receiver** of the company is appointed;
- (d) a **company voluntary arrangement** takes effect in relation to the company;
- (e) the company goes into **liquidation** or a **provisional liquidator** is appointed; or
- (f) a convening order is made by the court in respect of a **restructuring plan**.

The prohibition does not apply to **schemes of arrangement** under Part 26 of the Companies Act 2006.

Termination and "doing any other thing" will still be permitted on any other basis. However, if the supplier had a right to terminate the contract or supply before the company became subject to an insolvency procedure but did not exercise that right, the supplier may not terminate for that reason during the relevant "**insolvency period**". Broadly, the relevant "insolvency period" is the period beginning when the company becomes subject to the relevant insolvency procedure and ending when the relevant insolvency procedure comes to an end or ceases to have effect.

Notwithstanding the above, the supplier can terminate the contract with the consent of the relevant office holder (i.e. the administrator, administrative receiver, liquidator or provisional liquidator) or the company or if a court grants permission for termination.

Certain derivatives contracts may fall within scope of the prohibition. However, as discussed further below, a **number of relevant exemptions are available for derivatives markets counterparties and contracts**.

¹ We note that the prohibition is actually wider than just 'termination'— it also extends to any insolvency procedure being used as a 'trigger' event for 'any other thing' taking place or entitling the supplier 'to do any other thing'. The 'any other thing' language is extremely broad. It means that any other contractual

rights triggered by or exercisable upon the commencement of an 'insolvency procedure' permanently cease to have effect except with company or office-holder consent, or a hardship order.

It is important to note that the prohibition is geared towards preventing company suppliers endangering efforts to rescue a business by ceasing (or threatening to cease) supplying goods and services to a company in financial difficulty (subject to certain safeguards² and a temporary exemption for small company suppliers).

The prohibition is **not intended to prevent the normal functioning of the derivatives markets** by prohibiting the use of termination provisions in derivatives contracts upon the insolvency or financial difficulty of a counterparty.

Derivatives contracts include termination provisions which are a key component of the close-out netting mechanism and essential to the proper functioning of derivatives markets

The ability to terminate derivative transactions under an ISDA Master Agreement or other netting agreement upon the insolvency of a counterparty is a key component of the close-out netting process: a fundamental part of the operation of derivative contracts. In fact, close-out netting is the principal device for reducing credit risk in the derivatives markets by ensuring that every counterparty has a net, as opposed to a gross, credit exposure to every other counterparty (with financial collateral securing the remaining net credit exposure once close-out netting has been applied).

Globally, regulators have widely acknowledged close-out netting as key to minimising credit and systemic risk and, to incentivise its use, require a reduced amount of regulatory capital to be held by banks and other institutions against

derivatives positions provided there is sufficient legal certainty as to enforceability.

Certain special insolvency regimes for financial services firms and market infrastructure providers which include protections for close-out netting, set-off and financial collateral arrangements are already in place to cater for the particular nature of these entities and the financial services markets and it is not intended that these existing special insolvency regimes are impacted by the proposed prohibition.

As a result, certain exemptions are proposed for certain financial services markets counterparties and contracts, including derivatives.³

² To ensure continued supplies are paid for and that if a supplier considers that the obligation to continue to supply is causing the supplier hardship then they will be able to apply to court for permission for the termination of the contract.

³ This is in addition to the safeguards and temporary exemption for small company suppliers mentioned above.

Excluded Entities: A number of financial services markets counterparties are intended to be excluded from the prohibition meaning that relevant termination and relevant other provisions in their contracts will remain enforceable

An exclusion is available for certain entities. Broadly, this includes⁴:

- **UK insurers;**
- **UK banks;**
- **UK electronic money institutions;**
- **Certain UK investment banks and investment firms;**
- **Certain UK payment institutions;**
- **Certain UK operators of payment systems and infrastructure providers;**
- **Recognised investment exchanges, recognised clearing houses and recognised central securities depositories;**
- **Certain UK securitisation companies;**
- **Overseas entities whose functions correspond with the above; and**
- **UK building societies, friendly societies and credit unions.**

These entities may benefit from an exemption when:

- (i) they themselves are in distress; or
- (ii) when they are a supplier to a counterparty in distress (irrespective of whether the counterparty is also an excluded entity).

However, if an entity cannot benefit from this exemption, this does not preclude relief by virtue of the relevant contract or arrangement benefiting from an exemption – *see further below*.

⁴ For full details please refer to Annex 1.

Excluded Contracts: A number of financial services contracts (including derivatives) are intended to be excluded from the prohibition meaning that relevant termination and relevant other provisions in those contracts will remain enforceable

The exclusion will apply to all excluded contracts irrespective of whether either of the counterparties may themselves benefit from an exemption. Broadly, this includes⁵:

- **Contracts for the provision of financial services** consisting of (i) lending (including the factoring and financing of commercial transactions), (ii) financial leasing, or (iii) providing guarantees or commitments;
- **“Financial contracts”** as defined in Article 2(1)(100) of the BRRD⁶ – although (unlike the BRRD) note that a “commodity” is expressly stated to include certain emissions units and allowances and renewable energy certificates;
- **“Securities financing transactions”** - namely, (i) repurchase transactions, (ii) securities or commodities lending and securities or commodities borrowing transactions, (iii) buy-sell back transactions or sell-buy back transactions and (iv) margin lending

transactions, each as defined in the SFTR⁷ - although references to “commodities” have been expanded to include certain emissions units and allowances and renewable energy certificates;

- **“Derivatives”** as defined in Article 2(5) of EMIR⁸;
- Certain **spot commodity contracts** and **spot FX contracts**;
- Certain **capital market arrangements**; and
- Certain **contracts forming part of a public-private partnership**.

Additional exclusions are available for certain financial arrangements including **set-off and netting arrangements** and **financial collateral arrangements**.⁹ Close-out netting, set-off and financial collateral arrangements entered into in the context of derivatives transactions are, therefore, intended to remain enforceable notwithstanding the prohibition.

⁵ For full details please refer to Annex 2.

⁶ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms.

⁷ Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012.

⁸ Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

⁹ For full details please refer to Annex 2.

The prohibition is, at least in its current form, not expected to have a significant impact on the derivatives markets

In line with the legislative intent, the expectation is that, the prohibition will not materially affect the functioning of the derivatives markets as **relevant close-out netting, set-off and financial collateral arrangements are intended to remain enforceable.**

Whilst this bulletin looks to address the likely immediate concerns of derivatives markets participants, the legislation is long and complex and we expect that market participants may have a number of questions relating to the scope of the prohibition and related exclusions as they work through the impact of these key reforms on their business. Please do get in touch with one of the contacts below or your usual Allen & Overy contact if we can help you work through this analysis.

Contacts



Richard Tredgett

Partner

Tel +44 20 3088 2467
richard.tredgett@allenoverly.com



Guy Antrobus

Partner

Tel +44 203 088 2674
guy.antrobus@allenoverly.com



Jennifer Marshall

Partner

Tel +44 20 3088 4743
jennifer.marshall@allenoverly.com



Ben Berry

Senior Associate

Tel +44 203 088 2726
ben.berry@allenoverly.com



Emma Lancelott

Senior PSL

Tel +44 20 3088 2982
emma.lancelott@allenoverly.com



Nicola Ferguson

Senior PSL

Tel +44 20 3088 4073
nicola.ferguson@allenoverly.com

Annex 1 – Excluded Entities

Part 2 (Persons involved in Financial Services) of Schedule 12 (Protection of Supplies of Goods and Services) of CIGB amends the Insolvency Act 1986 to include a new Schedule 4ZZA (Protection of Supplies under Section 233B: Exclusions) as follows:

“Introductory

2. Section 233B does not apply in relation to a contract for the supply of goods or services to a company (“**the company**”) where any of paragraphs 3 to 11 applies.

Insurers

3. (1) This paragraph applies where either the company or the supplier:

- carries on the regulated activity of effecting or carrying out contracts of insurance, and
- is not an exempt person in relation to that activity.

(2) In this paragraph:

- “**exempt person**”, in relation to a regulated activity, has the meaning given by section 417 of the Financial Services and Markets Act 2000;
- “**regulated activity**” has the meaning given by section 22 of that Act, taken with Schedule 2 to that Act and any order under that section.

Banks

4. (1) This paragraph applies where either the company or the supplier:

- has permission under Part 4A of the Financial Services and Markets Act 2000 to carry on the regulated activity of accepting deposits,
- is a banking group company within the meaning of Part 1 of the Banking Act 2009 (see section 81D of that Act), or
- has a liability in respect of a deposit which it accepted in accordance with the Banking Act 1979 or the Banking Act 1987.

(2) In sub-paragraph (1)(a) “**regulated activity**” has the meaning given by section 22 of the Financial Services and Markets Act 2000, taken with Schedule 2 to that Act and any order under that section.

- Electronic money institutions** 5. This paragraph applies where either the company or the supplier is an electronic money institution within the meaning of the Electronic Money Regulations 2011 (S.I. 2011/99) (see regulation 2 of those Regulations).
- Investment banks and investment firms** 6. (1) This paragraph applies where either the company or the supplier is an investment bank or an investment firm.
(2) In this paragraph:
“investment bank” means a company or other entity that has permission under Part 4A of the Financial Services and Markets Act 2000 to carry on the regulated activity of:
- safeguarding and administering investments,
 - managing an AIF or a UCITS,
 - acting as trustee or depository of an AIF or a UCITS,
 - dealing in investments as principal, or
 - dealing in investments as agent;
- “investment firm”** has the same meaning as in the Banking Act 2009 (see section 258A of that Act), disregarding any order made under section 258A(2)(b) of that Act;
- “regulated activity”** has the meaning given by section 22 of the Financial Services and Markets Act 2000, taken with Schedule 2 to that Act and any order under that section.
- Payment institutions** 7. This paragraph applies where either the company or the supplier is an authorised payment institution, small payment institution or a registered account information service provider within the meaning of the Payment Services Regulations 2017 (S.I. 2017/752) (see regulation 2 of those Regulations).
- Operators of payment systems, infrastructure providers etc** 8. This paragraph applies where either the company or the supplier is:
- the operator of a payment system or an infrastructure provider within the meaning of Part 5 of the Financial Services (Banking Reform) Act 2013 (see section 42 of that Act), or
 - an infrastructure company within the meaning of Part 6 of that Act (see section 112 of that Act).

Recognised investment exchanges etc

9. This paragraph applies where either the company or the supplier is a recognised investment exchange, a recognised clearing house or a recognised CSD within the meaning of the Financial Services and Markets Act 2000 (see section 285 of that Act).

Securitisation companies

10. This paragraph applies where either the company or the supplier is a securitisation company within the meaning of the Taxation of Securitisation Companies Regulations 2006 (S.I. 2006/3296) (see regulation 4 of those Regulations).

Overseas activities

11. This paragraph applies where either the company or the supplier does or has done anything outside the United Kingdom which, if done in the United Kingdom, would cause any of the preceding paragraphs of this Part of this Schedule to apply”

Part 2 (Consequential Amendments) of Schedule 12 (Protection of Supplies of Goods and Services) of CIGB makes additional amendments. Certain extracts are as follows:

“Amendments to Acts

2. In Schedule 15 to the Building Societies Act 1986 (application of companies winding up legislation to building societies), after paragraph 32 insert:

“Protection of supplies - 32A Section 233B of the Act (protection of supplies of goods and services) does not apply.”

3. In Schedule 15A to the Building Societies Act 1986 (application of other companies insolvency legislation to building societies), after paragraph 27F insert:

“Protection of supplies - 27FA Section 233B of the Act (protection of supplies of goods and services) is omitted.”

4. In Schedule 10 to the Friendly Societies Act 1992 (application of companies winding up legislation to friendly societies), after paragraph 35 insert:

“Protection of supplies – 35A Section 233B of the Act (protection of supplies of goods and services) does not apply.”

Amendments to subordinate legislation

8. In Schedule 3 to the Co-operative and Community Benefit Societies and Credit Unions (Arrangements, Reconstructions and Administration) Order 2014 (S.I. 2014/229), after paragraph 3 insert:

“3A Section 233B (protection of supplies of goods and services) does not apply in relation to a registered society that is registered as a credit union.””

Annex 2 – Excluded Contracts

Part 3 (Contracts involving Financial Services) and Part 4 (Other exclusions) of Schedule 12 (Protection of Supplies of Goods and Services) of CIGB amends the Insolvency Act 1986 to include a new Schedule 4ZZA (Protection of Supplies under Section 233B: Exclusions) as follows:

Introductory

12. To the extent that anything to which any of paragraphs 13 to 18 applies is a contract for the supply of goods or services, section 233B does not apply in relation to it.

Financial contracts

13. (1) This paragraph applies to a financial contract.

(2) “Financial contract” means:

- a contract for the provision of financial services consisting of:
 - lending (including the factoring and financing of commercial transactions),
 - financial leasing, or
 - providing guarantees or commitments;
- a securities contract, including:
 - a contract for the purchase, sale or loan of a security or group or index of securities;
 - an option on a security or group or index of securities;
 - a repurchase or reverse repurchase transaction on any such security, group or index;
- a commodities contract, including:
 - a contract for the purchase, sale or loan of a commodity or group or index of commodities for future delivery;
 - an option on a commodity or group or index of commodities;
 - a repurchase or reverse repurchase transaction on any such commodity, group or index;

- a futures or forwards contract, including a contract (other than a commodities contract) for the purchase, sale or transfer of a commodity or property of any other description, service, right or interest for a specified price at a future date;
- a swap agreement, including:
 - a swap or option relating to interest rates, spot or other foreign exchange agreements, currency, an equity index or equity, a debt index or debt, commodity indexes or commodities, weather, emissions or inflation;
 - a total return, credit spread or credit swap;
 - any agreement or transaction similar to an agreement that is referred to in sub-paragraph (i) or (ii) and is the subject of recurrent dealing in the swaps or derivatives markets;
- an inter-bank borrowing agreement where the term of the borrowing is three months or less;
- a master agreement for any of the contracts or agreements referred to in paragraphs (a) to (f).

(3) For the purposes of this paragraph “commodities” includes:

- units recognised for compliance with the requirements of EU Directive 2003/87/EC establishing a scheme for greenhouse gas emission allowance trading,
- allowances under paragraph 5 of Schedule 2 to the Climate Change Act 2008 relating to a trading scheme dealt with under Part 1 of that Schedule (schemes limiting activities relating to emissions of greenhouse gas), and
- renewables obligation certificates issued:
 - by the Gas and Electricity Markets Authority under an order made under section 32B of the Electricity Act 1989, or
 - by the Northern Ireland Authority for Utility Regulation under the Energy (Northern Ireland) Order 2003 (S.I. 2003/419 (N.I. 6)) and pursuant to an order made under Articles 52 to 55F of that Order.

Securities financing transactions

14. (1) This paragraph applies to a securities financing transaction.

(2) “Securities financing transaction” has the meaning given by Article 3(11) of Regulation (EU) 2015/2365 on the transparency of securities financing transactions.

(3) But for the purposes of that Article as it applies for the purposes of this paragraph, references to “commodities” in that Regulation are to be taken as including the units, allowances and certificates referred to in paragraph 13(3)(a) to (c).

Derivatives	15. This paragraph applies to a derivative, within the meaning given by Article 2(5) of Regulation (EU) No. 648/2012.
Spot contracts	16. (1) This paragraph applies to a spot contract. (2) “Spot contract” has the meaning given by Article 7(2) or 10(2) of Commission Delegated Regulation of 25.4.2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.
Capital market arrangements	17. This paragraph applies to a capital market arrangement within the meaning given by paragraph 13(2) of Schedule ZA1.
Contracts forming part of a public-private partnership	18. This paragraph applies to a contract forming part of a public private partnership project within the meaning given by paragraph 16 of Schedule ZA1.
Financial markets and insolvency	19. Nothing in section 233B affects the operation of: <ul style="list-style-type: none">– Part 7 of the Companies Act 1989 (financial markets and insolvency),– the Financial Markets and Insolvency Regulations 1996 (S.I. 1996/1469),– the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (S.I. 1999/2979), or– the Financial Collateral Arrangements (No.2) Regulations 2003 (S.I. 2003/3226).
Set-off and netting	20. Nothing in section 233B affects any set-off or netting arrangements (within the meanings given by section 48(1)(c) and (d) of the Banking Act 2009).

