JOINT ILA/CLLS ISSUES PAPER
INSOLVENCY AND CORPORATE GOVERNANCE PROPOSALS AND
CORPORATE INSOLVENCY REGIME REFORMS (2018/2019)

The Insolvency Lawyers' Association (ILA) Technical Committee

The City of London Law Society (CLLS) Insolvency Law Sub-Committee

ISSUES PAPER ON LEGISLATIVE REFORMS (2018/2019)

February 2019

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1. INTRODUCTION

1.1 This document has been produced in the context of the Government Response to the Insolvency and Corporate Governance Consultation published on 26 August 2018 (the **Government Response**) following meetings between members of the Insolvency Service Policy Unit and members of the Insolvency Lawyers' Association Technical Committee and the CLLS Insolvency Law Sub-Committee in November/December 2018. It aims to flesh out issues surrounding the proposals but it does not necessarily represent the collective view of those organisations.

1.2 By way of background, the ILA provides a forum for approximately 500 full, associate, overseas and academic members who practise restructuring and insolvency law. The membership comprises a broad representation of regional and City solicitors, barristers, academics and overseas lawyers. The Technical Committee of the ILA (the **ILA Committee**) is responsible for identifying and reporting to members on key developments in case law and legislative reform in the insolvency and restructuring market place.

1.3 The CLLS represents approximately 17,000 City lawyers, through individual and corporate membership, including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees. The CLLS Insolvency Law Committee, made up of solicitors who are expert in the field, has prepared the comments below in response to the Government Response in conjunction with the ILA Committee.

2. EXECUTIVE SUMMARY

2.1 This paper seeks to address both sections 2 to 3 of the Government Response, responding to the paper dated 20 March 2018 on Insolvency and Corporate Governance and section 5 of the Government Response, responding to the paper of May 2016 on the Review of the Corporate Insolvency Framework[1]. As a consequence, it is quite lengthy, reflecting the complexity of the issues, and so we have summarised our key responses below.

Moratorium

2.2 We are now more convinced of the need for reform in the areas covered by section 5 of the Government Response because of changing finance structures and to ensure that the UK remains competitive in a post-Brexit world. However, any changes need to work in the context of the UK insolvency regime as a whole. For the reasons given in Appendix 1, we are not convinced that the moratorium, as currently contemplated, would do so. Instead, we suggest two alternatives for the moratorium which would retain its key aspects, including the focus on rescuing the company and the potential for the existing management team to continue running the company's day to day business while a rescue plan is developed. The alternatives set out below, both of which are intended to be relatively "light touch", would, however, increase the potential use of the new procedure while also addressing identified concerns:

(a) A new Schedule to the Insolvency Act 1986 which would only apply where an administrator was pursuing the corporate rescue purpose and which would allow the administrator to delegate certain of his / her functions to the directors; or

(b) A new stand-alone corporate rescue procedure based on administration but, again, with the management powers being left with the directors.

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[1] We have not dealt with sections 2 and 4 of the Government Response where there are fewer concerns but we refer to the ILA and CLLS Insolvency Sub-Committee responses to the March 2018 paper in this regard.

Ipso facto provisions

2.3 The *ipso facto* proposals raise some difficult issues. Given the change of direction compared with the May 2016 paper, we are not sure that all of these have yet been fully thought through. We consider that, as a matter of policy (and given their interference with the important principle of freedom of contract), these provisions should be aimed at rescue proceedings. They should be inapplicable in a liquidation or distributing administration. We have real concerns with the provisions applying in a debtor-in-possession process (such as the proposed moratorium) controlled by a company's directors, although such concerns would be addressed if either of the moratorium alternatives outlined above were to be adopted.

2.4 We think there needs to be a clear trigger for removing rights of termination and a clear mechanism for the adoption and rejection of *ipso facto* affected contracts (see our suggestion in paragraph 4.5 of Appendix 2). Termination on the grounds of non-payment is especially problematic. There must be clear carve-outs to protect financial contracts and set-off though these will be difficult to define. Thought should also be given to any transitional provisions for existing contracts.

Restructuring proposal

2.5 In general terms, we support the proposals regarding the restructuring plan. The lack of a cross-class cram down mechanism in the existing scheme of arrangement is a draw-back (albeit one that we currently work around by using the scheme together with a pre-packaged administration to transfer the intermediate holding company to new shareholders where the existing shareholders are out of the money). We do have some questions, though, on the detail of the proposals as set out in Appendix 3.

Sales of businesses in distress

2.6 We are very concerned that the proposals in part 2 of the Government Response will place the holding company board in an inevitable and impossible position of direct conflict when considering a sale of a large distressed subsidiary or group of subsidiaries. We see such a conflict as the direct result of seeking to impose a new legal obligation on the board of a holding company to act in the best interests of its struggling subsidiary's stakeholders (i.e. the subsidiary's creditors), in addition to and alongside their statutory duty to act in favour of the holding company's stakeholders (i.e. its shareholders). We would instead propose that the holding company board be placed under a strict legal obligation to ensure that the board of the relevant stressed subsidiary has access to the funding and information necessary to enable it to obtain independent financial and legal advice.

2.7 This would guarantee that the subsidiary's directors were in a position to make the decisions already required of them under the existing legal framework. They would be able to do so on a fully informed basis without undue influence from either the holding company or the proposed purchaser. These obligations of the holding company board should strengthen the ability of the subsidiary's directors to comply with their existing obligations and reduce the perceived risk of such directors attempting to evade liability by "shutting their eyes" to the transaction or deliberately avoiding asking relevant questions.

Value extraction schemes

2.8 We are in favour of the measures proposed in section 3 of the Government Response as regards extortionate credit transactions and preferences. We consider those measures justifiable in relation to the general application of ss239 and 244 Insolvency Act 1986 (**IA 1986**) in addition to their potential application to value extraction schemes. We do not think that such measures need necessarily have any adverse effect on the provision of finance for distressed companies (which cannot be justified by the need to protect existing creditors from abusive transactions).

2.9 While considering ss.239 and 244 IA 1986, we would also encourage the Insolvency Service to consider a small amendment to s245 IA 1986 which would fix a defect and encourage the provision

of finance to companies. The proposed change (which is outlined in Appendix 6) would protect floating charges given within a short period of the loan those charges were to secure.

3. STRUCTURE OF THIS PAPER

3.1 We begin by providing our general comments (section 4) on the case for reform based on current and predicted changes in the finance market and monetary policy, and the implications of this for both the detailed working out of the individual reforms and the ways in which they could be implemented.

3.2 We then provide our comments on the actual proposals in the Government's Response as follows:

(a) the moratorium proposal in the Government's Response (Appendix 1)

(b) the *ipso facto* proposals (Appendix 2);

(c) the restructuring plan proposal (Appendix 3);

(d) proposals regarding sales of distressed businesses (Appendix 4);

(e) proposals regarding value extraction schemes (Appendix 5); and

(f) suggested amendments to s245 Insolvency Act 1986 (Appendix 6).

4. GENERAL COMMENTS

4.1 The Case for Reform

(a) Whilst we understand the political imperatives of:

(i) the World Bank "Doing Business" Report; and

(ii) compliance with the draft European Directive on Preventative Restructuring Frameworks,

in our view, the case for reform is not primarily made out by either of these initiatives. We consider, instead, that reform should be driven by the implications of changes in the finance market, and by the potential for, and impact of, changes in monetary policy.

(b) Based on this case for reform, we put forward two alternative ways forward (in place of the moratorium) that are designed to meet the identified needs, and are in line with the policies outlined in the Government's Proposals. This would sit side by side with a modified *ipso facto* regime (discussed in Appendix 2) and the restructuring plan (discussed in Appendix 3).

4.2 Changes in the Finance Market

(a) British companies have historically been heavily reliant on loan debt as a source of external finance, and large banks have historically acted as the providers of loan financing. Until comparatively recently, restructuring a large, distressed company was a largely an out-of-court affair. Loan finance was typically provided by banks from a relatively narrow banking sector. This meant that if a company faced financial difficulty it would negotiate time to pay, reduced interest payments etc with its bank or banks implemented by contract. After the 1970s, this was facilitated by what we might call the accepted rules of the game set out in the London Approach.

(b) In recent times, it has become more difficult to restructure loans out of court for a whole host of reasons: globalisation and a wider banking sector; loan trading; the rise of distressed

debt traders; different types of investor etc. The result has been that some sort of legal procedure has been needed more frequently to achieve a restructuring of large, leveraged companies since the financial crisis.

(c) However, these leveraged loans to larger corporates have been based on Loan Market Association documentation, and have typically contained a carefully negotiated suite of financial maintenance covenants. Financial maintenance covenants test, on an ongoing basis or periodically, a financial threshold or ratio by reference to the borrower's most recent set of accounts (such as the ratio of debt to earnings). If the covenant is breached when it is tested, the lenders have the same rights they would have on a payment default, including the right to stop further drawings (of a revolving facility), or to accelerate (or demand immediate repayment of) the loan. Most of the leveraged deals which have been restructured since the financial crisis have contained financial maintenance covenants which have acted as an early warning mechanism to force the parties to the table.

(d) The borrower has ordinarily been a finance holding company of the group and the lenders and the borrower have typically been negotiating whilst the operating subsidiaries still have liquidity to meet operational expenses. This liquidity, coupled with the detailed contractual moratorium mechanisms in the intercreditor agreement between the parties, has meant that the scheme of arrangement procedure has worked well to implement the largely consensual deal agreed over a period of months against remaining hold-out creditors at the finance holding company level. This is notwithstanding: (a) that the scheme does not offer a moratorium (other than, occasionally, through the case management powers of the court or where the scheme is used itself to create moratorium protection); (b) the lack of so-called *ipso facto* protection in a scheme; and (c) the fact that the scheme procedure lacks any cross-class cram-down mechanism.

(e) However, there has recently been an explosion in (i) high yield bonds; and (ii) covenant lite loans in leveraged financing in England and Wales. Because a high yield bond is held by a large number of bondholders who are not readily identifiable by the borrower, renegotiation costs on default are high. Hence, the high yield bond market has historically relied on incurrence covenants, rather than maintenance covenants. An incurrence covenant is only tested if the borrower takes certain actions, such as incurring further debt or granting security over its assets, so that absent such actions there is no ongoing formalised testing of financial condition.

(f) For complex reasons, the loan market has also recently adopted incurrence covenants, rather than maintenance covenants, in so-called covenant lite loans. Thus many recent leveraged loans lack the early warning mechanism of the maintenance financial covenant which has forced borrowers to the table since the crisis.

(g) Our concern is that this may mean that a borrower and its lenders come to the table much later, when the group is facing a much more severe liquidity crisis. At best, a purely financial restructuring of the finance holding company may still be possible, but the level of equitisation will be much deeper and the deal will in consequence be harder to strike. At worst, the financial distress will have spread to the group's operations as the liquidity crisis has been able to deepen before the lender and the borrower come to the table. The result is that operating subsidiaries and operating liabilities will also require restructuring. We are concerned that, while English law offers best-in-class tools to restructure the financial liabilities of a finance company, there are gaps in the toolbox for restructuring operating liabilities in an operating company.

(h) While the discussion above has focussed largely on more complex financing structures, concerns surrounding the lack of tools with which to restructure operating companies are potentially even more relevant to SMEs which encounter financial difficulties, as, under

existing legislation, such companies can find themselves facing an unsatisfactory choice between a business sale (often a pre-pack) and liquidation.

(i) This is the first reason for our supporting the case for reform. As set out below, this gives rise to a number of policy concerns which do not arise, or do not arise to the same extent, when only the finance company and financial liabilities need addressing.

4.3 **Monetary Policy**

(a) The second reason we support the case for reform is that potential changes in monetary policy could significantly impact on corporate restructuring. Since the financial crisis, quantitative easing and the low interest rate environment have led to significant liquidity, together with a well-documented 'search for yield'.

(b) This has meant that:

(i) there has been a significant appetite for investors to refinance. This can mean that loans are in effect rolled over; and

(ii) debt has generally traded well during corporate restructuring negotiations. This means that those who do not support the restructuring can trade out, and those who wish to support it can trade in.

(c) However, as quantitative easing is unwound, and if interest rates start to rise, we are conscious that the debt market generally, and the distressed debt market specifically, may become significantly less liquid.

4.4 **Implications**

(a) Both of these concerns raise issues with:

(i) the availability of moratorium protection;

(ii) the strength of moratorium protection;

(iii) the ability to restructure operational, as well as financial, liabilities;

(iv) the ability to impose a plan on an entire dissenting class of creditors; and

(v) raising financing during the negotiations.

(b) This is because:

(i) Even if the financial liabilities in the finance holding company are sufficient to absorb the loss, it is more likely that the restructuring plan will not offer sufficient consideration to all classes of finance creditor to facilitate a quasi-consensual deal capable of implementation through a scheme. This may result in senior secured lenders deciding that they have no choice but to go down a security enforcement route, even where this is comparatively value-destructive.

(ii) At the same time, if lenders who do not support a restructuring have been unable to trade out, it may become harder to bring them to the table to do a deal. In addition, the fact that lenders are seeking to trade out may prevent them from becoming involved in the restructuring process, if they do not want to receive confidential information which could restrict their ability to trade.

(iii) If an operating subsidiary is also facing a liquidity crisis, it may need moratorium protection to prevent non-financial creditors, who fall outside the intercreditor arrangements, from taking potentially value-destructive action against the company.

(iv) Seeking protection for an operating subsidiary could trigger a creditor's ability to terminate a contract for insolvency (so called *ipso facto* clauses) in England.

(v) Finally, if the group is experiencing operational liquidity issues, it may become more common to need to raise finance *during* the negotiations.

(c) Whilst we believe that the English scheme procedure is best in class to achieve a quasi-consensual restructuring of financial liabilities confined to a finance holding company, we are concerned that it lacks some of the tools needed to tackle a deep equitisation and/or a financial and operational restructuring. We comment on the proposed reforms against this background.

(d) We recognise the advantages of implementing straightforward, free standing, amendments to England's corporate insolvency regime. Were the existing gaps in the procedures needed for financial restructuring, we would wholeheartedly agree with that approach. However, as we have already identified, our view is that the reforms are needed to deal with operational restructurings. This raises the following public policy concerns which do not arise, or arise to a lesser extent, in a financial restructuring:

(i) A trade creditor with debts outstanding to it at the commencement of a procedure may face serious cash flow challenges in continuing to supply during the procedure. This may mean that complex decisions need to be taken in developing the *ipso facto* ban around (i) which procedures should entitle the debtor company to impose the ban, given its potential consequences; (ii) whether to distinguish between creditors with sums outstanding to them before commencement and those who do not; and (iii) if this distinction is drawn, whether to facilitate payment of outstanding amounts to so-called "ransom" or critical suppliers during the procedure. The *ipso facto* ban assists in holding the business together while a restructuring is worked out, but more may be needed to restructure the operations of that business so that the company or its business can emerge from the restructuring procedure. In the US, the debtor-in-possession (in a Chapter 11 proceeding) has a set of tools enabling it to assume or terminate contracts in the course of that process. These tools do not dispense with the need to reach an agreement with the creditor, but they do shift bargaining power into the hands of the debtor. We are of the view that some of these tools may need to be added to the English corporate insolvency law toolbox, in addition to an *ipso facto* ban, particularly if there is a desire to increase the possibility of preserving operating companies as going concerns.

(ii) While issues of 'fairness' do, of course, arise in a financial restructuring, they are mitigated by the fact that the creditors are sophisticated financial creditors who had the full range of investment options open to them and who are party to detailed financial contracts which carefully allocate control rights in distress. These issues do not apply to many trade creditors, and there may be greater inequality of bargaining power between creditors in a mixed financial and operational restructuring. Indeed there will often be further subdivisions of creditors, such as between large and small trade creditors and between connected and unconnected parties. In the US this issue is dealt with by close court supervision. In the UK it has traditionally been dealt with by a division of labour between an actively engaged insolvency practitioner (for commercial issues) and the court (for legal questions), but other models are possible such as the CVA where there is a division of labour between management, the insolvency practitioner and the court. In our view, there must be some sort of 'honest broker' in a mixed operational and financial restructuring.

(iii) We are of the view that a simple approach to valuation questions in cross-class cram down is defensible in a financial restructuring, provided the approach is clear to the creditors *ex ante* and the creditors had the chance to allocate control rights appropriately in the financial contracts. However, we consider that much more difficult issues of 'fairness' may arise in valuation in a mixed financial and operational restructuring, and the court may need more active guidance to navigate the issues. This also applies to deviation from the absolute priority rule (**APR**), which is more likely to be required in a mixed financial and operational restructuring. Accordingly, we are concerned that a very light touch procedure for cross-class cram down may not be appropriate in a mixed financial and operational restructuring context.

4.5 The Way Forward

(a) We are, therefore, of the view that any new tools need to be carefully embedded in a properly worked-out and structured procedure, which carries the confidence of the participants who will use it. At the same time, we understand, and are sympathetic to, the wish not to make changes or amendments to tried and tested procedures. We would therefore like to suggest two possible ways forward which have similar objectives and which would overlap in many respects, as:

(i) each is focussed on the survival of the company as a going concern. Neither would therefore be available where the aim was to rescue a company's business, rather than the company itself;

(ii) in order to address concerns about management-displacement, both ways forward would see the reversal of the existing legislative scheme, so that powers would stay with the directors except to the extent that the insolvency officeholder determined otherwise. This should reduce costs and allow management to continue running the company, under the supervision of an insolvency officeholder, while a restructuring plan is developed; and

(iii) in order to assist the rescue process, both ways forward would see the moratorium and the *ipso facto* ban being engaged (with further thought given to the detailed operation of the *ipso facto* ban). Both would then provide a new set of tools allowing an insolvency officeholder to adopt or terminate contracts, moving bargaining power towards the debtor to facilitate new bargains so that the company can successfully emerge from the insolvency procedure and trade on.

(b) The first way forward would be to add a new Schedule to the Insolvency Act 1986 which would only apply where an administrator was pursuing the corporate rescue purpose set out in Sch B1 para 3(1)(a), whether contractually, by proposing a scheme of arrangement, by proposing a restructuring plan or by proposing a company voluntary arrangement. The new Schedule would provide that the *ipso facto* ban could be engaged in these circumstances (with further thought given to the detailed operation of the ban). It would provide a new set of tools allowing an administrator to adopt or terminate contracts, moving bargaining power towards the debtor to facilitate new arrangements so that the debtor can successfully emerge from administration and trade on.

(c) In order to address the concern that administration is management-displacing, the existing legislative scheme would be reversed, so that powers would stay with the directors except to the extent that the administrator determined otherwise. This could be done via the existing provisions in the current para 64, Sch B1 IA 1986. Paragraph 64 allows, in effect, an administrator to delegate his or her powers of management to a company's directors. However, it does not provide guidance as to the circumstances in which this might occur. We suggest that if this approach is adopted that any guidance given is not prescriptive but is some express statement that the administrator might delegate management powers in

whole or in part where here or she considers that doing so would be likely to further achievement of the rescue objective. We advocate against prescriptive guidance since experience shows that one of the attractions of the English restructuring and insolvency process to stakeholders is its inherent flexibility. That flexibility stands in contrast to the more interventionist approach taken by the courts in a Chapter 11 reorganisation. The restructuring plan proposal would be available as a free-standing procedure, for purely financial restructurings where a deeper debt write-down was required. However, if the restructuring plan was being used on a stand-alone basis, moratorium protection would be left to the finance documents and consideration would need to be given as to whether to include the *ipso facto* ban.

(d) The alternative way forward would be to create a new, stand-alone corporate rescue procedure, which could be called the 'Moratorium' but might better be labelled 'Company Rescue'. The only exits from this procedure would be a contractual restructuring of the company's debts or via a scheme, CVA or a restructuring plan which resulted in the survival of the company. Pre-pack sales would not be an option. If it became clear that such an exit was no longer feasible, the procedure would end and the company would be put into administration or liquidation instead.

(i) One of the major arguments in favour of this approach is that of simplicity – a company would either go into (i) a corporate rescue regime, the purpose of which was to save the company, (ii) what has become primarily a business sale regime (administration) or (iii) a liquidation procedure. If the company went into "Moratorium/Company Rescue", suppliers, customers, employees, other stakeholders and the press should all know that the outcome currently being worked on was the survival of the company.

(ii) This procedure would require an insolvency practitioner or similar officer, the "monitor", who could propose a restructuring plan, having developed it in consultation with the company's management team. As with the previous option, powers would be left with the directors except to the extent that the monitor determined otherwise. Moratorium protection would be engaged, and an *ipso facto* ban provided for. However, other powers which an administrator currently has, and which we consider a monitor would need, such as the power to pay critical suppliers for pre-filing liabilities, would be built into the procedure.

(iii) In essence, the monitor would have many of the same powers and duties as an administrator (they should, for example, be subject to equivalents to actions under Paras 74 and 75 of Schedule B1). In addition, case law relating to administrators should, where relevant, apply equally to the monitor. There would, however, be obvious technical challenges in implementing this.

(e) The route suggested in paragraphs (b)-(c) maintains the *status quo* but provides an administrator with the tools which are needed for a corporate restructuring when pursuing the company rescue purpose in Sch B1 para 3(1)(a) of the Insolvency Act 1986 with a view to making administration fit for purpose not only as a business rescue tool but also as a corporate rescue tool. The route suggested in paragraph (d) accepts that in practice administration is no longer equated with the survival of the company, as it is generally only used for the purposes provided for in Sch B1 para 3(1)(b) and 3(1)(c) (selling the business and assets, or assets) and that the purpose in para 3(1)(a) should now be pursued through a separate procedure. We would be very happy to discuss the pros and cons of each approach with you, if that were helpful.

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APPENDIX 1

MORATORIUM PROPOSAL

1. GOVERNMENT RESPONSE - SUMMARY

1.1 Entry requirements

(a) The entry into the new moratorium will be triggered by filing papers at court, similar to those for an out of court appointment of an administrator. The monitor will need to file his/her consent to act and confirm that they have assessed the eligibility tests and qualifying conditions and are satisfied that these have been met.

(b) The Government believes that the test for entry into a moratorium should exclude companies that are insolvent. The test on financial state should be one of prospective insolvency, i.e. based on the requirement that a company will become insolvent if action is not taken. It is intended that this prevents the process being abused by healthy companies with minor short-term cash flow issues.

(c) The test for whether the moratorium can be entered into is that rescue is more likely than not. It will be for the proposed monitor to assess whether or not a company meets this condition.

1.2 Who is eligible

(a) A company must have sufficient funds to carry on its business during a moratorium, meeting current obligations as and when they fall due as well as any new obligations that are incurred in the moratorium. It will be for the proposed monitor to assess whether or not this condition is met.

(b) The Government's intention is to exclude companies falling within the scope of the exceptions listed in paras 4A to 4J of Schedule A1 to the Insolvency Act 1986. The Government has also considered the issue of the Financial Collateral Arrangement Regulations and agrees that companies within the scope of these regulations should not be eligible for a moratorium.

1.3 Duration and anticipated outcome

(a) The moratorium will last for an initial period of 28 days, which may be extended. This allows a company reasonable time to explore possible rescue options.

(b) The initial 28-day moratorium can be extended up to a further 28 days by the company, but the monitor must confirm that the qualifying conditions continue to be met. The monitor would then be required to notify creditors of the extension.

(c) It will be possible to extend the moratorium beyond 56 days, but the Government appreciates that suspending creditors' rights beyond 56 days should only take place where there remains a good prospect of achieving a better outcome for creditors than might otherwise be possible. Such extensions must therefore be approved by creditors, both secured and unsecured. The required threshold for approval will be more than 50 per cent of secured creditors by value and more than 50 per cent of unsecured creditors by value. The Government also intends to allow the company to apply to court to extend a moratorium (much in the same way as it may extend the period of an administration) if there are situations where seeking consent for an extension from creditors is impracticable.

(d) Where a monitor concludes that a company no longer meets the qualifying conditions, he or she will immediately seek the termination of the moratorium.

(e) It is expected that a typical outcome from a moratorium is that a company agrees a consensual restructuring with its creditors or it enters an insolvency procedure (either a rescue procedure or a liquidation procedure).

1.4 **Challenge to the moratorium**

The Government intends to allow creditors to challenge the moratorium at any time during the process. There is a well-established body of case law where creditors have applied to court to have an administration moratorium lifted and the Government will take a similar legislative approach. However, unlike administration, the monitor will not be able to consent to actions that contravene the effect of the moratorium – the company has to consent or else the creditor has to seek permission from the court.

1.5 **Moratorium monitor**

(a) Only an insolvency practitioner can act as a monitor. The company's directors remain in control of the company's operations during the moratorium, and consequently the role of the monitor will be limited in scope to functions necessary to support the integrity of the moratorium process and to ensure that creditor interests are protected.

(b) As an additional safeguard for suppliers and creditors, the monitor will be required to sanction any sale or other disposal of assets outside the normal course of business during the moratorium.

(c) There is no prohibition on insolvency practitioners providing additional services to a company in a moratorium, such as restructuring advice or consultancy services.

(d) The monitor will be an officer of the court.

(e) There will be a prohibition on the monitor taking an insolvency appointment within 12 months, but this will only apply in the case of administration and liquidation of the company to which he or she was appointed as monitor. The monitor will be permitted to take a subsequent appointment as a supervisor in a CVA of the company concerned.

1.6 **Following termination of a moratorium**

(a) Following termination, creditors will again have full rights to enforce their debts. Monitors will have immunity from claims stemming from erroneous termination, providing that they acted in good faith.

2. **ADDITIONAL INSOLVENCY SERVICE QUESTIONS**

During the various meetings with the ILA Committee and the CLLS Insolvency Sub-Committee, the Insolvency Service asked the following questions:

(a) What is wrong with Schedule A1? The Schedule A1 small company moratorium ahead of a CVA has been little-used since it was inserted into the Insolvency Act 1986 in 2000. We have been told that this is due to issues in the legislation itself- we are interested to explore this further (with reference to the specific paragraphs in Schedule A1 (or Rules in IR16) that present these problems).

(b) Government does not want creditors' position to worsen in a moratorium and the response states that the company must be able to meet its ongoing (i.e. in the moratorium) obligations when they fall due (para 5.33, p48). We do not want there to be confusion on what 'falling due' means (particularly if this could lead to companies managing entry into the process specifically to avoid a debt 'falling due' within it) and wonder if wording like para 7(1)(e)(ii) Sch A1 might be a helpful form of drafting to avoid such issues (though we are obviously

interested to know if this was one of the issues practitioners had with Sch A1) and would welcome views.

(c) The August response (para 5.55, p52) stated that creditors/court should be able to extend a moratorium beyond 56 days. We would be interested in views on any maximum length that this extension could be for (we note that the European Commission's draft directive on preventive restructuring frameworks is proposing a 12-month maximum length).

3. OUR OBSERVATIONS

3.1 Summary

(a) We have been unable to answer all of the Insolvency Service's questions in a meaningful manner, because we have reservations concerning the general principles under which the new moratorium proposal are intended to operate. We highlight the following, specific areas of concern:

(i) Generally: what is the purpose of this proposed moratorium, in the context of the existing restructuring and insolvency framework established by existing legislation and market practice?

(ii) Specifically: which companies would want to use the new moratorium process, given that it is intended to apply to companies which are:

- not then insolvent (or perhaps not even likely to be become insolvent); and
- which have the liquidity to pay their debts for the proposed moratorium period, as they fall due.

(b) Put another way, if a company is not yet insolvent and has sufficient liquidity to pay its debts as they fall due for the next 28 days (or, perhaps, 56 days) then what purpose is the moratorium intended to serve and which companies would want to take advantage of it? A moratorium is generally considered as a 'breathing space' that prevents creditor enforcement for a period of time whilst a wider plan (or realisation process) is proposed and/or implemented. If the company is 'solvent' and is prospectively capable of paying its debts as they fall due, then which creditors are realistically in a position to enforce their debts, which the moratorium would be seeking to address? This is a key point, as, unless there is immediate creditor pressure, a well advised director is unlikely to enter into the moratorium process, given the potential impact on customer, supplier and credit insurer sentiment of admitting that the company will become insolvent unless it can be rescued.

(c) Against that context, we comment on the following:

(i) the **financial test for entry** into the new moratorium process;

(ii) the **requirement for a company to be able to pay its debts**, **as they fall due, during the moratorium period** and what this might mean in practice; and

(iii) the **role of the monitor**.

3.2 The financial test for entry

(a) We believe that the financial test for entry requires careful consideration for the following reasons:

(i) it needs to be **easily understandable**, so that users of the process (and their advisers) can clearly understand whether the process is available; if it is not clear-cut,

then significant time and effort will be spent analysing the entry test and any uncertainty will give rise to litigation and expense, which could be avoided; and

(ii) **if eligibility is too 'early' in the decline process then the moratorium will be of no use** (see above) and if it is on the cusp of insolvency then it would be similar to the administration test ("..is or is likely to become unable to pay its debts").

(b) On the first point, we flag that the test of "unable to pay its debts" is a difficult one to interpret, in light of recent case law. It might be relatively easy to determine when a company "is or is likely to become unable to pay its debts"[2], but proving the opposite, for a company in decline, might be difficult. This is because the forward-looking nature of the test (see the *Eurosail* and *Cheyne Finance* line of cases) makes it difficult to establish over what period the test might apply.

(c) Other potential formulations, for discussion, might be a variant of the wrongful trading test (for example, a company is in financial decline, but which has a reasonable prospect of avoiding an insolvency process, if the moratorium were used). Alternatively a test along the lines of that set out in the EU draft directive could be considered: " 'likelihood of insolvency' means a situation in which the debtor is not insolvent under national law but in which there is a real and serious threat to the debtor's future ability to pay its debts as they fall due."

(d) That said, we consider that the second question is the starting point – namely, what is the purpose of the process? It is necessary to start with what is intended to be achieved – and the scenarios in which this process is intended to apply – rather than working back from the test to establish the process.

(e) The policy issue, therefore, is what existing 'gap' is this intended to plug, or indeed what 'improvement' is this intended to make? We accept the general principle – often repeated for good reason in the restructuring community – that earlier intervention often achieves better results. However, we question here what the moratorium is intended to achieve, where the company is not then unable to pay its debts. (See in particular section 4.5 of the Introduction to this for suggested alternatives to the proposed Moratorium which should have a greater practical impact.)

(f) We are aware of the Government's desire to implement a moratorium process at least in part in order to enhance World Bank rankings. However, we are concerned that any new moratorium process should not be designed purely for that purpose: it must also be right for the UK's insolvency regime, and not inadvertently damage lending and capital markets. Any new moratorium process must both fill a need that exists in our current restructuring and insolvency regime, and dove-tail with existing procedures.

3.3 **The requirement for the company to be able to pay its debts during the moratorium period**

(a) As identified by the Insolvency Service's requests, as well as begging the question of what the moratorium is intended to achieve, this gives rise to potentially illogical outcomes. For instance:

(i) if a large debt falls due just <u>before</u> the moratorium commences, could a company 'time' its entry so that debt became subject to the moratorium and remained unpaid (assuming for these purposes that a large unpaid debt which became due just prior to the moratorium did not preclude the company from entering the moratorium – see comments on entry test above)?

[2] i.e. it is then insolvent or imminently to become so.

(ii) conversely, creditors with large debts falling due for payment during the process might be entitled to receive their payment, in full, but where the services they have provided fall partly outside the moratorium period (or, potentially, wholly outside the moratorium period if the invoice relates solely to a pre-moratorium supply), they might not.

(b) This issue has, to some extent, already been grappled with by the courts in the context of whether rent is payable as an administration expense (see the *Goldacre* and *Game* line of cases). The first instance cases reached differing conclusions (and led, anecdotally, to different approaches to the issue being taken by tenants, insolvency practitioners and landlords), until the Court of Appeal determined that the apportionment approach was the correct one.

(c) It is submitted that, if the intention behind this aspect of the moratorium process is to ensure that creditors are paid for their post-moratorium supplies, then a similar approach could be taken here. That would address 'ordinary' (or time-based) supplies, but careful thought would also need to be given to 'financial' liabilities.

3.4 **Role of the monitor**

(a) One of the main criticisms of the Schedule A1 process is that the obligations imposed on the nominee are too imprecise, wide-ranging and potentially burdensome. We fear that the same might apply here, and it is critical that the monitor's role (and liability) is clearly defined. It is important to avoid creating a role that would leave the monitor in office, but not in power, since this would not maintain an adequate debtor / creditor balance. In addition, such an outcome, combined with the consequent reputational risk, would probably deter many insolvency practitioners from taking on the role.

(b) Finally, we note that a monitor would be precluded from accepting a subsequent appointment as administrator or liquidator to a company where he or she had acted as monitor (although it has been suggested by the Insolvency Service during our meetings that someone else from the monitor's firm might be able to take that appointment). The monitor role might therefore be one which duly qualified insolvency practitioners may be unwilling to accept, particularly given the other concerns outlined above. We understand the conflict (and, importantly, perception of conflict) issue, but that has to be balanced against having a regime that is fit for purpose in its chosen market.

(c) There might also be a risk that monitors (who are not precluded from providing restructuring advice during the moratorium), might, for their own purpose, be biased towards a CVA or a scheme, rather than administration or liquidation, because in the case of the former, the monitor is not precluded from continuing to act.

JOINT ILA/CLLS ISSUES PAPER
INSOLVENCY AND CORPORATE GOVERNANCE PROPOSALS AND CORPORATE INSOLVENCY REGIME REFORMS (2018/2019)

APPENDIX 2

IPSO FACTO PROPOSAL

1. GOVERNMENT RESPONSE – SUMMARY

1.1 In the previous 2016 proposal, the idea was to designate certain suppliers as essential and to apply the *ipso facto* ban to those suppliers. The Government Response departs from this original concept, on the grounds that the essential supplier proposal proved too problematic in terms of cost, speed, fairness and impact on SME suppliers (as well as the difficulties in defining essential suppliers).

1.2 Instead, the Government announced plans to "**legislate to prohibit the enforcement of 'termination clauses' by a supplier in contracts for the supply of goods and services where the clause allows a contract to be terminated on the ground that one of the parties to the contract has entered formal insolvency**" [5.97].

1.3 The response provides that "suppliers will retain the ability to terminate contracts on any other ground permitted by the contract. These would include … any other ground that gave rise to termination, **save for those connected with the debtor company's financial position**, or the fact it had entered a moratorium, restructuring plan or insolvency procedure" [5.99]. This implies that *ipso facto* clauses linked to the debtor's financial position will be restricted, in addition to clauses triggered by formal restructuring or insolvency proceedings.

1.4 The response acknowledged that **certain types of financial products and services represent special cases** and therefore accepted that there are grounds for exempting such products and services (but with no further details) [5.102].

1.5 **Licences, such as for use of software or patents, will be covered** by the *ipso facto* provisions, but not licences issued by public authorities [5.104].

1.6 **Hardship: as a safeguard of last resort**, in rare cases where a supplier will be in a position that it is significantly adversely affected by not being able to rely on a contractual termination clause, it will be allowed to exercise such a right (on application to court) on the grounds of **undue financial hardship**.

1.7 **Personal guarantees** should **not** be required where a supplier continues supplies, due to not being able to rely on insolvency-related termination clauses.

2. EXISTING REGIME (s233 and s233A IA 1986)

2.1 The existing regime already contains an 'essential supplier' provision (s230 IA 1986) and one *ipso facto* provision (s233A IA 1986), albeit that s233A is one limited in its application to the supply of the same 'essential services' that are protected by the s230 obligation to supply.

2.2 S233 and 233A IA 1986 are currently designed to enable an administrator or liquidator to either continue to trade or, alternatively, wind-down the debtor's business by ensuring the continued supply of, and preventing the termination of, utilities and essential contracts such as IT suppliers and electronic payment providers. Unlike s233, s233A does not extend to companies in liquidation.

2.3 We understand, from the Insolvency Service's comments at our meetings, that the existing essential supplies regime is thought to be too cumbersome, with too much court involvement, and that there is a concern that it is not used enough. Accordingly, the *ipso facto* reforms are intended to build out (but not replace) the existing regime.

2.4 In our view, any new *ipso facto* provision of more general application should not simply sit alongside s233A. In the absence of some compelling reason based on the nature of the supplies in question, there should be just one *ipso facto* provision in the legislation. This is to promote the coherence of

the legislation and to avoid both any potential questions about which provision applies and unintended anomalies.

3. ADDITIONAL INSOLVENCY SERVICE QUESTIONS

3.1 In our meetings with the Insolvency Service, the following questions have been posed:

(a) The Government Response said that clauses that terminate supply on an insolvency event would be unenforceable. Should a clause for termination on grounds of non-payment still be allowed to take effect (para 5.99, p61 gives the Government's position on this point but we would welcome views)?

(b) Should an insolvency-related clause that does something other than termination be included/excluded (e.g. require higher payments when supplying the company should it become insolvent)?

(c) Para 5.100-5.101 of the Government Response state that exemptions from this provision will be needed in certain areas. We would be interested to hear your views as to what these areas should be.

4. OUR OBSERVATIONS

4.1 Summary

(a) At the ILA meeting with the Insolvency Service, we understood that the policy objective behind this aspect of the proposed reforms is to improve:

(i) the UK's position in the World Bank's Doing Business rankings - we note that the rankings evaluate (among other things) whether the insolvency framework allows the continuation of contracts supplying essential goods and services to the debtor[3]; and

(ii) the prospect of rescue of financially distressed companies.

(b) To expand on this, we suggest that, in contrast to the existing s233/s233A IA 1986 regime, which is aimed at facilitating the insolvency process, the policy objective of a new *ipso facto* regime should be to preserve business critical contracts in a company rescue scenario.

(c) It follows that any *ipso facto* tool should apply to only those procedures capable of delivering rescue, and only so long as a rescue is still viable.

(d) We agree that a new *ipso facto* provision could be a useful tool for company rescue, particularly in an operational restructuring, if combined with a well-designed restructuring plan, a CVA, a rescue administration, or (possibly) a scheme of arrangement because it would have the effect of shifting bargaining power towards the debtor to help negotiate the continuity of business critical relationships in the period beyond the end of the rescue process. An *ipso facto* tool cannot, however, replace the need to come to a commercial agreement with critical suppliers post rescue (see also Introduction, paragraph 4.5).

(e) Although there are concerns about applying an *ipso facto* tool to a stand alone moratorium, in practice, there is little point building an *ipso facto* tool into the restructuring plan, a CVA or administration if it can be by-passed during a prior moratorium. However, the way in which the tool operates in respect of a moratorium, which will have fewer creditor protections and less oversight, and will be administered largely by directors who have little experience and expertise in restructuring processes (rather than officeholders who are officers of the court), will need to be carefully considered, and may need to be different than for the other

[3] See page 56 of the World Bank's 2019 Doing Business profile for the UK.

more comprehensive procedures that lead directly to a rescue outcome. Such concerns would, however, be addressed if either of the two alternatives set out in paragraph 4.5 of the Introduction to this paper were to be adopted, as creditors would have the same protection that they would have had in an administration.

(f) Careful consideration must also be given to the scope of the provision, and to necessary carve-outs.

(g) In formulating these observations, we have drawn on the *ipso facto* regime that has existed for many years in the US Chapter 11 regime, and also from the very new Australian provisions that came into force last summer. Whilst there are elements of the US *ipso facto* tool that may be needed in a UK regime (touched on in the Introduction), the English restructuring and insolvency regime is very different to the heavily court-based US "debtor in possession" Chapter 11 process. Hence a different version of the *ipso facto* will be needed to ensure that it is consistent with the less interventionist United Kingdom regime. Our view is that the *ipso facto* tool in the UK should operate as a suspension of rights, rather than by terminating those rights completely, with adequate creditor protections to prevent the tool being used oppressively.

4.2 **To which contracts should the *ipso facto* reforms apply?**

(a) **Governing law**: We understand the Insolvency Service's position is that the restriction should apply to relevant contracts irrespective of governing law, where the company is subject to a UK insolvency/restructuring procedure. This may not be 100% effective in cross-border situations, particularly where there is no automatic recognition of UK insolvency proceedings post Brexit.

(b) **Goods and services**: We note the stated intention for the new restriction to apply only to contracts for the supply of goods and services. With the exception of a small number of very large 'just-in-time' supply chains, the majority of contracts for the supply of goods and services in the UK result from one-off orders, where an *ipso facto* tool will not be relevant because there will be minimal or no outstanding supply obligations to terminate (or to the extent that supply contracts are not already drafted in this way, they will be after the introduction of an *ipso facto* tool).

(c) The response already mentions **licences** (including of intellectual property), which can often be critical to the survival of the company through a rescue or insolvency process. This is an area in an operational restructuring where the *ipso facto* tool is likely to be more beneficial, although this is also an area where any potential overlap with the existing S233A IA, should it remain in force, would be particularly problematic.

(d) **Other counterparties**: We note the stated intention for the new restriction to apply only to suppliers. For the reasons related to those in sub-paragraph (b) above, and as in the US and Australia, it would be beneficial to extend the *ipso facto* tool to customer contracts and other counterparties (with adequate protections).

4.3 **To which insolvency/restructuring procedures should the new *ipso facto* provision apply?**

(a) In light of its business rescue purpose, the *ipso facto* provision should only impact clauses triggered by formal insolvency or restructuring processes whose objective is rescue. This could include company voluntary arrangements and the new restructuring plan (subject to there being adequate supervisory protections, or possibly only in conjunction with a moratorium); we explore its application to other procedures below.

(b) **Moratorium**: The Insolvency Service will recall from the ILA meeting that certain of us were concerned that the *ipso facto* restriction should not restrict termination based on a company's entry into the moratorium. However, views were divided on this. On the one hand, if the *ipso*

facto tool is to be of any help in a subsequent restructuring plan or CVA (for example) it will be necessary to apply the tool to the preceding moratorium. On the other hand, the moratorium is stand alone, short, and very light touch in terms of office holder or court supervision. It may be difficult to adequately protect creditors, particularly in an operational rescue where many of the affected suppliers could struggle to fund a continued supply without being paid any arrears, and may not have the means to bring a challenge to court. The introduction of either of the two alternatives set out in paragraph 4.5 of the Introduction to this paper should, however, largely address these concerns.

(c) **Liquidation**: The *ipso facto* tool should not apply to termination provisions triggered by liquidation, because liquidation almost always results in the business ceasing to trade immediately (i.e. there is no rescue). The exception to this could perhaps be a Carillion-style liquidation, where it might be useful to have *ipso facto* protection. Perhaps the provision could provide for *ipso facto* protection to be available in liquidation only at the discretion of the court, rather than automatically.

(d) **Administration**: A general *ipso facto* provision should only apply in administration while there is still a prospect of company rescue. Slightly different considerations apply if it is intended to apply a general *ipso facto* provision to business rescue rather than restrict it to company rescue, which are not explored here since the focus of the Government Response is company rescue.

(e) **Schemes of arrangement**: The question of whether the ipso facto provisions should apply in the context of schemes is more difficult. For the reasons given in the Introduction re the restructuring plan, where schemes are used to achieve a restructuring of financial indebtedness at the holdco level, the terms of the finance documents should provide the necessary protections without the need for an *ipso facto* provision. Also query whether a party should be required to continue to supply where it will not be paid for that supply under the proposed scheme (although if this was the case, it might provide the creditor with grounds to challenge the scheme on the basis of unfairness). On the other hand, in a creditor scheme of arrangement in which the alternate comparator is insolvency proceedings, there is a greater argument for inclusion of the provisions.

4.4 **What precisely should be the restricted grounds of termination?**

(a) Since the purpose of the provision is preserving business critical contracts during a rescue procedure, the prohibition should be limited to termination clauses triggered directly or indirectly by the rescue procedure itself or by proxy events for the commencement of proceedings. Care must be taken to frame the provision broadly enough to prevent evasion of the tool by drafting around it, but not to frame it so broadly as to allow the scope for abuse by unscrupulous debtors. A trigger based on the company's financial condition alone, not coupled with the existence of a rescue procedure, would be too broad, for example. A good precedent might be s 48Z(6)(b) of the Banking Act 2009

(b) The *ipso facto* restriction could be framed along the lines of:

> *'For the duration of [*define the period during which the *ipso facto* restriction should apply] a *contract cannot be terminated [or modified - discussed below] on the grounds of:*
>
> *(a) the company's entry into administration [(or filing of a notice of intention to appoint an administrator)], filing for a moratorium or proposal of a company voluntary arrangement, restructuring plan or a creditors' scheme of arrangement (if the alternate comparator in the scheme of arrangement is insolvency proceedings); or*

(b) the occurrence of any event directly linked to the proceeding or action referred to in paragraph (a)[4].

(c) Consider also "direct or indirect" wording e.g. 'a contract cannot be terminated directly or indirectly on the ground that the company has entered administration / filed for a moratorium…" although it is less clear on its face than the Banking Act provisions cited above.

4.5 **Does there need to be a mechanism to facilitate adoption or rejection of *ipso facto* affected contracts?**

(a) Chapter 11 has machinery dealing with assumption, rejection and termination of contracts. Under the US mechanism the debtor has an 'election window' (effectively until the chapter 11 plan is confirmed, which usually takes about three months but can be much quicker in the case of a "pre-packaged" plan) within which it can decide whether to assume or reject the contract. In practice, this is likely to be too long and heavy-handed to be workable in a UK context, with the currently envisaged procedures (particularly a moratorium). For a general *ipso facto* tool to work in the UK, we should consider whether we want to adopt a similar mechanism to the US one, or whether a more flexible approach would suit better.

(b) We suggest that the Government models the new *ipso facto* tool on the current mechanism used for disclaimer. For contracts to which the *ipso facto* tool applies, termination rights should be suspended upon commencement of the relevant procedure. However, an affected counterparty would be permitted to serve, say, a 28 day notice, during which time the debtor has to decide whether to adopt the contract. If the debtor does not choose to adopt the contract within the relevant period, the right to terminate would revive. Revival of the termination right should not give rise to any prioritised expense claim or immediate right to payment. In other words, the operation of the notice would not have any *Lundy Granite* style implications.

(c) Consequences of a decision to adopt the contract need to be carefully considered. For example it could give the supplier the right to be made whole for any arrears (as it does in the US). It is arguable that, in order to procure the creditor's agreement to continue to supply past the end of the rescue procedure (which is presumably critical to the company's future else why would it adopt the contract at all), a deal will, in any event, need to be done in respect of any arrears. On the other hand, giving such creditors the automatic right to historic arrears may provide suppliers with unfair leverage, potentially at the cost of floating charge holders. The reforms are intended to provide a debtor with a period of time within which to renegotiate and restructure its relationship with its creditors. If suppliers are entitled to demand payment of historic arrears as a condition of continuing to supply, this strategic advantage could potentially undermine the purpose of the proposed reforms.

(d) The length of the 'election window' or notice period would need to fit all the procedures in which the *ipso facto* provisions would operate, including potentially the 28-day light touch moratorium, whilst at the same time, giving the company a sufficient time to work out which contracts are genuinely needed to facilitate its rescue plan.

4.6 **Should termination on grounds of non-payment be permitted?**

(a) **Non-payment for post-petition supplies**: we understand, following our meeting, that the Insolvency Service's position is that the supplier should be able to terminate the contract in the event of non-payment for goods/services supplied following the insolvency trigger.

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[4] The wording in (b) is based on section 48Z(6)(b) of the Banking Act 2009. An alternative would be the Australian language which switches off a trigger based on "a reason that, in substance, is contrary to this section" although there would be less clarity as to when this would apply,

(b) **Non-payment of 'pre-filing' arrears**: This issue has generated much debate. Some felt strongly that if a contract is adopted, then the counterparty should be made whole, and as an expense of the relevant procedure. This would provide protection for trade creditors in an operational restructuring who may not have the means to continue to supply and yet also may not be in a position to launch a court application on hardship grounds. Others felt equally strongly that giving counterparties whose arrears are not paid the right to terminate their contract gives too much bargaining power to the creditors and may defeat the rescue purpose.

Relevantly:

(i) Payment of certain pre-insolvency arrears already happens in administration where business critical suppliers demand (and receive) ransom payments as a condition of continuing to supply. We consider it important this practice be permitted to continue, both in administration and in other contexts.

(ii) There may be some concerns about letting directors, in a debtor-in-possession process, decide to pay off all outstanding payment arrears without limitation, especially in the absence of much supervision from the court or an insolvency office holder. This would be less of a concern either of the two alternatives set out in paragraph 4.5 of the Introduction to this paper were to be adopted, as the insolvency officeholder could act as the "gatekeeper" for such decisions, with aggrieved parties having an ability to apply to court if the officeholder had acted inappropriately.

(iii) Genuine payments of pre-filing arrears in respect of *ipso facto* elected contracts would need protection from clawback as an unlawful preference, if the company later were to enter into administration or liquidation.

(iv) We could provide that if the debtor elects to adopt the contract, pre-insolvency arrears must be paid in full, with adequate assurance of future payments as a priority expense of the proceedings. Otherwise, if the debtor elects to reject the contract, the supplier should have the right to terminate the contract. Or the payment of arrears could be left to the negotiation about the post-rescue process relationship.

(v) Alternatively, we could draw on the continuity of supply provisions in The Investment Bank Special Administration Regulations 2011. Regulation 14(3) provides that, where, before the commencement of special administration, a contractual right to terminate a supply has arisen but has not been exercised, then the commencement of special administration shall cause that right to lapse. The supply may only be terminated if another ground of termination arises:

(A) charges in respect of the supply (post-commencement of the special administration) remain unpaid for more than 28 days;

(B) the administrator consents to the termination; or

(C) with court permission, if the supplier can show that the continued provision of the supply causes financial hardship (see Regulation 14(2)(a)).

However, it should be acknowledged that, in the special administration regime for investment banks, this provision only applies to essential supplies; it is difficult to see the policy objective behind a wider application of this principle.

4.7 **Should the *ipso facto* provision also prohibit contract modification as well as termination on grounds of an insolvency procedure?**

(a) This is a policy question about the extent to which rescue principles should override freedom of contract principles.

(b) We can see arguments for the *ipso facto* restriction to apply to provisions which, based on an insolvency/restructuring trigger:

(i) require significantly higher payments; or

(ii) impose more onerous terms on the company e.g. payment on delivery as opposed to standard terms.

(c) Note that the US Chapter 11 regime generally prohibits the termination or modification of executory contracts and unexpired leases based on *ipso facto* clauses (11 U.S.C.§ 365).

(d) Arguably, enforceability of such clauses penalises debtors and potentially damages the prospect of rescue. However, it is understandable that suppliers will want to avoid additional (and, almost invariably, unsecured) exposure to a company in difficulty.

(e) Accordingly, on balance, we recommend that the new provisions should only restrict contract modifications that impose substantially higher payments or otherwise impose substantially more onerous terms on the company. Some increase in payments or shortening of credit periods would seem reasonable in the circumstances in some contracts, for example in finance contracts, which habitually contain default interest and payment acceleration terms in the event of default (but see also our recommendation to carve out finance contracts from the *ipso facto* provisions altogether, see 4.8).

(f) This is a difficult point to get right and will inevitably involve some sort of reasonableness test, or a test requiring an assessment of what is 'substantial' in this context. Care needs to be exercised to ensure that parties do not insert unrealistic provisions into agreements in order to 'game the system'. For example: requiring payment on delivery should not ordinarily be restricted - but imagine a clause in a supply contract which provides that, upon the customer's entry into restructuring/insolvency proceedings, the customer will be deemed to order 10 times the quantity of its previous order and must pay for the goods upon delivery. Such a clause would likely oblige the insolvent customer to immediately terminate the contract itself, to avoid oversupply/cash flow issues. This might be akin to an indirect *ipso facto* clause. Other areas of English law, such as the anti-deprivation principle and (what remains of) the law on penalty clauses, might provide some protection for debtors in this situation. However, this would put the onus on the financially distressed debtor to bring a case, as opposed to restricting the supplier from exercising the termination right in the first place.

4.8 **Carve outs/exemptions**

(a) There should be a blanket carve out for **finance arrangements**. In practice, no rescue process will take place without the support of majority lenders and so nothing is lost by carving them out. To include them will cause great panic and resistance. We note, however, the difficulty in defining finance arrangements as was seen with the recent debates on the Business Contract Terms (Assignment of Receivables) Regulations 2018.

(b) Great care must be taken with the carve-outs; for example defining what constitutes a finance arrangement may not be clear-cut. Consider the example raised at our meeting: is a large gas futures contract a supply contract or a finance arrangement?

(c) When drawing inspiration on *ipso facto* carve-outs from other jurisdictions, it must be borne in mind that each regime operates as a whole. In particular, in the US, the *ipso facto* regime operates alongside the automatic moratorium, which does extend to finance arrangements.

(d) Other exemption candidates include **financial products and services such as close-out netting; rights of set-off; rights of termination under a standstill or forbearance agreement** notwithstanding these may all be very difficult to define accurately.

(e) We also note the proposal to exclude **licences/permits/approvals issued by a government authority**. We understand, from our meeting, that the rationale for this is that licences are there to protect the public, and it was felt that there is less risk of the government holding a company to ransom. Nonetheless, we question whether this provision can really be justified.

(i) The fact that the Government should not hold a company to ransom does not mean that government licensing bodies will be supportive of rescue attempts. For example, historically HMRC has a record of not supporting CVAs.

(ii) Even if the Government does not hold the debtor to ransom, the fact that a licence may be terminable may cause cross-defaults in other contracts (which could bring the house of cards down).

(iii) The *ipso facto* proposals, if enacted, significantly impact commercial freedom of contract. If there is a public protection need to terminate a public licence in rescue circumstances, it will almost certainly be terminable upon other existing grounds, without the need to rely upon insolvency termination. And if the public interest is not threatened by the continuation of the licence in rescue proceedings, it is hard to see why a public licensing body should be exempt. Why should the government not accept similar constraints on its own freedom to terminate as those it wants to impose upon private counterparties? The government licence is likely to be more important than any other contract for goods or services: the business is unlikely to be able to function without it and there is no alternative "supply". Consequently, government licenses should be included in the scope of the *ipso facto* reforms, subject to a carve-out permitting an authority to terminate a licence where necessary on grounds of public protection.

(f) **Property/leases:** introducing *ipso facto* ban to leases requires further consideration. It would interfere with long-established principles of forfeiture, and more recently established rules on payment of rent as an administration expense, for example. It is questionable whether an *ipso facto* prohibition is really necessary for leases, or whether it could destabilise the commercial property market. Further consideration would also need to be given to how the *ipso facto* prohibition on termination might apply in the context of a landlord CVA.

4.9 **Should the new *ipso facto* provisions apply to existing contracts, or only those entered into after it comes into force?**

(a) We note that s233A applies only to contracts entered into following the effective date of the legislation (see s233A(10); effective from 1 October 2015). This means existing suppliers can still rely on contractual provisions which e.g. allow for higher payments triggered by entry into insolvency proceedings. Similarly, the recent *ipso facto* reforms in Australia only apply to contracts entered into from the effective date.

(b) There are clearly advantages in having a new *ipso facto* tool extend to existing contracts, in order to ensure that those of the reforms given legislative force can take effect as soon as possible. Any distinction between contracts entered into before and after the effective date of the new legislation would:

(i) lead to confusion (as IPs would have to determine, quickly, to which of the company's contracts the *ipso facto* provisions apply);

(ii) create uncertainty, especially as to whether a substantial variation to an existing contract (perhaps with the goal of avoiding being caught by the new regime) should be deemed to be a new contract; and

(iii) given the longstanding nature of some supply contracts, mean that the benefit of the legislation could take many years to take effect.

(c) However a compromise position could be to use a transition period: for example to allow variations of existing contracts not to be caught by the *ipso facto* restriction, but for this "grandfathering" exception to be time-limited e.g. to 2023. A similar transition was used for the introduction of the recent Australian reforms.

(d) This proposal has the benefit of protecting existing contracts (and minimising public law issues which might otherwise arise), whilst ensuring the new regime is effective within a reasonable time.

(e) This would mean that from, say, 1 January 2023:

(i) parties to contracts entered into before the effective date of the reforms and which had not been amended in the interim would still be able to rely on *ipso facto* clauses;

(ii) parties to contracts entered into before the effective date of the reforms and which had been amended in the interim would no longer be able to rely on *ipso facto* clauses; and

(iii) parties to contracts entered into on or after the effective date of the reforms would, of course, not be able to rely on *ipso facto* clauses.

(f) For these purposes, "amended" would have to be drafted widely to include e.g. novated, assigned, varied etc.

4.10 **Practical issues**

(a) The *ipso facto* proposal needs to take into account practical limitations. For example a restriction on enforcement of *ipso facto* clauses is unlikely to be effective in forcing an unwilling SME supplier of goods to continue to supply. Despite being under a legal duty to do so, smokescreens could relatively easily be employed to delay or avoid delivery, without actually outright refusing. In a 28 day moratorium, the debtor company is unlikely to have much redress.

(b) However, this need not be problematic since the main purpose of the *ipso facto* provision is to preserve the contract in order to rescue the business. If the reluctant supplier can be brought back on side for when the company emerges from rescue with the contract intact, then the provisions will have served their purpose.

(c) There are concerns about the ability of ordinary directors in a debtor-in-possession process to be able to administer the *ipso facto* tool properly and fairly, including whether and when to pay arrears (as a ransom payment, or potentially as a result of a decision to adopt a contract), in the absence of much supervision from the court or an insolvency practitioner. This is one of the reasons we have suggested in the Introduction that deeper operational restructurings require greater oversight by an insolvency office-holder.

APPENDIX 3

RESTRUCTURING PLAN PROPOSAL

1. GOVERNMENT RESPONSE – SUMMARY

The Government proposed introducing a new restructuring plan that would allow a company to bind all creditors, including junior classes of creditors even if those creditors voted against the plan, through the use of a cross-class cram down provision. Such a cram down could be imposed provided dissenting classes of creditors were no worse off than they would be in liquidation. The classes of creditors would be proposed by the distressed company on a case by case basis. For a class to vote in favour, 75 per cent of a class by value, and more than 50 per cent of the total value of unconnected creditors (within the class), would have to agree to the plan.

1.1 Eligibility

There will be no financial entry criteria – although some companies will be excluded from filing for a restructuring plan, mirroring the type of companies currently excluded from eligibility for the small company CVA moratorium, namely those involved in specific financial market transactions, and any similar undertakings.

1.2 Process

(a) The process will closely resemble that for schemes of arrangement under the Companies Act 2006 (**CA 2006**). A restructuring plan proposal will be sent to creditors and shareholders and filed at court – the Government has "something like the explanatory statement used in schemes" in mind as a means of assisting creditors and shareholders in reaching an informed view of the merits and demerits of the proposal. The Government believes that it is unlikely that anyone other than the debtor will be in a position to file a plan, at least in the first instance. Creditors and shareholders will, however, have the ability to submit a counter-proposal if they disagree with the directors' proposal. There will be minimal prescription of what type of proposal may be made. This can include a debt-for-equity, debt write-down or debt postponement as well as other matters such as a change in the management team or selling off loss-making parts of the company.

(b) At a first hearing the court will examine the classes of creditors and shareholders as defined by the company. Creditors and shareholders may challenge class formation if they think the company's classes do not accurately reflect the rights and interests of the different classes to which the proposal is expressed to apply.

(c) If satisfied, the court will confirm that a vote on the proposal may be conducted on a specified date before a second court hearing if required. Subject to the requisite voting thresholds being met and the rules for imposing a cross-class cram down being complied with, the court will then schedule a second hearing at which it will consider if the necessary requirements have been met and will make a decision whether or not to confirm the restructuring plan and make it binding on affected creditors and shareholders.

(d) A company could choose to appoint a "supervisor" to oversee the restructuring plan, but such an appointment will not be mandatory. Additionally, no specific qualification requirement is prescribed for the supervisor's role.

1.3 Term and effect

(a) There is no maximum period within which the restructuring plan needs to be implemented. An initial 12 month time period has not been taken forward.

(b) A restructuring plan confirmed by the court will be binding on all affected parties. Parties' rights following confirmation of a restructuring plan will be as provided for in the plan. Any previous rights will be extinguished by the plan being confirmed by the court.

1.4 **The role of the court**

(a) The restructuring plan will draw on case law established through the scheme of arrangement process. There will be an express right of appeal.

1.5 **Voting**

(f) In order for the plan to be approved, 75 per cent in value (measured by value of gross debt) of the creditors within each class (who vote) will need to vote in favour of the plan. No majority by number test will be introduced. However, the Government Response states that this 75 per cent in value threshold will be supplemented by a requirement that more than half of the total value of unconnected creditors vote will need to vote in support. Subsequently, in meetings with the ILA and CLLS, the Insolvency Service suggested that this 'unconnected creditor' test was wrongly summarised in the Government Response and was intended, instead, to reflect the same test as the current CVA 'unconnected creditor' test, namely that the plan will not be approved if more than half of the total value of unconnected creditors in each class vote against it.

1.6 **Cross-class cram down**

(a) The restructuring plan process will allow for cross-class cram down. A dissenting class of creditors must ordinarily be satisfied in full before a more junior class may receive any distribution or keep any interest under the restructuring plan (the absolute priority rule).

(b) However, in order to permit flexibility, the court will be able to confirm a restructuring plan even if it does not comply with the absolute priority rule where non-compliance is: (i) necessary to achieve the aims of the restructuring; and (ii) just and equitable in the circumstances.

(c) The court may only approve a cross-class cram down plan if at least one class of impaired creditors (that is, creditors who will not receive payment in full under the restructuring plan) has voted in favour of the plan.

(d) In order to assess whether the absolute priority rule is met, the Government has suggested that the test for valuation should be what the next best alternative for creditors is if the restructuring plan was not to be agreed.

2. ADDITIONAL INSOLVENCY SERVICE QUESTIONS

2.1 In the meetings between the Insolvency Service, the ILA Committee and the CLLS Insolvency Sub-Committee, the following questions were raised by the Insolvency Service:

(a) As with a scheme of arrangement, the new restructuring plan will require creditors to be placed into classes for voting purposes. Should classes be based on commonality of rights or commonality of rights AND treatment?

(b) Should a restructuring plan extinguish creditors' pre-plan rights forever, including where the plan is not fully implemented?

(c) Cross-class cram down - the response (5.167, p73) outlined the Government's plan that an impaired class of creditors must vote in favour of a plan where cross-class cram down is applied. Is this the right protection? Is there a danger of 'artificial impairment' in these circumstances? Do we need to stipulate a non-impaired class has to vote in favour as well.

3. OUR OBSERVATIONS

3.1 Summary

(a) In general, we support these proposals. The lack of a cross-class cram down mechanism in the existing scheme of arrangement is a draw-back (albeit one that we currently work around by using the scheme together with a pre-packaged administration to transfer the intermediate holding company to new shareholders where the existing shareholders are out of the money). We do have some questions, though, on the detail of the proposals as set out below.

(b) We suspect that, in practice, this tool will be used by larger companies (because of the costs involved) in order to facilitate debt restructurings; at the moment such debt restructurings are done using the tried and tested enforcement / intercreditor release route but it is possible this may change for the reasons given in section 4 of the Introduction. We consider that some of the proposals below (e.g. removing the counter-proposal option and providing additional guidance on "impairment") would help reduce the areas of uncertainty which may encourage creditors to use the new procedure.

3.2 Jurisdiction

The August 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 (paragraph 5.113). We favour the wide "sufficient connection" test but note should be taken that as negotiations in relation to the European Insolvency Regulation post Brexit evolve, an eye needs to be kept on this. Revisions may be necessary as more Brexit detail emerges.

3.3 Process

(a) It is suggested that creditors and shareholders will have the power to submit a counter-proposal if they disagree with the company's proposal. While this provision echoes that found in Section 896 of the CA 2006, it is unclear what would happen if different creditors each put forward separate proposals of their own (with some creditors refusing to consider either proposal at this stage, in order to allow them to continue trading their debt). While the initial answer may be that this would be a matter for the court's discretion, how would the court address a position where the company had put forward a proposal, only for two creditors with very different interests to put forward separate counter-proposals, with each stating that their proposal had widespread support? Further guidance on this point may be necessary.

(b) The current proposal does not have much detail on what a counterproposal by creditors or shareholders would have to look like.

(c) We see the danger that creditors or shareholders use the ability to put forward a counterproposal to create noise / derail any sensible restructuring. Paragraph 5.136 of the Government response correctly recognises that the company, its directors or a statutory office holder are likely in practice to be best placed to put forward a restructuring plan. Hence, we consider that it would be simpler for the legislation to mirror s896 of the CA 2006 by merely stating that a restructuring plan could be put forward by any of the company, a creditor or member or a liquidator or administrator. The effect of doing so would be to place all these parties under the same obligations in formulation a proposal.

3.4 Term and effect

We believe that (in response to the question in paragraph (b) of paragraph 2.1 above) if a restructuring plan is not fully implemented, the plan itself should expressly set out the consequences of such partial implementation.

3.5 **Voting - thresholds**

(a) We would like more clarity on the voting thresholds. We understand that the first test requires 75% of creditors in each class present (or by proxy) and voting to vote in favour of the plan. Therefore, a creditor who does not vote at the meeting (in person or by proxy) is excluded for this test.

(b) We understand that the connected parties sub-test is intended to be the one applied to company voluntary arrangements – and not as phrased in the Government Response. As there is confusion on the right test, we set out the test that applies to CVAs here in full:

Rule 15.34(4): "In a proposed CVA a decision is not made if more than half of the total value of the unconnected creditors vote against it."

Rule 15.34(5)(c): For the purposes of paragraph (4): "the total value of the unconnected creditors is the total value of those unconnected creditors whose claims have been admitted for voting."

(c) This leaves two questions:

(i) Is this sub-test applied per class or does it apply to all unconnected creditors of the company? A CVA of course does not have classes, so the question does not arise in a CVA. In order for the restructuring plan to be usable the "connected party" test will need to be applied on a per class basis. This would mean phrasing the test as follows: "In a proposed restructuring plan, a decision is not made if more than half of the total value of unconnected creditors in a class vote against it."

(ii) Is the "connected party" sub-test to be applied by reference to creditors who vote at the meeting (in person or by proxy)? If the CVA "connected party" test is adopted, then this is not the case, as the CVA test has as its denominator those unconnected creditors who have been admitted for voting – not simply those who actually vote. This would create an odd dynamic whereby the first test (75% of creditors in favour) is measured by those creditors who actually vote (in person or by proxy) whereas the sub-test has the wider denominator of those unconnected creditors who are admitted to voting, irrespective of whether or not they actually do so.

(d) On the whole, we would be in favour of not having the connected party subtest at all for the following reasons:

(i) The test is not the easiest to calculate – and the legislation with its double negative language wording is quite confused. Note also the comments above on the existing CVA test, and what the denominator would (and should) be.

(ii) The restructuring plan is different to the CVA: only creditors whose rights are actually affected will vote on it. In a CVA, by contrast, all unsecured creditors can vote, regardless of whether they are affected by the terms of the CVA.

(iii) The restructuring plan is different from a CVA as it will always involve the court. This is unlike a CVA where there the only direct involvement arises on a challenge. In a restructuring plan, by contrast, the court can deal with the issue of whether unconnected or minority groups were oppressed as part of the "normal" court process and without the need for a specific challenge to be brought to the court.

(iv) Separation of creditors into different classes for the restructuring plan provides a form of protection for minority creditors albeit in a different way to the connected party test.

(v) The courts are already equipped to be doing so, see Lewison J in British Aviation *Insurance* or the more recent decisions in *Lehman* or *Noble*.

(vi) In order to address any concern, the legislation could impose an express duty on the debtor company putting forward the plan to inform the court of the voting result as well as providing details of the make up of the majority or minority creditor groups taking part in the voting process, in order to ensure the court has all the information to hand that it needs to assess the fairness of the plan as it impacts on these groups.

3.6 **Voting – excluded liabilities**

(a) Paragraph 5.168 of the Government Response indicates that certain categories of debt will not be capable of being crammed down under a restructuring plan on public policy grounds. If this limitation is, as appears to be the case, intended to cover debts which are not provable in an administration or liquidation, it would result in the opposite outcome to an administration or liquidation, pursuant to which non-provable debts are rarely paid because they rank below provable debts and there is rarely a surplus after paying provable debts. Under the Government Response, in a restructuring plan, such non-provable debts would instead survive the process and have to be paid in full, while provable debts could be compromised by the plan. This seems a counter-intuitive outcome.

(b) In order to avoid uncertainty we also recommend that the government creates a list of those obligations that are not subject to cram down, e.g. fines.

3.7 **Cross-class cram down**

(a) We understand that the Insolvency Service has confirmed that cross-class cram down will also apply to classes of shareholder. This is essential if a restructuring plan is to be capable of delivering a debt to equity swap. We would like to see how this will be dealt with as a matter of company law. In the USA for example, any such process simply happens under the Chapter 11 order but the UK companies legislation is likely to need to be amended to deal with this issue as a matter of pure process at least.

(b) Cross-class cram down can be applied by the court if at least one class of impaired creditors has approved the plan. We would welcome further detail in relation to the definition of "impaired". For example, would a creditor be considered to be impaired merely because the maturity of its debt were extended by a month? Would impairment only be considered to go to value, rather than timing of repayments? Overall we do not consider the term "impairment" to be overly helpful. In order to vote on the plan, a creditor's rights will need to be affected (see above at class composition), therefore this should in itself cover any "impairment".

(c) The formulation in the abstract of the "next best alternative test" will be considerably easier than applying the test in practice. The simple liquidation test is attractive as it is easier to apply but we agree that in practice a "next best alternative" test is more sensible and that, in practice, a court may in any event adopt this approach. The courts will be the ultimate arbiter in these matters. To date they have not had to deal with valuation disputes to the extent to which such disputes are likely to arise in the development of jurisprudence in relation to the restructuring plan, albeit the courts do have general experience of reviewing, testing and where appropriate then applying valuation evidence. There may be more litigation risk, at least in the early days of applying the new test. However, the risks inherent when addressing valuation questions through litigation have long been a part of the current scheme of arrangement process. Cases such as *IMO Car Wash* illustrate the courts' experience in managing such cases.

(d) In larger cases, companies may appoint a supervisor to assist the court with valuation but this does not need to be prescribed for by law.

3.8 **Excluded companies**

(a) Paragraph 5.129 of the Government Response states as follows: "As set out in the consultation document, the Government does not intend to make the restructuring plan available to all companies. In line with the moratorium provisions, the type of companies currently excluded from eligibility for the small company CVA moratorium, namely those involved in specific financial market transactions, and any similar undertakings, will also be excluded from these provisions. This is to avoid interfering with the proper functioning and integrity of those markets."

(b) Similar wording is included in the section dealing with the proposed moratorium – for example, paragraph 5.35 states "The Government's intention is to exclude companies falling within scope of the exceptions listed in paras 4A to 4J of Schedule A1 of the Insolvency Act 1986 from the moratorium."

(c) We agree that there may be the need to exclude certain types of company (or potentially certain types of transaction) from the restructuring plan proposals in order to protect capital market and other types of transaction. However, the general exclusion for companies with liabilities in excess of £10m in para 4C of Schedule A1 would clearly not be appropriate given that the restructuring plan is likely to be used by large companies with indebtedness in excess of this amount. The exclusions to the general prohibition on appointing an administrative receiver in ss.72B to 72GA may bear some consideration but these focus on certain types of transaction rather than the company so thought would need to be given to how to adapt these exceptions. Each exclusion will need to be individually assessed to see whether it should be mirrored for the restructuring plan procedure.

(d) We note that there is no intention to limit the restructuring plan to large companies but it is acknowledged that it is more likely to be used by these types of company given the costs involved. We consider that this is the right approach. In practice, though, we think it is unlikely that the restructuring plan would be used by smaller companies where the directors are also the shareholders and where the plan would wipe out that shareholding. This does raise the question, though, as to whether small companies might use the restructuring plan in order to release personal guarantees (and whether this would be desirable). We would not recommend a general prohibition on the release of such guarantees as this can be a useful mechanism in a debt restructuring involving group guarantees (thus avoiding the need for separate proceedings in relation to the guarantor companies). But in the case of a smaller company, it could be a ground for the court refusing to sanction the restructuring plan.

JOINT ILA/CLLS ISSUES PAPER
INSOLVENCY AND CORPORATE GOVERNANCE PROPOSALS AND CORPORATE INSOLVENCY REGIME REFORMS (2018/2019)

APPENDIX 4

PROPOSALS REGARDING SALES OF DISTRESSED BUSINESSES

1. GOVERNMENT RESPONSE – SUMMARY

1.1 In the Government Response, with respect to "sales of businesses in distress", the Government proposes that directors of a holding company should be held to account in certain circumstances if they conduct a sale which harms the interests of the subsidiary's creditors where that harm could have been reasonably foreseen at the time of the sale.

1.2 More specifically, it is proposed that such provisions would apply following a sale of a subsidiary if:

(a) at the time of the sale, that subsidiary is either insolvent, or insolvent but for guarantees provided by other companies or directors in its group;

(b) that subsidiary enters into administration or liquidation within 12 months of completion of the sale;

(c) the interests of that subsidiary's creditors have been adversely affected between the date of the sale and the liquidation or administration;

(d) at the time that the directors made the decision to sell that subsidiary, the directors could not have reasonably believed that the sale would lead to a better outcome for that subsidiary's creditors than placing it into administration or liquidation taking into account matters such as:

(i) whether professional advice on the sale was considered;

(ii) the extent to which the board of the holding company engaged and consulted with the major stakeholders of the subsidiary prior to the sale; and

(iii) other steps taken by the directors to ensure, as far as within their means, that the sale was no worse an option than formal insolvency; and

(e) that subsidiary is a large subsidiary (meaning that it does not qualify as a small or medium sized company under the CA 2006).

1.3 If all the above requirements are met, the Government Response suggests that any such director who approved the sale may be subject to disqualification action and, should the Court find that a disqualified parent company director has caused loss to one or more creditors of the subsidiary, personal liability pursuant to a compensation order.

2. EXECUTIVE SUMMARY OBSERVATIONS

2.1 In our view, the current relevant legislation provides a framework that, if properly adhered to, should regulate the conduct of relevant directors so as to address the underlying concerns which have given rise to the proposals relating to "sales of businesses in distress". The question remains as to why the current framework is not being properly observed and whether there is a need to strengthen it to prevent abuse and facilitate effective enforcement. In our experience, lack of access to funding for independent advice, coupled with insufficient relevant information at the subsidiary board level, are the key factors contributing to subsidiary boards' failure to engage with, and participate appropriately in, discussions and negotiations relating to the disposal of that subsidiary. This exacerbates a general failure on certain subsidiary boards to recognise the inherent potential for conflict where a holding company is seeking to sell the shares of a subsidiary that is financially distressed. These factors also result in the subsidiary board being more susceptible to manipulation

by the seller or even the purchaser, whose objectives may naturally (and quite properly) conflict with those of the subsidiary.

2.2 The directors of a holding company owe their duties to that holding company's own stakeholders (namely its shareholders, assuming that it is solvent). The directors of a subsidiary have their own duties, which, assuming that it is insolvent (or in the "twilight zone"), are owed to its creditors which of course go beyond intercompany debts. The existing proposals blur these two separate and distinct set of obligations. This leads to an almost inevitable conflict of interest between the obligations of a holding company director to act in both the interests of its shareholders and the creditors of its subsidiary, making it simply untenable for a director to balance these competing duties. As a result, the proposed reforms may well lead to an increased number of insolvencies and are in any event, arguably, unnecessary given the extant obligations on subsidiary directors. Furthermore, the existing proposals can be easily circumvented by structuring the sale in a way to avoid its application.

2.3 To mitigate the concerns that the Government Response raises and ensure that the subsidiary's directors are in a position which allows them to adhere to their duties, we would propose that the holding company board be under a strict legal obligation to ensure that the board of the subsidiary has access to funding and information to enable it to obtain independent financial and legal advice. This would guarantee that the subsidiary's directors are in a position to make the decisions already required of them under the existing legal framework but on a fully informed basis without undue influence from either the holding company or the proposed purchaser. These obligations of the holding company board should strengthen the ability of the subsidiary's directors to comply with their existing obligations and reduce the perceived risk of such directors attempting to evade liability by "shutting their eyes" to the transaction or deliberately avoiding asking relevant questions.

3. ADDITIONAL INSOLVENCY SERVICE QUESTIONS

3.1 The Insolvency Service asked the following questions in our meetings with them:

(a) What must a director of a holding company do to show that they have considered the implications of the sale of a subsidiary on its stakeholders?

(b) Should directors of holding companies registered overseas be targeted?

4. ADEQUACY OF EXISTING REGIME

4.1 As set out in the CLLS response dated 13 June 2018 to the 20 March 2018 Insolvency and Corporate Governance consultation (the **Governance Consultation**), we consider that the current law provides an existing framework to regulate the conduct of directors in a manner which should be sufficient to address the underlying concerns which have given rise to the proposals relating to "sales of businesses in distress".

4.2 The general duties of directors to creditors were codified in the CA 2006, most notably, s172(3) of the CA06 which requires directors, in certain circumstances, to consider or act in the interests of creditors (as opposed to its shareholders, which would be the usual course). It is clear from the case law that s172(3) of the CA 2006 applies when the company is insolvent but, also, in scenarios when the company's insolvency is probable[5]. A director may be found to have breached s172(3) of the CA 2006 where they have failed to consider creditor interests and no intelligent or honest person could have reasonably believed that the action taken (or not taken) was for the benefit of creditors. Case law demonstrates that this duty applies to all actions taken by the directors including agreeing to or entering into a transaction that could not possibly have benefitted the creditors. Whilst a subsidiary which is reliant on its holding company for financial support has no direct control over the sale of its shares, on a practical level it is highly unlikely that a properly advised subsidiary with

[5] See very recent Court of Appeal decision: *BTI v Sequana* [2019] EWCA Civ 112

directors acting in accordance with their duties will have no role to play in such a sale. Such subsidiary will require replacement financial support at the point of sale in order to continue trading. As such, it is inevitable that the directors of the subsidiary will be required to consider at least certain elements of the transaction to comply with their duties to creditors and, as a matter of existing law, should do so in accordance with their duties under s172(3) of the CA 2006.

4.3 Furthermore, directors who have acted in breach of their duties under the CA 2006, where such breach has caused loss to the insolvent company, may also be pursued by an administrator for breach of duty, or by a liquidator for misfeasance pursuant to s212 IA 1986. If such action is successful, the directors may be held by the Court to be personally liable for the loss caused to the company as a result of such misfeasance. Section 212 IA 1986 allows the Court a significant degree of discretion in seeing that appropriate relief is applied in all of the circumstances of the case, allowing it to take a fact-specific approach to the matter.

4.4 Notwithstanding our comments above, even if the subsidiary board were not in a position obliging it to consider any specific elements of the transaction (which for the reasons above it must), further protections exist under the current legal framework. If that subsidiary is reliant on its holding company for financial support (which is highly likely to be the case if it is insolvent or in the "twilight zone"), that financial support will inevitably be impacted as a result of the sale (for example, the purchaser may not provide equivalent support and/or may be of an inferior covenant strength). The directors of that subsidiary could be found to be liable for wrongful trading under s214 of the IA 1986 if they continued to trade the subsidiary when they were aware (or should have been aware) that the subsidiary had no reasonable prospect of avoiding an insolvent liquidation or administration, and failed to do everything that they ought reasonably to do to minimise the potential loss to the subsidiary's creditors.

4.5 Upon learning that the shares in the subsidiary may be sold and that, as a result, any ongoing financial support provided by the parent is to be withdrawn, it is incumbent on the subsidiary board to assess the ongoing solvency of the subsidiary and if they conclude that the company is insolvent or in the "twilight zone", to act in the best interests of the subsidiary's creditors. In practice, this should prompt the subsidiary board to take a number of steps including (but not limited to):

(a) engaging independent professional advisors (lawyers and accountants), separate to the set of advisors acting for the holding company, in order to understand and explore the board's options and appropriate next steps, bearing in mind their directors' duties and the need to place subsidiary's creditors' interests as paramount;

(b) commencing its own contingency planning exercise, alongside its advisors, to consider what alternative options are available ahead of the holding company's proposed sale, which may include a formal insolvency process, and which of these possible routes will maximise the likely return to the subsidiary's creditors;

(c) increasing its financial reporting and holding more frequent board meetings in order to continually assess the subsidiary's financial position which will impact on and inform its contingency planning options; and

(d) engaging with its key stakeholders (including pension trustees and lenders) to understand on what basis they may be prepared to support the subsidiary's business going forward.

4.6 In addition, in relation to the holding company's proposed sale process, the subsidiary board should also seek access to and information from both the holding company and the proposed purchaser in order to understand (and query) the terms of the proposed sale and the purchaser's plan to support the subsidiary's business going forward. This will enable the subsidiary board to better assess the viability of its business immediately after the completion of the sale. The subsidiary board should also consider the need to separately diligence the proposed purchaser and the viability of its proposals, including any draft business plan. In such circumstances, it is entirely appropriate to

expect an open, three-way dialogue between the subsidiary, the holding company and the proposed purchaser.

4.7 Once the subsidiary board takes the above steps, it will be armed with the necessary information to be able "benchmark" the outcome of the holding company's proposed share sale against the alternative options it has considered with its own advisors in order to assess which of the available next steps will be in the best interests of the subsidiary's creditors, thereby effectively acting as a "check and balance" against the sale structure proposed by the seller holding company and proposed buyer. The alternatives available to the subsidiary may include:

(a) a sale of its valuable business and assets via an accelerated M&A process;

(b) a sale of its valuable business and assets via a pre-packaged administration;

(c) a trading administration process coupled with a sale process run by the administrator; and/or

(d) a managed wind-down of the business via administration or liquidation.

5. OUR OBSERVATIONS

5.1 By seeking to impose a new legal obligation on the holding company board to act in the best interests of its struggling subsidiary's stakeholders (i.e. the subsidiary's creditors), in addition to and alongside their statutory duty to act in favour of the holding company's stakeholders (i.e. its shareholders), the proposed reforms will place the holding company board in an inevitable and impossible position of direct conflict when considering a sale of a large distressed subsidiary/group of subsidiaries.

5.2 In such circumstances, there will be a natural (and entirely proper) conflict between:

(a) on the one hand, the interests of the solvent holding company's shareholders (which may also include the directors in their personal capacities) who the directors might reasonably consider will be best served by a sale of the shares in an insolvent subsidiary which is negatively impacting the performance, stability and financial health of the parent and the wider corporate group; and

(b) on the other hand, the interests of the distressed subsidiary's creditors, who the directors may recognise will in fact receive a better outcome if the sale were not to proceed and alternative steps taken instead (assuming the subsidiary is insolvent or in the "twilight zone", including as a result of the holding company deciding it is no longer willing or able to provide ongoing financial support). This may include, for example, in circumstances where the proposed buyer does not have (i) the adequate working capital or third party funding in place to support the subsidiary's business going forward; or (ii) the necessary expertise or resources to assist with a turnaround of the subsidiary's business to ensure it remains viable and able to continue on a solvent, going concern basis. In which case, it may be in the best interests of that subsidiary's creditors if steps are taken to sell the valuable parts of its business and assets or it instead files for insolvency protection. The subsidiary's creditors may receive a better pence in the pound return in these alternative scenarios than if the shares in the subsidiary are simply sold by the holding company and the struggling subsidiary enters insolvency shortly thereafter.

5.3 In practice, there are often common board members across a corporate structure. Hence, it is not unusual for the same individuals to hold several directorships at both holding company and subsidiary levels. This is not just the case in smaller businesses. It is a model often adopted by larger corporates. As a result, it is not uncommon to have the same individual directors wearing "different hats" when discharging their statutory duties to act in the best interests of each company to which they are appointed, and therefore each of those companies' respective stakeholders. Whilst each member of the corporate group is solvent and trading without financial difficulty,

directors who act in these multiple capacities are often able to successfully navigate the potential conflict of interests that may arise between each set of stakeholders.

5.4 However, as outlined above, a director's ability to manage this conflict of interest is much more difficult when a subsidiary is in financial distress and the parent is considering its next steps in relation to that subsidiary, including a potential sale to a third party. Further, as matters currently stand there is sometimes uncertainty, or deliberate opacity, as to which capacity the director is in when discussing (or even learning of) relevant facts.

5.5 The proposed reforms do not address this underlying conflict of interest issue. Instead, they are likely to end up imposing another layer of complexity to the responsibilities and duties of the holding company board, by requiring those directors to consider whether the sale is in the best interests of the subsidiary's creditors, whose interests will most likely be diametrically opposed to the interests of that holding company's shareholders.

5.6 If the reforms are implemented as proposed, we are very concerned that they will further polarise the distinctions between:

(a) diligent boards of directors, who pay due regard to their statutory duties and will be keen to ensure compliance with these legislative changes, but who will be likely be confused as to how they can be expected properly to discharge their legal duties whilst managing two conflicting sets of stakeholder interests, These boards may consider the need to focus on the outcome for the subsidiary's creditors as a fetter to their duty to act in the interests of the holding company's shareholders; and

(b) less diligent boards of directors (whom we assume to be the real targets of the Governance Consultation). These boards of directors are likely to seek out the opportunity to circumvent the new rules and continue to disregard their duties as directors of the subsidiary, in favour of the parent's shareholders (and potentially therefore their own personal interests). This could be achieved by artificially structuring any sale of a subsidiary in a manner which enables the subsidiary to "limp on" for another year and a day by, for example, the use of a "dowry" from the seller or by the buyer funding the subsidiary's future trading by exhausting the subsidiary's remaining valuable asset portfolio (referenced further at paragraph 5.8(a) below).

5.7 When tasked with managing these conflicting interests alongside their directors' duties and with the risk of potential personal liability at the forefront of their minds, there is, in our view, a greater risk that the more prudent boards simply opt for the safest course of action, by filing for the insolvency of the subsidiary. This mirrors our experience of working with directors of companies which are registered in overseas jurisdictions which have equivalent strict liability provisions (in some cases coupled with criminal sanctions) where directors are far less reticent about filing for insolvency. Often, such precipitative steps will not only be value destructive for the subsidiary's unsecured creditors (who will generally receive a lower return in an insolvency scenario), but from a more holistic perspective this may result in the failure of businesses which could have otherwise been restructured and saved without the need for a formal process, thereby leading to increased levels of corporate insolvency.

5.8 In contrast, the less dutiful boards of directors may focus their efforts on identifying ways in which to circumvent the proposed new rules to enable them to continue acting without due regard to the best interests of the subsidiary's creditors. This may include:

(a) by adopting artificial sale structures so as to ensure the subsidiary is sufficiently "propped up" and able to continue trading on for a period in excess of the proposed 12 month look-back period (i.e. for one year and one day). This could for example be structured by:

(i) way of a "dowry" contribution from the seller holding company to the buyer to ensure that the subsidiary is sufficiently funded for a period in excess of 12 months post-sale,

in order for the seller to put as much distance as possible between it and the subsidiary's subsequent collapse; and/or

(ii) the buyer using the valuable assets and/or properties which remain in the subsidiary/subsidiary group post-sale in order to fund its trading losses incurred for a 12 month period post-sale, thereby depleting any valuable assets that would have otherwise been available to the subsidiary's creditors,

both of which are scenarios which, in our view, would be far more difficult to implement if the subsidiary board was actively engaged in the sale process and was being independently advised;

(b) by restructuring the group structure and/or adjusting accounting practices in order to avoid the relevant subsidiary satisfying the "large company" definition, being the only entities to whom the new rules will apply; and

(c) by restructuring the corporate group to insert a non UK registered holding company into the structure, as it appears that directors of overseas holding companies will not be caught by the proposed reforms.

6. ALTERNATIVE SUGGESTIONS

6.1 As there is an existing legal framework, the question remains as to why the current framework is not being properly observed and whether there is a need to strengthen it to prevent abuse and facilitate effective enforcement. In our experience, lack of access to funding for independent advice, coupled with insufficient relevant information at the subsidiary board level, are the key contributing factors. If the directors do not receive proper engagement in respect of the transaction such that they do not have full visibility and access to financial and legal advice, then the directors cannot be expected to make the decisions required of them on a fully informed basis (and can equally attempt to evade liability on the basis of ignorance). We therefore advocate the following alternative solutions:

(a) that the directors of a holding company proposing to sell a subsidiary which is insolvent (or in the "twilight zone") have a strict legal obligation to ensure that:

(i) the subsidiary has access to sufficient financial resources (without prejudicing the position of that subsidiary's creditors) to enable the subsidiary to obtain independent financial and legal advice with respect to the transaction in support of the board's existing legal obligations;

(ii) the subsidiary has access to information and documentation relating to the transaction and the purchaser (including the purchaser's financial standing) as the subsidiary may reasonably require such that the subsidiary's board is in a position to make those decisions which are required of them in accordance with their existing legal obligations on a fully informed basis (and their advisors are equally able to advise them on such basis); and

(iii) the subsidiary is given sufficient time in advance of completion of the propose sale to consider the transaction with its advisors; and

(b) as suggested in the Government Response, a non-binding best practice guide for directors is put in place such that a positive learning framework is established.

6.2 The suggestions outlined above have the benefit of avoiding the inevitable conflict of interests that would arise under the existing proposals for directors of the holding company to act in both the interests of its shareholders and the interests of its subsidiary's creditors and maintains the fundamental tenet of English corporate law that each company has its own legal personality. The

ultimate decision as to whether to approve a transaction (or whether the subsidiary can continue to trade in light of the transaction) remains the responsibility of the subsidiary's board. However, the obligations placed on the holding company's board should strengthen the ability of the subsidiary's directors to comply with their existing obligations and reduce the perceived risk of such directors attempting to evade liability by "shutting their eyes" to the transaction or deliberately avoiding asking relevant questions. Ensuring that the directors of the holding company are obliged to procure the provision of information to the subsidiary's board will also negate the potential argument that a holding company director (who seeks to maintain that (s)he received the information in that capacity only) is entitled or obliged to disregard that information, even if relevant, when considering a matter in his/her capacity as a subsidiary director.

6.3 The suggestions above do not address the issue of how such obligations would be enforced against directors of a foreign company and therefore remain open to abuse. However, in our view, this particular issue cannot be addressed as a matter of English law alone.

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APPENDIX 5

PROPOSALS REGARDING VALUE EXTRACTION SCHEMES

1. GOVERNMENT RESPONSE – SUMMARY

1.1 In the Government Response, the Government decided not to pursue the proposal in the Governance Consultation to introduce a new transaction avoidance power targeting value extraction schemes. It noted that whilst responses to the March 2018 consultation had been broadly supportive, most respondents had noted the potential overlap with other existing transaction avoidance powers and had favoured amendment of those powers. Most respondents had also feared that the introduction of a new additional power on the lines mooted in the Governance Consultation would have had an adverse effect on the availability of finance for distressed companies.

2. EXISTING REGIME

2.1 The existing powers which are capable to being used to counter the examples of (abusive) value extraction techniques identified in the Governance Consultation are:

(a) transactions at an undervalue (s238 IA 1986) - management fees, excessive director pay or other payments, the sale and leaseback of assets, and, possibly, charges over property being granted;

(b) preferences (s239 IA 1986) - charges over property being granted; and

(c) extortionate credit transactions (s244 IA 1986) - excessive interest on loans.

3. SPECIFIC MEASURES NOW PROPOSED

3.1 The Government Response said that it will:

(a) reconsider the test for extortionate credit avoidance;

(b) introduce a presumption of insolvency where the recipient of a preference is a connected person; and

(c) consider clarifying whether the granting of security can constitute a transaction at an undervalue, whether misfeasance proceedings can be brought against shadow directors and the difficulties of pursuing wrongful trading claims.

4. ADDITIONAL INSOLVENCY SERVICE QUESTIONS

4.1 In our various meetings with the Insolvency Service, the following questions were posed:

(a) S244 is one of the antecedent recovery provisions that the response could be modified to make more useable for office-holders (para 3.6, p37 of the response). 'Grossly exorbitant' (s244(3)(a)) and 'grossly contravened ordinary principles of fair dealing' (s244(3)(b)) were widely seen as setting a too high bar to challenge such payments. We are concerned that any changes do not go too far in the other direction and set the bar too low and would be interested to hear views on where the threshold could be lowered to?

(b) Should there be any connected parties (i.e. the lender was connected to the debtor) or insolvency test (the debtor company was insolvent, or insolvent as a result of the transaction in question) if the threshold is lowered?

(c) What are our views on a rebuttal presumption for transactions at undervalues to connected parties i.e. where the onus is on the connected recipient to show that the transaction is for value and in good faith.

5. OUR OBSERVATIONS

5.1 Summary

We are in favour of the measures proposed in the Government Response as regards extortionate credit transactions and preferences. We consider those measures justifiable as regards to general application of ss239 and 244 IA 1986 in addition to their potential application to value extraction schemes. We do not think that such measures need necessarily have any adverse effect on finance for distressed companies (which cannot be justified by the need to protect existing creditors from abusive transactions).

5.2 Extortionate credit transactions

The existing statutory formulations – "grossly exorbitant payments" or "grossly contravened ordinary principles of fair dealing" – have been found to set so high a test for intervention that the power is rarely encountered in practice despite the presumption (in s244(3)) in favour of the office-holder that an impugned transaction is extortionate. We recognise a potential difficulty in articulating an alternative standard in a way which is sufficient to widen the scope of the provision whilst at the same time restricting that scope to transactions which are not commercially justifiable. The circumstances in which credit is advanced and the risks undertaken by the creditor are infinitely varied and it is important that transactions that are or bear comparison with open market transactions should not be capable of being attacked if the amended provision is not to have an adverse effect on the availability of finance. We think that the test, however expressed, must ultimately be one of reasonableness leaving it to the courts to decide which side of the line any given transaction may fall.

There should, however, be a statutory safe harbour where it can be demonstrated that the company made *bona fide* attempts to obtain alternative sources of funding and that the terms of the funding which it eventually obtained were the best available, given the company's circumstances.

6. Preferences

Arguably, the absence of any presumption of insolvency for s239 purposes has always been an anomalous distinction between ss238 and 239. The presumption of insolvency for s238 purposes (contained in s 240(2)) only applies where the transaction in question was a transaction with a connected person and, provided the same applies to s239 as amended, we consider that any potential adverse effect on finance will be justifiably balanced by the protection of existing creditors. We have two more specific comments:

(a) There is a further distinction to be drawn between ss238 and 239 in that the presumption of insolvency in respect of the former covers transactions with all connected persons whereas the presumption of a desire to prefer for the purposes of latter does not apply to persons who are connected only by reason of being employees. We consider that it would be right to maintain the distinction when introducing a presumption of insolvency in relation to preferences. Whilst employees need some protection from receipt of their emoluments being too easily attacked as preferential, we see no reason why an employee who is shown to have received a payment influenced by a desire to prefer should be in a different position to any other connected person when considering the question of solvency. (The alternative view is that employees are a special class deserving of general protection, in which case the logical response would be to introduce an employee exception to the s240(2) presumption in respect of transactions at an undervalue.)

(b) The decision in *Re Casa Estates (UK) Ltd* [2013] EWHC 2371 (Ch), on appeal [2014] EWCA Civ 383, highlights the difficulty that a connected person will have in rebutting the presumption of insolvency where the issue concerns future debts because the further forward the issue goes, the more difficult it becomes for the respondent connected person to prove (on a balance of probabilities) that the company can reasonably be expected to meet its liabilities. This is an inherent feature of the test of insolvency under s123 IA 1986 as applied by the courts which already exists under s240(2), and which will be no different when the presumption applies also to preferences, but there is a potential for injustice in cases which turn on where the burden of proof lies.

7. Other possible reforms

We are ready and willing to have discussions with the Insolvency Service in respect of the matters identified in the Government Response as being matters for further consideration.

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APPENDIX 6

SUGGESTED AMENDMENTS TO S245 INSOLVENCY ACT 1986

1. Introduction

1.1 Paragraph 3.4 of the Government Response states that "The Government does not wish to deter lenders who fund business turnarounds and thereby save companies that may otherwise end up in formal insolvency procedures, leading to job losses." The current wording of s245 of the IA 1986 has, however, on occasion, formed a potential obstacle to lenders prepared to provide emergency funding as part of a business turnaround process.

1.2 The Government Response states that the Government will bring forward legislation as soon as parliamentary time permits in order to make amendments improving the effectiveness of s239 IA 1986 (preferences) and s244 IA 1986 (extortionate credit transactions) This Appendix proposes that a small technical adjustment should be made to s245 IA 1986 at the same time, in order to address this potential obstacle. The amendment should not prejudice the interests of any stakeholder group, but it should facilitate the provision of rescue finance and make it easier for directors to take appropriate legal advice before creating security.

2. The existing legislation

2.1 Section 245(2) IA 1986 provides that *"Subject as follows, a floating charge on the company's undertaking or property created at a relevant time is invalid except to the extent of the aggregate of–*

> *(a) the value of so much of the consideration for the creation of the charge as consists of money paid, or goods or services supplied, to the company at the same time as, or after, the creation of the charge…"* [our emphasis]

2.2 Courts have applied a very narrow test when considering whether money was advanced "at the same time as" the creation of security for the purposes of s245. In the leading case of *Re Shoe Lace Ltd. Power v Sharp Investments Ltd* [1993] B.C.C. 609, Sir Christopher Slade held that:-

> *"In a case where no presently existing charge has been created by any agreement or company resolution preceding the execution of the formal debenture, then, in my judgment, no moneys paid before the execution of the debenture will qualify for the exemption under the subsection, unless the interval between payment and execution is so short that it can be regarded as minimal and payment and execution can be regarded as contemporaneous."*

2.3 Sir Christopher went on to suggest that, in this context, the interval between making the advance and executing the relevant security document should be "so short that it can be regarded as *de minimis* – for example a "coffee-break"".

3. Why is this provision problematic?

3.1 In reality, there is often an unavoidable gap of a few days between the provision of liquidity funding and the creation of the security package required in connection with that funding. This is particularly the case where a large number of companies in different jurisdictions are being required to provide security.

3.2 One practical example would be where a lender negotiates a confidential emergency liquidity facility with a parent company in the United States or Asia and requires security supporting that facility over the book debts of the group's European subsidiaries. Typically, the management of those subsidiaries would be aware of the negotiations, and would also be aware that they urgently needed to utilise the facilities once put in place, but there would not be time to brief them on exactly what security might be required (particularly where this was the subject of on-going negotiation).

3.3 While it may clearly be in the interests of each subsidiary to provide the requested security, well advised directors of those subsidiaries would, before creating the requested security:

(a) need to satisfy themselves, having taken appropriate legal advice. that it was in the interests of the company and its stakeholders to create the requested security;

(b) review and negotiate the terms of the proposed security document. This may not be straight-forward where multiple jurisdictions are involved, as the lender may require each subsidiary to create security based on either a template from another jurisdiction or a list of agreed security principles. Where an English subsidiary is required to provide security, the liquidity lender might therefore have to draft a bespoke English law debenture and then negotiate its terms with the English subsidiary; and

(c) check that the provision of security does not contravene the terms of any financing arrangements entered into by the company (including any debt factoring or invoicing arrangements if the proposed security extended to book debts) and, where this was the case, agree any necessary consents or waivers.

3.4 In practice, there may be insufficient time for the directors of group companies to take such steps before the liquidity facility has to be drawn down in order to meet an urgent funding requirement such as the payment of employee wages. This creates an immediate problem under Section 245 IA 1986 where the requested security includes a floating charge (or security which could be re-characterised as a floating charge).

4. Lenders' reaction to this problem

4.1 While it is always possible that subsidiaries may fail to provide the requested security, the providers of urgently needed liquidity are often willing to take this risk, on the basis that the new facility offers obvious benefits for group members, whose continued survival often depends on that new liquidity (and liquidity providers are often existing lenders to the group).

4.2 Lenders are typically more concerned that a subsidiary may be willing to execute the necessary security, having taken advice, but that such security could still be void, whatever the corporate benefit, by virtue of Section 245 IA 1986. In response to this risk, lenders may either:

(a) refuse to provide the necessary financing;

(b) increase the pricing of the facility, which is typically already very high, in order to reflect the Section 245 risk, thereby adding to the financial strain on an already struggling group of companies; or

(c) resort to solutions that are potentially damaging to the business of group members, such as imposing restrictive controls on book debts, in order to allow the lender to argue that they had a fixed charge rather than a potentially void floating charge.

4.3 It may be argued that Section 245 is only problematic where the company in question was insolvent at the time when it created the security, but it is typically very hard to demonstrate to the satisfaction of the relevant lender that a group member requiring an emergency liquidity injection is still solvent, particularly as the lender would normally have a very limited time in which to carry out any due diligence on the financial position of the relevant group member. A lender's typical working assumption is therefore that the subsidiary in question might be insolvent, and that it has to protect itself against any potential resulting risks.

5. **Our proposal**

5.1 We would suggest that s245(2)(a) IA 1986 should be amended so as to provide that *"Subject as follows, a floating charge on the company's undertaking or property created at a relevant time is invalid except to the extent of the aggregate of–*

(a) the value of so much of the consideration for the creation of the charge as consists of money paid, or goods or services supplied, to the company at the same time as, or after, the creation of the charge or during the period of 7 days preceding the creation of the charge…"

5.2 The provision of a 7 day window of opportunity, during which group members may consider both their own position and the terms of the security document, would address the issues outlined above, improving the position of both the company and the lender.

6. **Is this proposed modification consistent with the policy underpinning S245 IA 1986?**

6.1 Our proposal would be consistent with the approach to interpreting the predecessor to s245 IA 1986 adopted in *Re Columbian Fireproofing Co Ltd* [1910] 1 Ch 756 and the subsequent case of *Re F&E Stanton Ltd* [1929] 1 Ch 180, in which Maugham J noted (at p 193), when considering what sort of delay would invalidate a floating charge, that:-

> *"I am not thinking of a delay such as would ordinarily be necessary for the passing of the resolution and the consideration of the form of the debenture and its actual execution, because the four or five days necessary in most cases to do those things is clearly not a delay which, according to the authority of the first case I have mentioned, the Columbian Fireproofing case, would be sufficient to invalidate the debentures…"*

6.2 While this was accepted as good law under s212 of the Companies (Consolidation) Act 1908 and s322 of the Companies Act 1948 (the predecessors to s245 IA 1986), s322 was reviewed by the Cork Committee, who sought to "strengthen" it, primarily by extending the relevant period to 12 months. The Cork Committee amendments resulted in the current form of s245 IA 1986, but it is not clear from the Cork Committee Report that they intended to remove the company's ability to take a short period in which to consider the proposed security.

6.3 It seems a somewhat arbitrary result, from a policy perspective, that Company A and Company B could both execute exactly the same floating charge at the same time, in order to secure monies advanced the previous day, but that only Company B's floating charge would be valid, on the basis that its directors had promised 10 minutes prior to drawdown to execute the security, while Company A's directors had gone away and taken legal advice before agreeing to execute the security.[6]

6.4 It must also be open to doubt as to whether the legislation in question, or the subsequent *Shoe Lace* judgment [1992] BCC 367, anticipated circumstances such as the provision of emergency liquidity to a group with subsidiaries in many jurisdictions. The Court of Appeal in the *Shoe Lace* case noted that "it is always open to the lender not to lend until the charge has actually been executed: this must be the prudent course". While that may have been true in the last Millennium, when UK lenders were typically advancing monies to a UK company and requiring it to execute their standard form security document, neither this solution, nor the current wording of s245 IA 1986, reflect the current realities of complex cross-border restructurings. Companies may fail as a result.

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[6] A promise to execute a debenture may "*create a present equitable right to a security*". If moneys are advanced in reliance on it, the delay between the advances and the execution of floating charge "*is immaterial as the charge has already been created and is immediately registrable, so that other creditors of the company will have had the opportunity to learn of its existence*" (*In re Jackson & Bassford Ltd* [1906] 2 Ch 467).