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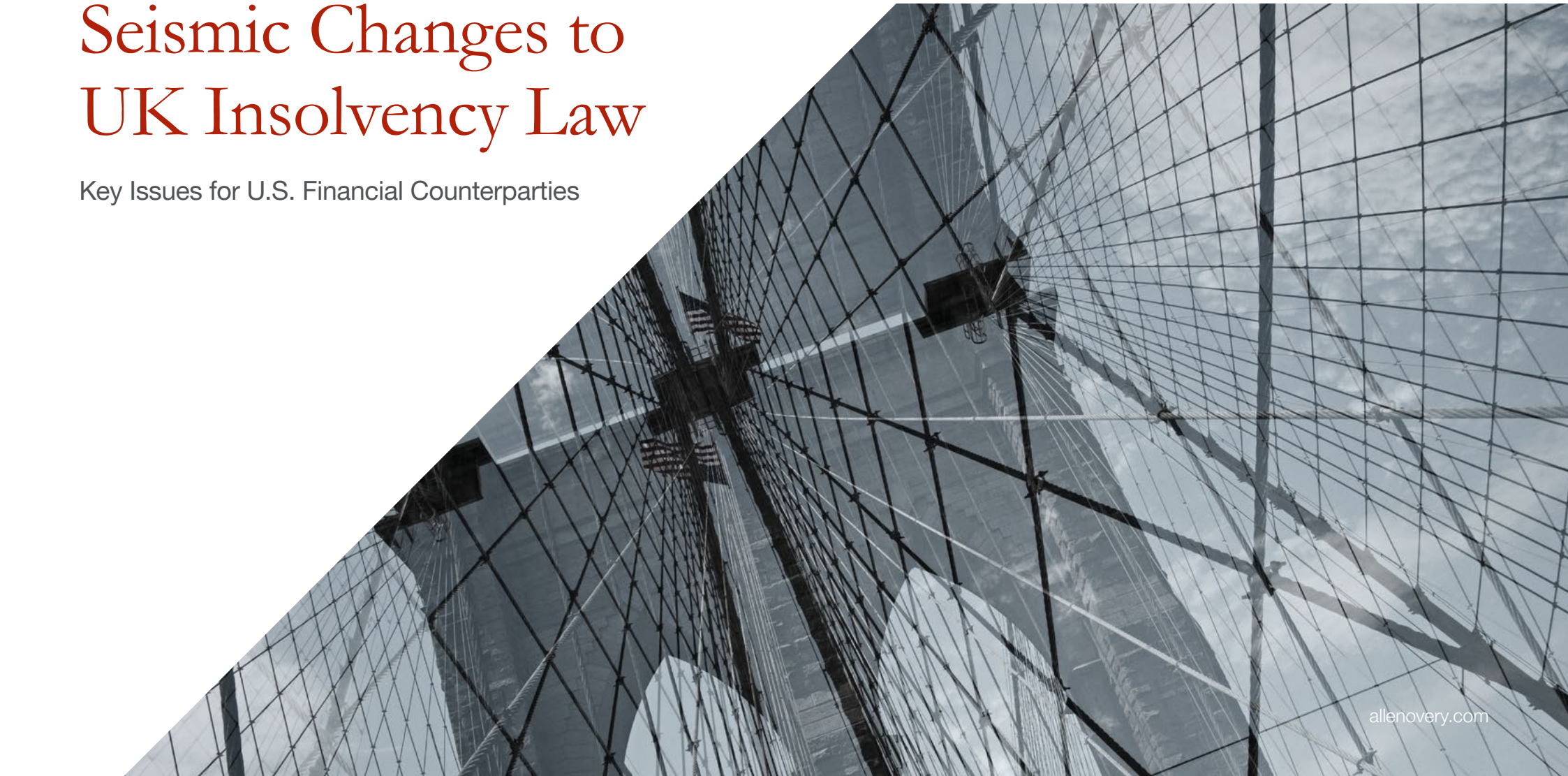
Seismic Changes to UK Insolvency Law

Key Issues for U.S. Financial Counterparties



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On 26 June 2020, the Corporate Insolvency and Governance Act 2020 (the UK Act) came into force and made the most significant changes to UK insolvency law for over a decade. The UK Act makes permanent and temporary amendments to UK insolvency and restructuring laws. It is the permanent measures that will be of most interest to U.S. financial counterparties.

While these permanent measures have been contemplated for some time, the financial crisis emerging in the wake of Covid-19 has precipitated their enactment. At their heart, these measures are intended to help companies maximize their chances of survival and protect jobs, all part of the rescue culture prevailing in Europe and the UK and will no doubt help to sustain the UK's position as one of the jurisdictions of choice for cross-border restructurings. (Our client bulletin describing the UK Act generally is available here).

The following new measures will be of particular interest to U.S. banks and other financial institutions that lend to or enter into financial transactions with UK counterparties:

1. a new standalone moratorium during which a "payment holiday" will apply to certain pre-moratorium debts and certain actions cannot be taken against a company without leave of court (the **Moratorium**);

2. a new restructuring plan, very similar to the existing UK scheme of arrangement but with the added benefit of cross-class cram down (similar to the U.S. Chapter 11 Plan) and, potentially, cross class cram up;

3. a prohibition on the enforcement of *ipso facto* clauses (provisions that terminate or modify the contract on the basis of the company's insolvency) in contracts for the supply of goods and services (the **Termination Clause Override**); and

4. exceptions from certain of the foregoing measures for the exercise of rights by certain categories of excluded entities and under certain excluded contracts (the **UK Safe Harbors**).

These standalone moratorium and *ipso facto* provisions are comparable to the automatic stay on the exercise of *ipso facto* clauses under the U.S. Bankruptcy Code (the **Bankruptcy Code**), as well as the safe harbors for qualified financial contracts thereunder*. However the UK safe harbors appear to be broader in several respects. While a more detailed comparison of the Bankruptcy Code and the UK Act is provided in the table below, we note the following key features of the UK Act that may be particularly relevant to U.S. financial counterparties to UK entities.

– First, the Moratorium and Termination Clause Override do not apply where the insolvent entity is an excluded entity type, which includes certain insurers, banks, payment institutions, infrastructure providers, and securitization companies, and overseas entities with similar functions.

– Secondly, even where the insolvent entity is not an excluded entity type, the Termination Clause Override does not apply where the counterparty (ie the supplier) is a bank, insurer or other excluded entity type (including U.S. institutions that fall within the identified categories of excluded entity). Hence even if the insolvent entity goes into one of the specified types of insolvency proceedings that triggers the *ipso facto* provisions, an excluded entity counterparty would still be able to terminate its contract as a result of the commencement of those insolvency proceedings.

– Thirdly, even where neither the insolvent entity nor the counterparty is an excluded entity, there are protections for certain excluded types of financial contract (such as swaps, repos, loan agreements and bonds). The scope of safe harbored excluded contracts under the UK Act is broader than that under the Bankruptcy Code, and notably includes "capital market investments" such as secured and unsecured bonds. Such contracts are protected from the effects of the Termination Clause Override and, in the case of the Moratorium, are not subject to the payment holiday (although they will be stayed from pursuing self-help remedies). For example, if the counterparty has an excluded contract, it will be able to exercise a contractual termination right or set off right, but would be barred by the Moratorium from attaching assets, suing for any deficiency or enforcing security (except for financial collateral). Given that financial contracts (including loan agreements and bonds) are not subject to the payment holiday in the Moratorium, it may be that such counterparties would not need to take enforcement action in any event.

The UK Act replicates the various protections for close-out netting and other rights that are already available under bank resolution and insolvency legislation, including protections for the exercise of certain "set-off and netting arrangements" that are exempted from the scope of both the Moratorium and the Termination Clause Override.

While these features of the UK Act are intended to preserve counterparties' close-out netting rights under derivatives and other financial contracts, where U.S. financial institutions face UK counterparties that might be subject to UK insolvency proceedings (such as the Moratorium) they should review whether the UK Act affects the netting position for their transactions. This review would include determining whether the Moratorium and Termination Clause Override would be available in the first instance and, if so, whether the parties and/or transactions are of a type that would benefit from the UK Safe Harbors. Even if the netting position remains positive, institutions may need to procure updates to their existing netting opinions to reflect changes to the legal analysis (especially if the updated analysis would need to rely on the UK Safe Harbors).

Further, given that the UK Act was motivated by a desire to increase the options available to UK companies in financial distress, it may lead more parties to restructure through a formal process instead of through an out-of-court restructuring. This could increase the likelihood of a bankruptcy Event of Default or Credit Event being triggered. Parties will also more generally need to consider the possibility of a Moratorium and Termination Clause Override when evaluating counterparty risk, especially if the UK Safe Harbors would not apply and parties could therefore be left in a position where they cannot take legal action against, or terminate their contracts with, a UK counterparty in distress. In particular, the Termination Clause Override is a fairly significant change to UK insolvency law that goes beyond the existing anti-deprivation principle that has long applied in UK insolvency proceedings and introduces considerations similar to those under the *ipso facto* provisions of Bankruptcy Code.

*The Bankruptcy Code safe harbors generally permit an eligible counterparty to a qualified financial contract with a debtor to exercise termination, liquidation, acceleration, netting, and collateral enforcement rights under such contract notwithstanding any stay or prohibition on the enforcement of *ipso facto* clauses that might otherwise apply. Qualified financial contracts include certain "securities contracts," "commodity contracts," "forward contracts," "repurchase agreements," "swap agreements," and "master netting agreements."

Comparison of Bankruptcy Code Safe Harbors and the UK Safe Harbors

	Bankruptcy Code	UK Bill	Comment
Moratorium	Automatic stay of virtually all actions against the debtor or its property, wherever located. By default lasts for the duration of the bankruptcy case.	Moratorium against the enforcement of security (except financial collateral), the commencement of insolvency or other legal proceedings against a company and forfeiture of a lease. No stay on the exercise of contractual termination rights (unless *ipso facto* provisions apply) or self help remedies such as set-off. Lasts for an initial period of 20 business days, with an ability to extend for a further period of 20 business days without consent and with the possibility of further extensions of up to one year or more.	The UK Act Moratorium appears to be more limited than the Bankruptcy Code automatic stay in scope and, unless extended by consent or the court, will be more limited in duration. It is not yet clear when (and for how long) the court will grant an extension. It is possible that an extension will be granted for the purposes of putting together a compromise proceeding such as a company voluntary arrangement, scheme of arrangement or restructuring plan but this remains to be seen.
Termination Clause Override	Provisions in executory contracts or unexpired leases that permit the termination or modification of such agreements based upon (a) the financial condition of the debtor, (b) the commencement of a bankruptcy case, or (c) the appointment of a trustee in a bankruptcy case are generally not enforceable.	A supplier of goods and services may not terminate, vary, or exercise any right under a contract due to its counterparty entering into certain specified insolvency or restructuring procedures (and automatic termination rights triggered by the commencement of such proceedings are ineffective). Furthermore termination rights for grounds other than insolvency that are not exercised prior to the commencement of such insolvency proceedings are lost if not exercised before the commencement of such proceedings.	The UK Act prohibition on *ipso facto* clauses appears to be more limited than the Bankruptcy Code prohibition on *ipso facto* clauses insofar as the latter would also prevent the enforcement of clauses triggered by insolvency or financial condition (ie, not just clauses triggered by the formal commencement of insolvency or restructuring procedures.
UK Safe Harbors – Excluded Parties	Types of parties entitled to exercise safe harbored rights depend on the type of contract (eg, safe harbor for close-out of "securities contracts" is available to counterparty that is a "stockbroker," "financial institution," "financial participant," or "securities clearing agency," and safe harbor for close-out of "swap agreements" is available to counterparty that is a "swap participant" or "financial participant").	The Excluded Parties concept for the Moratorium and the Termination Clause Override operate somewhat differently: – For the Moratorium, the insolvent entity must be the Excluded Party (ie. certain types of Excluded Party are not eligible for the Moratorium) – For the Termination Clause Override, either the insolvent entity or the supplier can be an Excluded Party for the provisions not to apply. The UK Act generally excludes financial firms that have their own special insolvency or resolution regimes, including certain insurers, banks, investment banks and investment firms, electronic money institutions, payment institutions, operators of payment systems, infrastructure providers, etc., recognized investment exchanges, etc., securitization companies, and overseas entities with similar functions.	Whereas the Bankruptcy Code safe harbors are available to qualifying counterparties based on type of contract, the UK Safe Harbors (i) disapply the Moratorium and the Termination Clause Override altogether where the debtor is an excluded entity type and (ii) disapply the Termination Clause Override, but not the Moratorium, when the counterparty is an excluded entity type but the debtor is not.
UK Safe Harbors – Contracts Covered	Contracts that fall into definition of "securities contract," "commodity contract," "forward contract," "repurchase agreement," "swap agreement," or "master netting agreement."	Contracts that constitute "financial contracts," "securities financing transactions," "derivatives," "spot contracts," "capital market investments," "contracts forming part of a public-private partnership," and (in the case of the Moratorium) "market contracts", "qualifying collateral arrangements and qualifying property transfers", "contracts secured by certain charges", "default arrangements and transfer orders" and "contracts to accept and process card-based payment transactions." "Financial contracts" include certain "contracts for the provision of financial services consisting of lending, financial leasing or providing guarantees or commitments," "securities contracts," "commodity contracts," "futures or forwards contracts," "swap agreements," "inter-bank borrowing agreements," and "master agreements."	Whereas the Bankruptcy Code safe harbors are generally limited to derivatives and securities and commodities transactions, the UK Safe Harbors also apply to a broader scope of transactions including loan agreements and secured / unsecured bonds.
UK Safe Harbors – Protected Rights	Rights (i) to cause the liquidation, termination, or acceleration of one or more qualified financial contracts or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more qualified financial contracts and (ii) under security agreements or arrangements or other credit enhancements forming a part of or related to any qualified financial contract.	UK Safe Harbors apply to parties or contracts on a categorical basis and are not expressly limited to certain types of rights.	Whereas the Bankruptcy Code safe harbors only protect certain types of rights under qualified financial contracts, the UK Safe Harbors are not so limited and are categorical exemptions from the Moratorium and the Termination Clause Override.

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