COVID-19 NEWS OF INTEREST

COVID-19 UK Insolvency Law Reforms

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Introduction

In recent weeks the UK Government has announced a range of support packages (including loans and guarantees, job retention scheme grants for furloughed workers, and tax deferrals) in an effort to mitigate the impact of the COVID-19 pandemic on businesses and the wider economy (please click here for an overview).

In conjunction with these measures, the UK Government has now also announced proposals to suspend and reform UK insolvency laws with a view to supporting businesses and providing reassurance to directors of UK companies affected by the COVID-19 pandemic.

In this note we summarize the UK Government's insolvency law proposals.

Scope and Effect

On 28 March 2020, the UK Government announced a range of proposed changes to UK insolvency law, including the suspension of wrongful trading liability for directors of UK companies, in response to the COVID-19 pandemic. In addition, the implementation of various UK insolvency law reforms previously announced in 2016 (and detailed in a consultation response paper in August 2018), aimed at enhancing statutory rescue mechanisms for businesses, will now be accelerated.

The UK Government has stated that legislation to implement these changes will be introduced to Parliament at the "earliest opportunity". However, on 25 March 2020, Parliament announced it would commence its Easter recess early due to COVID-19 and would adjourn until 21 April 2020. Whilst MPs will still be undertaking constituency work and the House

of Commons has passed a motion allowing Select Committees to work remotely during the recess, it seems unlikely that these reforms could be put before Parliament until late April at the very earliest.

Suspension of Wrongful Trading

The existing wrongful trading provisions are set out in the Insolvency Act 1986 ("**IA 1986**")[1] and provide that if a director of a UK company that has gone into insolvent liquidation or administration proceedings knew or ought to have concluded (at some time before the commencement of those proceedings) that there was no reasonable prospect of the company avoiding insolvency, that director may be held personally liable. A defence is available if the director took "every step" with a view to minimizing potential loss to the company's creditors. This is a rather onerous requirement which in practice is frequently interpreted as requiring directors to immediately commence formal insolvency proceedings, such as liquidation or administration, thereby hindering the rescue of the company.

A liquidator or administrator has standing to bring an action for wrongful trading, and if a director is found liable, the court has discretion to order the offending director to make a personal contribution to the company's assets. Typically, the appropriate personal contribution will be the amount by which the company's assets were depleted by the director's conduct in continuing to trade when he or she should have commenced formal insolvency proceedings.

Whilst it is unusual in practice for wrongful trading liability to arise, the potential for personal liability can have a strong influence on the decisions directors take and can cause precipitous insolvency filings and attendant value destruction. Furthermore, a director found liable for wrongful trading may face a disqualification order under the Company Directors Disqualification Act 1986.

Given the significant impact of the COVID-19 pandemic on many businesses due to exceptional circumstances beyond the control of the directors, the UK Government has proposed a temporary suspension of the IA 1986 wrongful trading provisions in order to allow company directors to continue trading without facing the threat of personal liability. Once implemented, the suspension would apply retrospectively from 1 March 2020 for three months, but the UK Government has also stated that provisions will be included to enable the changes to be extended if necessary.

The suspension of these rules will provide welcome reassurance to directors in making decisions about the future viability of their businesses in the current climate of uncertainty. In particular, it is expected to facilitate access to the UK Government support packages referred to above and/or new private funding.

[1] Sections 214 and 246ZB IA 1986.

Directors are still required to properly discharge their duties under the Companies Act 2006 and common law and may still be held liable under other insolvency law provisions (e.g. for fraudulent trading,[2] which requires actual dishonesty and can carry criminal sanctions, or misfeasance for breach of duty).[3]

Accordingly, directors of UK companies must at all times be cognizant of their duties when discharging their responsibilities. In particular, directors should remember that the duty to promote the success of the company for the benefit of its members (i.e. its shareholders) as a whole[4] shifts when the company is in the vicinity of insolvency (sometimes referred to as the "twilight zone", a grey area which can be difficult to pinpoint), so as to require the directors to have proper regard for the interests of the company's creditors.

New Standalone Moratorium

In the 28 March 2020 announcement, the UK Government stated that the legislation being implemented in response to COVID-19 would include the new restructuring procedures referred to in its August 2018 consultation response paper, specifically including a short moratorium or 'breathing space' that will give solvent companies facing financial difficulty time to explore options for rescue.

The moratorium will be a new standalone tool available to solvent companies of all sizes, subject to certain eligibility criteria, the chief of which is that the company must face prospective insolvency (it must also not have been subject to a moratorium filing, administration proceedings or a company voluntary arrangement in the last 12 months). The moratorium will be similar in scope to the existing administration moratorium, preventing creditor enforcement (but with a carve-out for enforcement of collateral falling within the scope of the Financial Collateral Arrangements (No. 2) Regulations 2003).

Compliance with the qualification criteria will be assessed by a "Monitor" (who must be a licensed insolvency practitioner) prior to and for the duration of the moratorium, to ensure that the company is not insolvent, has sufficient funds to carry on its business during the moratorium, meets its obligations as and when they fall due, and that a rescue of the business remains more likely than not. Despite the appointment of the Monitor, the directors of the company will remain in control, although the Monitor will be required to approve any non-ordinary course sale or disposal and/or the grant of any new security.

[2] Sections 213 and 246ZA IA 1986.

[3] Section 212 IA 1986.

[4] Section 172 of the Companies Act 2006.

Initially, the moratorium will be for a duration of 28 days, subject to a 28-day extension at the option of the company. Further extensions may be obtained by the approval of more than 50% of secured creditors in value and more than 50% of unsecured creditors in value.

The company will be required to notify creditors of the moratorium, including any extensions thereto, and creditors would be able to challenge the moratorium on the basis of the qualifying conditions not being met and/or unfair prejudice.

New Supplier Contract Termination Prohibition

Another envisaged reform is the introduction of a regime prohibiting the enforcement of termination clauses in contracts which trigger upon the financial condition or formal insolvency of a debtor company, also known as '*ipso facto'* termination clauses. If a company enters either a formal insolvency process, the new pre-insolvency moratorium procedure outlined above, or the new restructuring plan outlined below, termination of contracts on these grounds will be prohibited and its counterparties will therefore have to continue to fulfill their contractual obligations.

However, this prohibition will not prevent termination for reasons of non-payment, or the exercise of any other right to terminate that might exist under the relevant contract (for example, in accordance with termination by notice provisions).

The 2018 UK Government consultation response contemplates that these measures will extend generally to contracts for supplies of goods and services as well as to licences for software and patents, but that there will be certain exemptions. Exemptions highlighted in the paper include contracts for certain types of financial products and services, as well as licences granted by public authorities.

A contractual counterparty may also apply to court to be permitted to exercise an otherwise prohibited termination right, on the grounds of undue financial hardship in circumstances where the counterparty would be significantly adversely affected by the inability to terminate. The court will consider if being compelled to continue with the contract would make it more likely than not that the counterparty would be forced into insolvency, as well as considering the effect of termination on the debtor company.

New Restructuring Plan Procedure

Finally, in its 2018 consultation response, the UK Government also announced the introduction of a new rescue procedure, namely a "restructuring plan", which appears to be a hybrid of the existing English-law scheme of arrangement[5] and US Chapter 11 proceedings. In common with the existing scheme of arrangement proceedings, it will

[5] Under Part 26 of the Companies Act 2006.

be a flexible procedure with no formal entry requirements, and the class composition test/court hearing and meeting procedure will be the same.

The voting thresholds have been tweaked to require approval of the restructuring plan by (i) at least 75% in total value of creditors within each class who vote (in common with the existing test for schemes of arrangement), as well as (ii) more than half of the total value of creditors who are not ‘connected’ with the company (in common with the existing test for company voluntary arrangements).

The most radical (and potentially powerful) departure from existing rescue tools under English law, however, will be the introduction of a cross-class cram-down concept, meaning that a restructuring plan will be capable of being imposed on an entire dissenting class of creditors that does not approve it. The cram-down can be imposed on a dissenting class of unsecured or secured creditors if:

- at least one class of impaired creditors (i.e. who will not receive payment in full under the restructuring plan) approves it;
- the dissenting class of creditors would be better off under the restructuring plan than they would be under the ‘next best alternative’ if the restructuring plan were not approved;
- the restructuring plan complies with the general requirement 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 (subject to some limited flexibility to depart from this rule if the court is satisfied that it is both (i) necessary to achieve the aims of the restructuring and (ii) just and equitable in the circumstances); and
- the court is satisfied that it should exercise its discretion to confirm the restructuring plan so that it becomes binding on affected creditors.

Conclusion

The suspension of wrongful trading liability will provide welcome relief to directors of hard-hit businesses who have enough to deal with during the crisis without also having to worry about personal liability. The acceleration of the wide-ranging reforms to UK insolvency laws previewed in the UK Government’s 2018 consultation response is also broadly to be welcomed, although as always, the devil will be in the detail as questions remain about a number of elements of the new standalone moratorium, the new supplier contract termination prohibition and the new restructuring plan procedure. Hopefully, stepping up the introduction of these reforms will not preclude careful scrutiny by Parliament and clarification in the drafting process.

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