Feature

KEY POINTS

- Due to the carve-out for financial contracts, a distressed company will not be able to prevent financial creditors from terminating or accelerating loans on the commencement of an insolvency procedure and so discussions should be had with such creditors before the insolvency procedure is commenced.
- It is unclear why the new regime should apply where a company is in liquidation.
- A system more akin to that included in s 365 of the US Bankruptcy Code could have facilitated a fairer system.

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UK Corporate Insolvency and Governance Act: effects on *ipso facto* clauses

This article provides a high-level overview of the UK's *ipso facto* regime prior to the changes made by the Corporate Insolvency and Governance Act 2020 (CIGA), the reforms to this regime under the new legislation and the practical effects of such reform, highlighting some potential issues with the new legislation where clarificatory guidance would be welcome.

Contracts for the supply of goods or services commonly contain a clause which permits a party to that contract to terminate solely on account of an insolvency event affecting the other party. These are known as *ipso facto* clauses and in the UK, prior to the Corporate Insolvency and Governance Act 2020 (CIGA) which came into force on 26 June 2020, they would generally be enforceable. This is out of step with many other countries, such as the US and the Netherlands. The CIGA prohibits reliance on such clauses, subject to certain exceptions, in order to assist distressed companies to continue as a going concern and to preserve value in the business for stakeholders.

The World Bank's Doing Business rankings, which provide objective measures of business regulations based on an assessment of whether the measures enhance business activity or constrain it, takes into account whether a country's insolvency framework allows the continuation of contracts supplying goods and services essential to a business. This indicates that, while the new measures shift from the traditional emphasis on freedom of contract, the focus on prioritising corporate rescue may be welcome to encourage business activity.

EXISTING *IPSO FACTO* REGIME: SS 233 AND 233A OF THE INSOLVENCY ACT 1986

As mentioned, *ipso facto* clauses are generally enforceable. There are, however, exceptions to this (even prior to the CIGA) under ss 233 and 233A of the Insolvency Act 1986 (the Act), which aims to assist with the rescue of an insolvent company as a going concern by trying to preserve a business's operational capabilities in the context of financial distress.

Section 233 has been in the Act for some time and seeks to preserve the supply of utilities such as gas, water and electricity. Before the introduction of s 233A of the Act, a supplier falling outside one of these limited categories was able to demand all existing debt be paid, increased payments or guarantees from office holders in exchange for continued performance under the contract. This created ransom situations and put such suppliers in a stronger position than other creditors and potentially undermined rescue efforts.

The effect of s 233A of the Act is that *ipso facto* clauses cease to have effect in contracts for the supply of "essential" goods and services. In addition to the utilities previously covered by s 233, the provisions were extended to cover certain IT services such as computer hardware and software or data storage and processing. Contracts for the supply of "essential" goods and services cannot be terminated when a company enters administration or when a company voluntary arrangement is approved; the restriction does not apply when a company enters any other insolvency procedure, for example liquidation. This is in line with the policy aim of s 233A of the Act; on a liquidation, the company is likely to cease to continue as a going concern. In practice, the effect of s 233A of the Act is that an insolvency office-holder can compel continued supply of "essential" services (so long as the company continues to pay for them) and suppliers are limited in their ability to impose onerous terms or conditions on a distressed company. Section 233A does not apply to "non-essential" contracts for goods and services.

THE CORPORATE INSOLVENCY AND GOVERNANCE ACT: S 233B OF THE ACT

The government has introduced a new *ipso facto* regime within the CIGA, amidst other changes to the existing insolvency legislation.

Although the CIGA includes some temporary measures designed to help UK companies navigate, and survive, the COVID-19 landscape, many of the measures introduced via the CIGA, including the new *ipso facto* regime, are permanent changes to the UK insolvency regime that have been proposed since 2016 as part of the government's review of the UK's corporate insolvency framework.

The CIGA proposes to create a new s 233B of the Act, the effects of which are a change to the ability to utilise certain termination or other rights in all contracts, including "non-essential" contracts, for the supply of goods and services which are triggered by a counterparty entering into an insolvency procedure.

Section 233B of the Act applies to certain contracts entered into by a company subject to one of the relevant insolvency procedures, whether or not the contract is governed by a UK law. In addition, the company does not necessarily have to be incorporated in the UK; the company may be utilising the relevant insolvency procedure due to its COMI being based in the UK or if there is a sufficient connection to the UK (with the test varying depending on which insolvency proceeding is being utilised).

In relation to foreign law contracts, there is a further question as to whether the effects of s 233B would be recognised in the jurisdiction of the governing law, particularly if the contract in question has an exclusive jurisdiction clause in favour of the courts of the governing law. This may depend on whether that foreign court would recognise the English insolvency proceedings and its effects (including on foreign law governed contracts) and/or whether the counterparty had assets outside of England over which it could enforce its rights.

As under s 233A, 233B provides that any provision which allows for the termination of a contract for the supply of goods and services or for a party to do "any other thing" when a counterparty enters into a relevant insolvency procedure, ceases to apply once the counterparty enters into that relevant insolvency procedure. Insolvency procedure used in s 233B, unlike s 233A, includes liquidation and the new restructuring plan introduced by the CIGA but still excludes schemes of arrangement (the rationale for this is unclear given the similarities between schemes of arrangement and the new restructuring plan).

We note that the ability of the supplier to terminate the contract, through company or relevant officer-holder consent or through permission from the court, if the continuation of supply would cause "hardship" on the supplier, applies equally to both ss 233A and 233B of the Act.

FINANCIAL SERVICES CARVE-OUTS TO S 233B

The carve-outs to s 233B are provided for in Sch 4ZZA of the Act and include certain financial contracts and certain persons involved in financial services. In summary:

- loan agreements, hedging arrangements and other types of financial contract are carved-out of the application of s 233B; and
- certain entities (for example deposit-taking and investment banks and insurance companies) are excluded from the effects of s 233B, regardless of whether they are the insolvent entity or the supplier. Entities outside of the scope of the list will have to rely on the contract's exclusion in Sch 4ZZA.

There is also a carve-out for any set-off, netting arrangements or capital market investments.

For the majority of financial creditors, the exclusion of certain financial entities and certain financial contracts will come as a relief as this enables financial creditors to, among other things, withdraw committed funds on the commencement of the relevant insolvency process (and thus mitigate against risk), charge default interest on overdue amounts and accelerate debt in order to enforce security and call upon guarantees on the occurrence of an insolvency event. To a large extent, the carve-outs mirror the regime under the US Bankruptcy Code.

The financial contracts exclusion lacks clarity as to whether it covers all loan transaction documentation; for example, on a strict reading of the new Sch 4ZZA, intercreditor agreements would not be excluded from the prohibition. Whether intercreditor agreements are agreements for the supply of services is unclear. Moreover, an intercreditor agreement is inextricably linked to loan documentation and it would be a peculiar outcome if these agreements were not captured in the carve-out. It may be possible to rely on the notion that the terms of the intercreditor agreement are incorporated by reference into the loan agreements, however, this remains to be tested.

IMPLICATIONS OF THE NEW S 233B: OTHER SUPPLIERS

For other (non-financial) suppliers of goods and services, mostly trade suppliers, although the supplier will be unable to terminate or "do any other thing" on the commencement of an insolvency procedure, they will retain the right to terminate or "do any other thing" with respect to any non-insolvency related events contained in the contract, where this occurs after the commencement of the insolvency procedure. These include, for example, non-payment (however, in practice, this may only assist suppliers with reasonably short payment terms) and also indirect consequences of the insolvency process (ie downgraded credit rating or cessation of business), *provided that* the contractual right to terminate did not arise pre-insolvency and was not exercised.

In practice, we may see suppliers adding to the number of non-insolvency related events which may trigger termination or amendment of contractual terms; for example adding cross-default clauses, triggered when the distressed company fails to pay amounts due to any of the company's creditors or adding triggers on actual (compared to formal) insolvency triggers such as cash flow or balance sheet insolvency.

There are several issues suppliers may face:

- First, the CIGA implies that the supplier will need to keep supplying even before the officeholder has confirmed he or she actually wants the goods in question (and potentially when the distressed company is in liquidation and the business is shutting down). In practice, discussions between the supplier and the officeholder are likely to establish if the supplies are required by the distressed company as this would be in the interests of all parties involved. However, this is not without risk to a supplier who relies on the officeholder engaging efficiently and without delay. A mechanism similar to s 365 of the US Bankruptcy Code would have provided a fairer and more structured process. Section 365 of the US Bankruptcy Code means that under a US Chapter 11 process, the trustee or debtor in possession has an election window of three months in which to assume, reject or assign supplier contracts.
- Second, it may be difficult for suppliers to rely on the financial hardship exclusion as the government has suggested that the threshold would be quite high (essentially if the continued supply threatens the supplier's own insolvency). There is minimal further guidance on the point in either the CIGA or the explanatory notes. Moreover, litigation is expensive and time consuming and for SME suppliers, unlikely to be cost effective. Suppliers may consider getting insurance to cover non-payment of supplies during an insolvency procedure.
- Third, due to the inclusion of liquidation as a relevant insolvency procedure, suppliers may be concerned they are supplying to a company that has an

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inability to pay further debts. The stated policy intention of the new *ipso facto* prohibition is to help companies trade through a restructuring or insolvency procedure, maximising the opportunities for rescue of the company or the sale of its business as a going concern. However, with the inclusion of the appointment of a liquidator or provisional liquidator in the new s 233B, the new laws oblige a supplier to continue to supply even where the company is in liquidation and there may be no or little returns for unsecured creditors. For further protection to the supplier, the officeholder should ensure that the costs of any supplies during the process should be expenses in any liquidation or administration and paid in priority to unsecured and floating charge claims.

- Fourth, the reference to "any other thing" is extremely broad. This includes exercising any other contractual rights triggered by or exercisable upon the commencement of an insolvency procedure. Such provisions will cease to have an effect without consent of the officeholder or a financial hardship order. This includes any provision requiring higher payments or payments on default, for example, default interest or margin ratchet and an acceleration of unpaid payments. These provisions would also cover the invalidation of any guarantee in the supplier's favour where the supplier would be prevented from making any claim under such guarantee as a result of the company's insolvency. The supplier will need to rely on non-payment or another (non-insolvency related) event of default, as noted above, to call upon the guarantee. Where there are group supply arrangements it is unclear what rights that supplier would have against other companies within the group who are not subject to an insolvency procedure, ie could a supplier restrict payment terms following one company's insolvency and what affect would that have on the other members of the group?
- Finally, it is unclear what affect these provisions will have on credit insurance policies that require a supplier to exercise rights to terminate supply upon counterparty insolvency in order for the insurance company to pay out. Suppliers will need to re-write these credit insurance policies.

It is arguable that the measures go too far to the detriment of suppliers. It will be interesting to see how these measures work in practice and whether they are effective in forcing an unwilling SME supplier of goods to refrain from delaying or avoiding delivery for whatever reason, without outright refusing.

IMPLICATIONS OF THE NEW S 233B: DISTRESSED COMPANIES

For distressed companies, s 233B will be a welcome addition to the insolvency toolkit. Due to the prohibition on counterparties terminating and from doing "any other thing" as a consequence of the insolvency procedure, the distressed company can focus efforts elsewhere and not have their hands tied when dealing with powerful suppliers to the business; the bargaining power will shift.

Due to the carve-out for financial contracts, the distressed company will not, however, be able to prevent financial creditors taking away committed funds including working capital facilities. However, the absence of this carve-out may have prompted financial creditors to incorporate earlier triggers into financial documentation to enable the creditor to pull crucial working capital facilities at a point when insolvency is reasonably likely, to avoid the effects of the suspension, which may have been more detrimental to the distressed company.

COMPARISON WITH THE DUTCH *WET HOMOLOGATIE ONDERHANDS AKKOORD* OR WHOA

In the Netherlands, the options available for companies to restructure their debts will improve after the introduction of WHOA and the new restructuring plan (which is a mix between the UK Scheme of Arrangement and the US Chapter 11 procedure) later this year.

The new UK *ipso facto* regime is similar to that proposed under WHOA; under WHOA, a restructuring plan proposal by a debtor or the appointment of a restructuring expert, and all acts directly related and reasonably necessary to the implementation of the plan, cannot be used by a counterparty as a reason to amend, suspend or terminate a contract with the distressed debtor company. As under the new UK *ipso facto* regime, other triggers, such as non-payment, can be used to amend, suspend or terminate a contract during the restructuring plan phase. Unlike under the UK regime, where office-holder consent or a hardship order is required to rely on pre-insolvency defaults, relying on a pre-insolvency default under the WHOA is only barred if a separate stay has been ordered and security is provided for the performance of new obligations that arise during that stay.

Interestingly, under WHOA all contracts and claims are captured and there are no carve-outs for certain types of contract, for example financial arrangements as under the new UK *ipso facto* regime.

CONCLUSION

The measures clearly prioritise distressed debtor companies and financial parties over the interests of suppliers. This is in line with policy and the desire to shift the bargaining power away from such suppliers and to assist companies to continue trading. It remains to be seen whether this is a reasonable exception to the principle of freedom of contract entrenched into the UK's legal system; it is unclear why this regime should apply where a company is in liquidation and some points require clarification, either by the government through guidance or by the courts through case law. A system more akin to that included in s 365 of the US Bankruptcy Code could have facilitated a fairer system.

Overall, s 233B will be a welcome addition to the insolvency toolkit for distressed companies and more closely aligns the UK insolvency regime with the US regime and the notion of corporate rescue. ■

Further Reading:

- *Ipso facto* protection: as dead as the language and rightfully so? (2019) 6 JIBFL 370.
- Is wi-fi the new water? (2015) 6 JIBFL 344.
- LexisPSL: Banking & Finance: Corporate Insolvency and Governance Act 2020.