ALLEN & OVERY

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UK Corporate Insolvency Reforms

What do I need to know?

SPEED READ

The UK Government's response issued on 26 August 2018 confirms that the UK corporate restructuring toolbox will change (and expand). Some of the proposed changes could be significant for borrowers, creditors and distressed investors, potentially impacting their decision-making in future restructuring scenarios. We are encouraged to see that the UK Government is considering how to ensure that UK proceedings remain competitive in a post-Brexit world. However, in our view, the reforms are unlikely to be imminent and key questions remain as to their detailed provisions. This means a firm conclusion on the utility of the reforms in future restructurings, particularly those involving foreign companies, is not possible at this stage. We expect there will be further opportunities to consult on draft legislation and we look forward to doing so. This bulletin summarises, and provides our initial thoughts on, the key reforms set out in the Response.

Contents

Introduction 2

Key take-aways 2

Corporate insolvency reform 3

- New pre-insolvency moratorium 3
- Supplier termination clauses 5
- New restructuring plan 6
- Rescue finance 8

Mitigation of major corporate failure 8

- Selling subsidiaries in distress 8
- Value extraction schemes 9
- Other reforms 9

Conclusion 9

Key contacts 10

Introduction

On 26th August 2018 the Department for Business, Energy and Industrial Strategy (BEIS) published the Government's Response (the **Response**) to a consultation on Insolvency and Corporate Governance issued in March 2018[1] and an earlier Review of Corporate Insolvency Framework consultation held in 2016[2].

The consultations sought views from stakeholders on new proposals aimed at improving the UK's corporate governance and insolvency framework. The March 2018 consultation can be seen partly as a response to a number of high profile business failures in the UK such as BHS and Carillion and many saw the 2016 consultation as the UK Government's response to certain European initiatives, in particular the European consultation issued earlier in 2016 which resulted in the proposal for a new European Directive on preventative restructuring frameworks (the **European Restructuring Framework Directive**)[3].

Both consultations can be viewed as a proactive step to improve the UK's insolvency regime so as to achieve "best in class" status, promote business rescue and encourage investment.

The Response summarises the stakeholder responses received to both consultations and sets out the Government's proposed next steps. Those steps will either take the form of legislative reform or further consultation. The timing of such next steps is unclear, particularly given the current focus on Brexit related legislation. We suspect, though, that we are unlikely to see the reforms come into force until post April 2019.

This note summarises concrete proposals for legislative change made by the Government which we consider to be of most relevance to the restructuring community.

[1] The Response and the March 2018 consultation are available at: https://www.gov.uk/government/consultations/insolvency-and-corporate-governance

[2] The 2016 consultation is available at: https://www.gov.uk/government/consultations/a-review-of-the-corporate-insolvency-framework

[3] The European Restructuring Framework Directive is available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016PC0723&from=EN

Key take-aways

1. **Timing is unclear**. The Response refers to legislation "*as soon as parliamentary time permits*" but, with all the Brexit related legislation, this may not be for some time. We would hope that there will be the opportunity to comment on draft legislation in due course.
2. **Key parts of the proposals are unclear**. For example, there is uncertainty as to whether the cross-class cram down of a dissenting class will apply to shareholders as well as creditors (it is hoped and assumed that it will).
3. The **invalidity of *ipso facto* clauses** (clauses purporting to allow termination on, among other grounds, the commencement of insolvency proceedings) in all contracts, not just those relating to essential services, is new and contentious. There will need to be complex and multiple exclusions for financial and derivative transactions.
4. Some of the proposed changes (eg the moratorium and restructuring plan with potential cram-down of a dissenting class) echo proposals in the **European Restructuring Framework Directive**. Arguably, in a post Brexit world we will get the option to pick

the best parts of the Directive and ignore what we do not like.

5. **A company cannot be actually insolvent to use the moratorium** and must be able to meet current obligations as and when they fall due (plus any new obligations incurred during the moratorium). Query whether this means that contractual standstills and waivers will still be required.
6. The restructuring plan applies the **US bankruptcy "absolute priority rule"** (whereby the claims of a class of creditors must be paid in full before any junior class can receive any returns) but with some flexibility where (a) necessary to achieve the aims of the restructuring; and (b) just and equitable in the circumstances. Query whether this will put a greater burden on the courts when establishing whether these tests are met.
7. A key question will be whether the new moratorium and restructuring plan processes can be used in respect of **foreign companies**. The Response does not answer this question but states that the Government will consider it in the context of the Brexit arrangements. This in itself suggests to us that these reforms are not imminent.
8. In conclusion, it is welcomed that the Government is considering how to ensure that UK proceedings remain competitive in a post-Brexit world. As always, however, the devil will be in the detail.

Corporate insolvency reform

The proposals to improve the current corporate insolvency regime are the most concrete and potentially most significant for insolvency and restructuring practitioners and investors. There are three main areas of change: (i) a new pre-insolvency moratorium (ii) a prohibition on *ipso facto* clauses; and (iii) a new restructuring plan.

NEW PRE-INSOLVENCY MORATORIUM

A new moratorium will be introduced to prevent creditor enforcement action whilst a company considers its options for rescue.

The new moratorium will operate on a standalone basis and is available to all companies subject to certain eligibility criteria and certain exclusions (see below). The directors will remain in control of the company during the moratorium (ie it is a debtor in possession tool); however a monitor will be appointed to protect creditors' interests (see further below).

The new moratorium will be initiated by filing papers at court (in the same way as for an out of court administration). The monitor will file a consent to act and confirmation that he or she is satisfied that the eligibility criteria and qualifying conditions are met. The monitor will notify creditors of the moratorium and register the company's entry into the moratorium at Companies House.

Scope and duration

The new moratorium will be modelled on the same parameters as the administration moratorium.

It will last for an initial period of 28 days which can be extended by a further 28 days subject to the monitor's confirmation that the qualifying conditions continue to be met. If further extensions are required they have to be approved by more than 50% in value of unsecured creditors and more than 50% in value of secured creditors unless the company considers it impractical to obtain creditor votes in which case it can apply to the court for an extension.

Where a statutory procedure such as a scheme of arrangement or CVA has been proposed to creditors before the expiry of the moratorium, but the outcome has not yet been determined (eg because a vote is pending), the moratorium will stay in place until the creditors approve or reject the proposal.

Qualifying conditions/eligibility

In order to be eligible for a moratorium:

- a company cannot already be insolvent but should be in a state of prospective insolvency; presumably this is on a cash flow basis but this is not expressly stated in the Response;
- it must be more likely than not that a compromise or arrangement with creditors can be agreed (in practice this may require the monitor to consult informally with creditors); and
- the company needs to be able to meet its current obligations and those incurred during the moratorium as they fall due.

In addition a company:

- must not have entered into a moratorium, administration or a CVA in the previous 12 months;
- must not be subject to a petition for a winding up on public interest grounds; where there is a pending winding up petition on grounds other than public interest the court may approve the entry into a moratorium but the out of court filing method is not available;
- must not be a company excluded from the CVA moratorium applicable to small companies contained in Schedule A1 to the Insolvency Act (for example the capital markets arrangements exclusions will apply). Financial collateral arrangements will also be excluded from the scope of the moratorium. (The Response notes that the Government intends to repeal the small companies CVA moratorium contained in Schedule A1 to the Insolvency Act 1986.)

Monitor

To avoid abuse of the moratorium, a qualified insolvency practitioner will be appointed to supervise the moratorium (a **monitor**).

The monitor will assess the eligibility and qualifying conditions at the commencement of the moratorium and for the duration of the process.

The monitor will be obliged to terminate the moratorium if the qualifying conditions (eg the company being able to meet its current obligations) cease to be met. The monitor will have immunity from claims arising from an erroneous termination of the moratorium provided he or she acted in good faith.

The monitor will be responsible for sanctioning asset disposals outside the course of normal business, and the granting of any new security over company assets.

A monitor will not be prohibited from providing additional services to a company subject to a moratorium, eg restructuring advice, or from being appointed as a CVA supervisor or advising in relation to a restructuring plan (see below). However, a monitor cannot take an appointment as an administrator or liquidator in the 12 months following the expiry of the moratorium.

Challenge to moratorium

Creditors can challenge the moratorium either on the grounds that the qualifying conditions are not met (or the company is ineligible) or on the grounds of unfair prejudice to creditors at any time during the moratorium.

A creditor may make a request to the company or the court to lift the moratorium stay and the same principles will be applied as apply in relation to an application to lift the administration moratorium. However, the monitor will not be able to consent to the lifting of the moratorium stay.

Costs incurred during moratorium

Costs incurred during the moratorium will be treated in the same way as an expense in an administration and will have priority over any costs or claims in a subsequent administration or liquidation (including the expenses of these procedures). The highest priority will

be given to the claims of suppliers who are prevented from relying on termination clauses (see below). Other costs rank behind these followed by the fees of the monitor. However, the official receiver's fees will not be subordinated to any unpaid moratorium costs.

There is no intention to modify set-off rules during the moratorium process.

Comment

The intention in limiting the moratorium to solvent companies which can meet their obligations as they fall due is to encourage companies to address financial difficulties at an early stage. However, it may in practice be challenging to meet the financial eligibility criteria. If an interest payment or amortisation cannot be met during the moratorium period will creditors need to extend the date for payment if the company is to qualify as solvent? How far in the future does the company have to look to for the purposes of determining that it is solvent at the time of entry into the moratorium?

Does the ability of creditors to challenge the moratorium limit its usefulness in practice? Can the making of a demand, eg by a creditor with on demand facilities, effectively bring the moratorium to an end?

The Response is also silent on the jurisdictional requirements for a company to apply for a moratorium. It is therefore unclear whether it will be available to non-UK registered companies.

SUPPLIER TERMINATION CLAUSES

The government will legislate to prohibit the enforcement of so called *ipso facto* clauses, ie termination clauses which permit one party to terminate a contract due to the insolvency or financial condition of the other party.

The government intends that such clauses will not take effect in a contract for the supply of goods and services or under a contractual licence eg of software or patents where the recipient of the goods and services or beneficiary of the licence enters a formal insolvency procedure, ie administration, liquidation or a CVA or the new moratorium process referred to above or the new restructuring plan described below. Consequently suppliers will have to continue to fulfil their commitments under their contract with the debtor company.

Suppliers will retain the ability to terminate contracts on other grounds permitted by the contract including:

- for non-payment of liabilities incurred following entry into a moratorium, restructuring plan or insolvency procedure;
- by giving notice in accordance with the terms of the contract; and
- for reasons unconnected with the company's financial position or the fact it has entered into a moratorium, restructuring plan, or insolvency procedure.

The Response states that certain types of financial products and services represent special cases and will be exempted although no further details are given. Licences issued by public authorities (eg regulatory licences) will not be covered by the *ipso facto* provisions.

Where a supplier will be significantly adversely affected by these measures, it will be able to apply to court to exercise a right to terminate on grounds of undue financial hardship. In considering such application the court will need to assess whether or not the supplier will be more likely than not to enter an insolvency procedure as a result of being compelled to continue supply. The court will also need to consider whether exempting the supplier from the obligation to supply is reasonable in the circumstances have regard to the effect of non-supply on the debtor company and the prospects of rescue.

The Government intends the threshold for the court to grant an exemption from continuing to supply to be high so that a supplier should only seek an exemption

from the court if continued supply threatens its own insolvency.

Comment

In principle the *ipso facto* provisions apply to all suppliers. This contrasts with the current regime which provides for continuity of supply of essential services such as utilities and IT. It is also a departure from the narrower proposals in the 2016 consultation. A key issue will be the definition of "goods and services" and the scope of exemptions from the provisions. Which types of financial products and services will be exempted? Will lenders have to continue to make available overdraft facilities or revolving credit or letter of credit facilities? What will the position be in relation to asset leasing arrangements? Depending on the scope of the termination provisions there may be a trend towards negotiating earlier termination triggers in contracts which could defeat the purpose of ensuring continuity of supply.

Of course, a key concern is how these provisions will affect close-out netting and set-off under derivative transactions. Clearly carve-outs will be needed but these could become complex given the many different types of derivatives transactions.

There is also a lack of clarity on whether the prohibition on termination will apply only following the entry into insolvency or the new moratorium or restructuring plan or whether it will prevent termination on grounds linked to financial condition eg the state of insolvency outside a formal insolvency or pre-insolvency process.

NEW RESTRUCTURING PLAN

The Government proposes the introduction of a new standalone restructuring procedure that may be proposed by solvent or insolvent companies (subject to certain exclusions as described below). A principal feature of the new plan would be the use of a cross-class cram down provision, which would allow a company to bind all creditors including junior classes and (it is hoped) shareholders.

Eligibility

Those companies which are excluded from the small companies CVA moratorium and which will be excluded from the new moratorium (for example companies involved in capital markets arrangements) will not be able to propose a restructuring plan.

There will be no financial entry criteria and a company acting through its insolvency officeholders as well as a company acting by its directors will be able to propose a restructuring plan. However, unlike a scheme of arrangement only a company rather than its creditors may propose a restructuring plan. In practice schemes are usually proposed by a company in any event.

It is not clear what the jurisdictional test will be for a company wishing to propose a restructuring plan eg whether it will be a COMI based test (like administration) or a "sufficient connection" test as for schemes of arrangement. The Response states that the Government will continue to consider the issue of jurisdiction in the context of the UK's departure from the European Union.

Process

The process will closely resemble that for schemes of arrangement. The Response states that a restructuring plan proposal will be circulated to creditors and shareholders and filed at court. It also says that the company will formulate classes. It is therefore not clear if the company has to submit the plan to a vote of shareholders and all creditors or whether shareholders and creditors are only required to vote if they are a class which is affected by and intended to be bound by the scheme.

As in the case of a scheme of arrangement there will be a first hearing to examine the classes of creditors and shareholders proposed by the company, the formulation of which may be challenged by creditors and shareholders. The Government intends that the jurisprudence which has developed in relation to schemes be applied in relation to class formation for the new restructuring plan. If satisfied with class

composition, the court will confirm a date for a vote to take place (which is likely to be by way of electronic voting procedure rather than a physical meeting).

The Government will prescribe certain mandatory information which will be required to be provided to creditors/shareholders which may take a form similar to the explanatory statement used in schemes.

The Government does not intend to prescribe the terms or duration of the restructuring plan so as to give a company maximum flexibility to address its financial difficulties.

In a departure from the formal scheme process, it is expressly contemplated that creditors or shareholders may submit counterproposals which the court may allow to be put to other creditors and shareholders. However, there is no detail as to the timing and process for counterproposals to be submitted, eg it is unclear whether they need to be submitted and assessed before the first hearing or between the first hearing and the vote. The Response states that if no counterproposals are submitted or permitted by the court the creditors and shareholders will vote on the proposal.

If the requisite voting majorities are met and the rules for imposing a cross-class cram down are complied with, there will be a second hearing at which the court will consider whether the relevant requirements have been met and will make a decision whether or not to confirm the restructuring plan.

Voting majorities

The voting majority will be 75% in value (measured by value of gross debt) of the creditors (and presumably shareholders) in each class (who vote) with the additional requirement that more than half of the total value of unconnected creditors must also vote in favour. This removes the “majority in number” requirement applicable in a scheme and aligns the voting thresholds to those in a CVA, although in a CVA the requirement is that more than half of the value of unconnected creditors do not vote against the proposal rather than vote in favour.

Notwithstanding that a class does not vote in favour, a creditor or (it is hoped) shareholder may be bound by the plan if the cross-class cram down rules are met.

Cross-class cram down

At least one class of impaired creditors (ie who will not receive payment in full under the restructuring plan) must vote in favour of the restructuring plan in order for it to be confirmed by the court.

The restructuring plan legislation will also provide that a dissenting class of creditors must be satisfied in full before a more junior class may receive any distribution or keep any interest under the restructuring plan. This is similar to the rule contained in Chapter 11 of the US Bankruptcy Code (known as the **absolute priority rule**). However, in response to criticism of the inflexibility of the absolute priority rule in Chapter 11, the Government intends that a court may confirm a plan notwithstanding that it does not comply with the restructuring plan priority rule where non-compliance is necessary to (i) achieve the aims of the restructuring and (ii) is just and equitable in the circumstances. Nonetheless the test for overriding the priority rule is intended to create a high threshold.

Comparator

In determining whether a plan which effects a cram down of dissenting classes is fair, the test will be whether the plan gives a better outcome to creditors than the next best alternative. This may not necessarily be liquidation. For example, administration may be a realistic option and deliver a higher value than liquidation. In the event of challenge the court will determine what the next best alternative for creditors is.

Comment

A key issue in the context of cross-border insolvencies will be the jurisdictional test for a company to apply for a restructuring plan.

The inclusion of the cross-class cram down provision and the next best alternative comparator may lead to challenges and require more detailed valuation evidence than that submitted in schemes of arrangement where each affected class has a vote.

It is also unclear whether the next best alternative comparator will just be relevant to cross-class cram down, or whether it will inform class composition.

RESCUE FINANCE

The Government has decided not implement proposals to encourage rescue finance, but will keep the issue under review.

Mitigation of major corporate failure

SELLING SUBSIDIARIES IN DISTRESS

Measures will be introduced so that a director of a holding company which sells a large subsidiary in financial distress and who does not give due consideration to the interests of the stakeholders of the subsidiary can be disqualified and made personally liable via a compensation order if the subsidiary enters into insolvent administration or insolvent liquidation within 12 months.

A director will not be exposed to liability if they had a reasonable belief at the time of the sale that the sale would deliver no worse an outcome for the stakeholders of the subsidiary than if it had been placed into insolvent administration or insolvent liquidation.

The Government will provide a non-exhaustive list through legislation and/or guidance of matters which the court may take into account in determining the reasonableness of a director's beliefs in relation to the impact of a sale, which may include: (i) whether professional advice on the impact of the sale on the stakeholders' subsidiaries was considered and (ii) the extent to which the board of the holding company consulted with major stakeholders of the subsidiary prior to the sale.

The measures will apply only to the sale of a large subsidiary (ie not a small or medium company for the purposes of the Companies Act 2006).

As regards the definition of "financial distress" for the purposes of these measures, the March 2018 consultation focussed on a situation where at the time of the sale the subsidiary is either insolvent or insolvent but for guarantees provided by other companies or directors in its group. It is unclear whether this test is intended to apply or whether any subsidiary is in scope if it goes into insolvency within 12 months of the sale. If it does apply, it is unclear how insolvency has to be tested.

Comment

The Government has sought to strike a balance between encouraging holding company directors to consider the interests of the subsidiary's stakeholders and protecting the holding company directors from liability so as not to deter legitimate business rescue. Nevertheless, there are a number of concerns for holding company directors and the risk of personal liability could mean that directors are incentivised to put more subsidiaries into insolvency and potentially for more companies to be sold via a pre-pack insolvency process.

Although the Government have dismissed this concern, there is a potential for conflicts of interest between the duties the director owes to the holding company and to the subsidiary's stakeholders.

In order to establish that they have acted reasonably directors of the holding company may have to diligence the business plans and creditworthiness of the purchaser. Until the Government publishes guidance for directors in these situations the burden this new measure will impose on directors will be unclear.

VALUE EXTRACTION SCHEMES

The Government does not propose to introduce new standalone powers to challenge transactions which extract value from companies in the lead up to insolvency.

However, the Government does propose to change the law so that where a company has provided a preference to a connected person there is a presumption that the company is insolvent at the time of the transaction. This aligns the position with that for transactions at an undervalue.

The Government will also consider changes to make it easier for an insolvency officeholder to challenge extortionate credit transactions, whilst recognising the risks being taken by credit providers, and will consider whether changes can be made to other existing provisions so as to make it easier to pursue antecedent transaction claims.

Areas for potential change include addressing uncertainty about whether the granting of security can constitute a transaction at an undervalue and whether a shadow director can be subject to a remedy under section 212 of the Insolvency Act 1986 (remedy against delinquent directors) and dealing with the challenges of pursuing wrongful trading claims against directors.

OTHER REFORMS

Dissolved companies

The Government will make amendments to the Company Director Disqualification Act 1986 in order to allow investigation of former directors of dissolved companies without having to restore dissolved companies to the register.

Prescribed Part

The Government will increase the current £600,000 cap on the proportion of ring-fenced funds to be paid to unsecured creditors in insolvencies to £800,000. The increase matches inflation since the cap’s introduction in 2003.

Conclusion

The Government’s proposals potentially give the UK some helpful new restructuring tools. In particular, the new moratorium and restructuring plan (with its ability to cram down dissenting classes of creditors) could enable the UK to compete with the US and other jurisdictions that are improving their insolvency and restructuring laws. However, the devil will be in the detail (in particular the ability of foreign companies to use these procedures) and we will need to review the draft legislation in order to understand what it will mean in practice. Legislation will be put forward “*when parliamentary time permits*”, so in practice it could be some time before the new tools are capable of being put to work.

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