ALERT MEMORANDUM

# UK Corporate Insolvency and Governance Bill: A Game-Changer?

*June 1, 2020*

On May 20, 2020, the UK government published its highly anticipated Corporate Insolvency and Governance Bill (the "Bill").[1] The Bill is intended to provide businesses with increased flexibility and breathing space to continue trading despite the challenges presented by the coronavirus ("COVID-19") pandemic. The Bill also introduces new corporate restructuring tools to the UK insolvency regime in an effort to maximise distressed companies' chances of survival. While some measures have been introduced specifically to support businesses experiencing financial difficulties as a result of COVID-19, other measures contained in the Bill have been in the making for several years.

Key reforms under the Bill include the introduction of a new restructuring procedure which would allow the court to bind classes of dissenting creditors or shareholders to a restructuring plan, a new stand-alone moratorium process and the temporary and retrospective suspension of wrongful trading rules from March 1, 2020 to June 30, 2020.

While a number of the measures proposed by the Bill will be temporary and are a response to the disruption caused by COVID-19, the new and flexible cross-class cram-down restructuring procedure, in particular, is a potentially game-changing restructuring tool.

The Bill has been laid before the UK parliament and its passage into law is expected to be expedited by way of a fast-track procedure. The second reading of the Bill is scheduled to be held on June 3, 2020.[2]

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[1] *See* Corporate Insolvency and Governance Bill: https://publications.parliament.uk/pa/bills/cbill/58-01/0128/20128.pdf.
[2] *See:* https://services.parliament.uk/bills/2019-21/corporateinsolvencyandgovernance.html.

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## I. Cross-Class Cram-Down Scheme

### A. *Key Features*

A new restructuring procedure (a "Cram-Down Scheme")[3] will be available to distressed companies which is modelled on the existing scheme of arrangement procedure and contains certain features of the U.S. Chapter 11 proceedings.

Although a company will not need to be insolvent in order to propose a restructuring plan under a Cram-Down Scheme, it is a condition that the company "has encountered, or is likely to encounter, financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern".

The procedure for a Cram-Down Scheme will largely mirror that of an ordinary scheme of arrangement. The proponent (which, in most cases, is likely to be the company) will put forward a restructuring proposal and apply to the court for the convening hearing. Following the first hearing, the notice of a creditors (or members) meeting and an explanatory statement will be circulated. After the stakeholder classes have voted on the proposed restructuring plan, a second court hearing will be held whereupon the court will decide whether or not to sanction the scheme.

As is the case for the current scheme of arrangement procedure, the Cram-Down Scheme will not automatically benefit from a moratorium or stay.

Courts have been prepared to use their broad case management powers under the English Civil Procedure Rules to impose a *de facto* moratorium on creditor proceedings while the scheme process is still ongoing. While the courts have stressed there must be special circumstances to grant a stay of proceedings, the courts have accepted that a scheme of arrangement may amount to special circumstances if there is a reasonable prospect of the scheme going ahead. The same approach may be used in the Cram-Down Scheme.

Furthermore, and provided the eligibility criteria for the new moratorium process discussed below are met, companies may also avail themselves of the new free-standing moratorium in conjunction with a Cram-Down Scheme. The utility of such a moratorium remains to be seen, given that the moratorium period is relatively short, the moratorium does not include "contracts for the provision of financial services" (including lending) and creditors may still enforce security over shares that qualify as financial collateral arrangements. Capital markets issuers are also not eligible to apply or file (as appropriate) for the free-standing moratorium. The Bill also includes certain restrictions on companies who have benefited from such a moratorium to then propose a Cram-Down Scheme with respect to moratorium debt or pre-moratorium debt that did not have a payment holiday within 12 weeks after the end of the moratorium (as discussed below in Part II, paragraph A). Given the commonality between the new Cram-Down Scheme and the existing scheme of arrangement procedure, we expect that the courts will continue to draw on the existing body of scheme case law to the extent relevant, including in respect of issues relating to class constitution, third party releases and the insolvency comparator.

At present, for a scheme of arrangement to become effective against the relevant class of scheme creditors or shareholders, at least 75% by value and a majority by number of such class must vote in favour of the scheme (subject to the court sanctioning the scheme). Creditors or members who are not part of the class that is the subject of the scheme are unaffected by it and retain their existing rights.

A Cram-Down Scheme, as currently proposed, will also require the consent of 75% by value in

[3] To be inserted as a new Part 26A in the Companies Act 2006.

each class of creditors or shareholders and sanction by the court. This remains higher than the two-thirds threshold required under the U.S. Chapter 11 proceedings. However, unlike a scheme of arrangement, there is no requirement for consent of the majority by number of those voting and, most importantly, neither is the failure of one class of creditors to vote in favour of the scheme fatal.[4] There is also no requirement to obtain the approval of the majority of unconnected creditors by value, which is required under a company voluntary arrangement.[5]

In effect, this will allow the court to bind classes of dissenting creditors or shareholders to a restructuring plan ("cross-class cram-down"), provided that the following two conditions are met. Creditors or shareholders who voted against a proposal but who would be no worse off under the restructuring plan than they would be under the most likely outcome were the restructuring plan not to be agreed (and are thus not financially disadvantaged) cannot necessarily prevent it from proceeding. Cross-class cram-down will only be permitted where at least one class which would receive a payment, or which would have a genuine economic interest in the company in the most likely alternative outcome, has voted in favour of the Cram-Down Scheme. The focus on the most likely alternative outcome will place significant emphasis on the role of the courts in ensuring the appropriate comparator is used for the purposes of determining whether or not a Cram-Down Scheme ought to be approved.

Every creditor or shareholder of the company whose rights will be affected by the restructuring plan proposed under the Cram-Down Scheme must be permitted to participate in a meeting and vote on the proposed restructuring.

As is the case with the current schemes (and unlike a company voluntary arrangement which can only be used in relation to unsecured debt), the Cram-Down Scheme will also have the ability to bind both secured and unsecured creditors.

One ramification of the proposed changes is that operational creditors (such as suppliers, who for various reasons relating to class composition and voting practicalities have typically not been brought within the scope of schemes to date, save for a few recent exceptions) may find that their claims are brought within the scope of a Cram-Down Scheme and written down as a result.

An interesting aspect of the Cram-Down Scheme is that the Bill proposes to codify the current case law position by allowing companies to disregard classes that have no economic interest in the outcome of the scheme. Under the Cram-Down Scheme, the company may apply to the court (likely at the same time as requesting the convocation of the meetings) to exclude classes from voting if they have no "genuine economic interest" in the company.

This will shine a spotlight on certain aspects of the process, including what an appropriate comparator might be and how the interests of various classes should be valued.[6]

It is likely that there will be a slow shift in how classes are constituted. Currently, for ordinary schemes, proponents are inclined to create one large class or as few classes as possible to avoid giving each class the ability to veto the scheme. The availability of the cross-class cram-down procedure may encourage proponents to break

[4] *See* Corporate Insolvency and Governance Bill, Schedule 9 (*Arrangements and reconstructions for companies in financial difficulty*), proposed Part 26A, paragraph 901F(1): "If a number representing 75% in value of the creditors or class of creditors or members or class of members (as the case may be), present and voting either in person or by proxy at the meeting summoned under section 901C, agree a compromise or arrangement, the court may, on an application under this section, sanction the compromise or arrangement."

[5] *See*: https://www.clearygottlieb.com/-/media/files/cvas-a-primer-june-14-2019.pdf

[6] Current case law on valuations is best summarised in *Re Bluebrook Limited and other companies (IMO)* [2009] EWHC 2114

the classes down more readily so as to improve the chances of at least one class voting in favour of the restructuring plan.

The Cram-Down Scheme, as currently proposed, also appears to be more flexible than certain aspects of Chapter 11 proceedings including, for example, the absolute priority rule, which requires the claims of a dissenting class of creditors to be paid in full before any class of creditors junior to such dissenting class may receive or retain any property in satisfaction of their claim. The absence of such safeguards will place more pressure on the English courts to ensure that the proposed plan is fair. Given the paradigm shift, we expect that the English courts will develop new case law to deal with the fairness issues that will inevitably come up in the context of cross-class cram-downs. It is worth noting that the Bill allows the Secretary of the State to impose additional conditions that will need to be met for the cross-class cram-down to be operational.

### B. *Implications for Non-UK Companies*

Schemes of arrangement have proved to be popular and flexible tools for restructurings by UK as well as foreign companies which have demonstrated "sufficient connection" to the UK. As we have discussed in a previous memorandum (available here),[7] the application of this test has resulted in, for example, companies with English law-governed debt that is subject to the scheme,[8] or with a small number of scheme creditors based in the UK,[9] availing themselves of English jurisdiction.

We expect that foreign companies will be able to use the Cram-Down Scheme, provided they meet the "sufficient connection" test as would be required under a scheme of arrangement (*e.g.*, where English law is the governing law of the contracts subject to the scheme). There will be no need for the company to have its "centre of main interests" in the UK.

Companies will need to consider carefully whether the restructuring plan will be recognised in other relevant jurisdictions, such as the jurisdiction of incorporation of the borrower or a guarantor, and where key assets are located. The court may refuse to sanction a Cram-Down Scheme where it would be ineffective in practice, in particular, through an inability to bind creditors under the rules of other relevant jurisdictions (*e.g.*, because there will be not automatic recognition under the European Insolvency Regulation). This will be an important issue in practice, and the courts are likely to continue to expect expert evidence on whether or not the Cram-Down Scheme will be recognised in relevant jurisdictions.[10]

## II. Company Moratorium

### A. *Key Features*

The Bill introduces the possibility of obtaining a free-standing moratorium for an initial period of 20 business days if the directors consider that a company is, or is likely to become, unable to pay its debts when these fall due. This measure is intended to allow companies the time to explore their rescue or restructuring options, free from certain creditor actions.

The directors may, in the last five business days of the initial 20 business day period, extend the moratorium for an additional 20 business days by filing a notice and other required documents with the court. Any extension of the moratorium beyond 40 business days will require the consent of the creditors or the court.

[7] *See*: https://www.clearygottlieb.com/~/media/organize-archive/cgsh/files/publication-pdfs/alert-memos/2016/alert-memo-201695.pdf

[8] *Re Apcoa Parking Holdings GmbH and others* [2014] EWHC 1867 (Ch); *In Re Stripes US Holdings Inc* [2018] EWHC 3098

[9] *Re DTEK Finance plc* [2017] BCC 165

[10] The extent to which Brexit, and the possible absence of a convention for the enforcement of judgments in the EU thereafter, and the introduction of scheme-like procedures in European jurisdictions will impact schemes of arrangements and Cram-Down Schemes alike remains to be seen.

During a moratorium, directors will remain in charge of the business (a form of "debtor-in-possession" proceeding, similar to a U.S. Chapter 11 restructuring process), subject to the oversight of a qualified insolvency practitioner acting as a "monitor" of the moratorium, whose role will include:

- ensuring the company's compliance with the moratorium requirements;
- approving sales of assets outside of the normal course of business; and
- approving any grant of new security over the company's assets.

The directors will need to file with the court, among other things, a statement that the company is, or is likely to become, unable to pay its debts. To benefit from a moratorium, a company must also provide a statement from the monitor attesting that the company is likely to be rescued as a going concern if the moratorium is granted. While the introduction of the new Cram-Down Scheme will make it easier to meet this standard, it remains a relatively high threshold to satisfy (especially given the limited scope of the moratorium and its longevity).

The Bill includes a number of creditor protection mechanisms, including restrictions on payments and disposals of assets during the moratorium. Creditors may also challenge the actions of the directors or the monitor on grounds that their interests have been unfairly prejudiced.

Once in effect, a moratorium will: (i) impose a "payment holiday" for debts falling due before or during the moratorium, save for specified exceptions; and (ii) prohibit, among other things, winding-up petitions and the enforcement of security interests (subject to exemptions including financial collateral arrangements).[11]

Debts that are excluded from a payment holiday during a moratorium notably include debts arising under contracts for the provision of financial services consisting of lending (including the factoring and financing of commercial transactions), financial leasing, providing guarantees or commitments, securities financing transactions, derivatives, spot FX contracts and, importantly, contracts secured by title transfer and security financial collateral arrangements under the Financial Collateral Arrangements (No. 2) (Regulations 2003) ("FCAR"), thus potentially limiting the value of the moratorium. In practice, this means that bank debt and many other financial obligations of a debtor (which may, for many companies, represent their most material financial obligations) will be excluded from the benefit of the moratorium. Furthermore, if the monitor considers that the company is unable to pay these excluded debts as they fall due, the monitor is required to bring the moratorium to an end.

In addition, any company that is a party to certain capital markets arrangements is not eligible for the moratorium. This broad exception means that many businesses with outstanding bonds[12] will be excluded entirely from the moratorium (including both the payment holiday and the restrictions on enforcement).

Further, in the event that a company that has employed a moratorium seeks to make use of the Cram-Down Scheme or a scheme of arrangement within 12 weeks of the end of the moratorium, the consent of each of the creditors whose claims were not subject to a payment holiday during the moratorium, but who were affected by the restructuring, would be required. Given that these tools are primarily used to restructure financing debts (which, as discussed above, are not subject to the moratorium), this may mean that implementing a moratorium would

[11] *See* Corporate Governance & Insolvency Bill, Chapter 4: https://publications.parliament.uk/pa/bills/cbill/58-01/0128/20128.pdf.

[12] It is unclear whether this exclusion is limited to publicly traded bonds or whether private placements will be excluded as well.

effectively exclude a company from the useful application of the Cram-Down Scheme or the scheme of arrangement for a significant period.

As such, while a moratorium may provide short-term working capital relief, companies with significant debt service obligations falling due may be better served by more traditional insolvency or restructuring tools, or the Cram-Down Scheme discussed above.

### B. *Implications for Non-UK Companies*

The new moratorium process will be available to all UK companies and unregistered companies that may be wound up under Part 5 of the Insolvency Act 1986 (the "Insolvency Act"). Accordingly, a non-UK company may be eligible for the new moratorium if it may be wound up under Part 5 of the Insolvency Act.

The courts may exercise the same discretion when considering such an application as they would when considering the winding-up of a foreign company. The court's power to wind up a foreign company is conferred by section 221 of the Insolvency Act, but the core requirements for whether an English court has jurisdiction to wind-up a foreign company have been established by English case law;[13] namely, there must be:

(i) a sufficient connection with England and Wales which may, but does not necessarily have to, consist of assets within the jurisdiction (*e.g.*, where the contract under which the company's relevant financial obligations arise is governed by English law);

(ii) a reasonable possibility, if a winding-up order is made, of benefit to those applying for the winding-up order (this is not limited to a direct financial benefit *e.g.*, it may include situations where the making of a winding-up order would entitle the petitioning creditor to claim against insurers[14] or to claim redundancy compensation);[15] and

(iii) one or more persons interested in the distribution of assets of the company over whom the court can exercise jurisdiction (*e.g.*, where the petitioning creditor has submitted to the jurisdiction of the English courts).[16]

The explanatory notes to the Bill further indicate that a foreign company will need to apply to the courts for a moratorium to ensure that it is within the jurisdiction of the UK courts before receiving the protection of a moratorium.[17] In respect of a UK company that is not the subject of a winding-up petition, mere filing with (rather than application to) the court is all that is required.

Given the categories of debts excluded from the moratorium (as stated above), it is not clear whether the moratorium process will offer significant benefits for non-UK companies to incentivise use of the process.

## III. Temporary Suspension of Wrongful Trading Rules

The existing insolvency rules, as set out in the Insolvency Act, provide that directors of limited liability companies may be personally liable for business debts if they allow the company to continue to trade once insolvent administration or liquidation becomes unavoidable.

As previously announced (see our memorandum on this subject available here),[18] the Bill

[13] *Stocznia Gdanska SA v Latreefers Inc (No 2)* [1998] EWHC 1203 (Comm)

[14] *Re Compania Merabello San Nicolas S.A.* [1973] Ch 75.

[15] *Re Eloc Electro-Optiek and Communicatie B.V.* [1982] Ch 43.

[16] In *Stocznia Gdanska SA v Latreefers Inc (No 2)*, the petitioning creditor (a foreign individual with no business presence in England) had the benefit of an English judgment debt, which the court noted involved submission to the jurisdiction.

[17] *See* Corporate Insolvency and Governance Bill, Explanatory Notes, Chapter 2, paragraph 104: https://publications.parliament.uk/pa/bills/cbill/58-01/0128/en/20128en.pdf.

[18] *See*: https://www.clearygottlieb.com/news-and-insights/publication-

temporarily suspends such provisions with retrospective effect from March 1, 2020 to June 30, 2020. Accordingly, liquidators and administrators will not be able to bring claims for wrongful trading against an insolvent company's directors for any losses caused by trading during the suspension period. It is important to note that certain companies are excluded from this suspension. Among those are debtors with capital markets arrangements, which will exclude many debtors who have issued bonds.

While the rationale for the suspension is to reduce the threat of personal liability in respect of wrongful trading should the company ultimately fall into insolvency, it is important to note that this will not change the general directors' duties regime and other insolvency law offences. Liquidators and administrators will still be able to bring claims against directors for breaches of such duties such as fraudulent trading,[19] transactions defrauding creditors,[20] and misfeasance.[21] These rules, together with director disqualification laws, remain in force to deter director misconduct.

Under the Insolvency Act, a director may only be found to have breached the wrongful trading rules if, at some point before the commencement of liquidation or administration proceedings, he or she knew or ought to have known that there was no reasonable prospect that the company would avoid insolvency and failed to take steps to minimise the potential loss to creditors. It is also balance sheet, not cash-flow insolvency, that tends to be relevant in wrongful trading. This arguably presents a high threshold test for breaches of the wrongful trading rules.

Conversely, a director's common law duty to consider the interests of creditors[22] when he or she knows, or ought reasonably to know, that the company is (or there is greater than a 50% likelihood that it will become) balance sheet or cashflow insolvent[23] is arguably engaged sooner than the threshold test for wrongful trading, and will not be suspended under the Bill. There is also a possibility that the Supreme Court, which is currently hearing the appeal in *BTI v Sequana SA*, may find that the trigger for a director's duty under Section 173(2) of the Companies Act 2006 (the "Companies Act") is lower than "*is likely to become insolvent*".[24] The test also looks at either cash-flow or balance sheet insolvency, as opposed to only the latter.

## IV. Temporary Prohibition of Statutory Demands and Winding-up Petitions

The Bill introduces temporary prohibitions on the service of statutory demands and making of winding-up petitions against companies that are unable to pay a debt as a result of the disruption caused by COVID-19.

A winding-up petition cannot be presented by a creditor during the period from April 27, 2020 (retrospectively) until the later of June 30, 2020 or one month following the Bill coming into force, unless the creditor has reasonable grounds for believing that:

- COVID-19 has not had a financial effect on the debtor; or
- the debtor would have been unable to pay its debts even if COVID-19 had not had a financial effect on the debtor.

COVID-19 is considered to have a "financial effect" on a debtor if the debtor's financial position worsens in consequence of, or for reasons relating to, COVID-19. It is likely to be very challenging for the court to determine whether or not the underlying insolvency event

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[19] *See* Sections 213 and 246ZA of the Insolvency Act.

[20] *See* Section 423 of the Insolvency Act.

[21] *See* Section 212 of the Insolvency Act.

[22] *See* Section 172(3) of the Companies Act.

[23] *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112

[24] The question on appeal is whether the trigger for the creditors' interest duty under s. 172(3) is merely "a real risk of" as opposed to a probability of insolvency.

would have occurred, disregarding the effect of COVID-19.

Statutory demands against companies between March 1, 2020 and June 30, 2020 also cannot be used as the basis of a winding-up petition if such petition is presented on or after April 27, 2020.

## V. Ipso Facto Clauses

The Bill further includes provisions aimed at preventing suppliers from terminating delivery of supplies on the grounds of the purchasing company's insolvency (so-called "*ipso facto*" clauses), if the supplies in question continue to be paid for.

Suppliers will not be allowed to amend the terms of their contracts in order to force increased payments, but may be relieved of the obligation to continue to supply companies if doing so results in hardship to the supplier's business.

There are notable exemptions for certain companies (predominantly in the financial services sector) and in respect of certain contracts (*e.g.*, set-off and netting arrangements) (see Part VII below), which are considered helpful to preserve legal certainty for financial market participants but will nonetheless require careful interpretation.

## VI. Temporary Extension of Certain Filing Deadlines

The Bill grants a temporary extension to the period in which public companies are required to file their annual accounts with the registrar at Companies House. For example, if a public company's accounting reference period ended on December 1, 2019, the directors of the company are required under Section 442 of the Companies Act to deliver the company's accounts and reports to the registrar on or by June 1, 2020. As this deadline of June 1, 2020 falls within the time period specified in the Bill (*i.e.*, after March 25, 2020 and before September 30, 2020), the deadline for filing will be extended until the September 30, 2020.

Under the Bill, the Secretary of State may make further extensions to specified filing deadlines listed in Section 38 of the Bill, including the period for registering a charge under sections 859A or 859B of the Companies Act. The extended period for filings must not exceed:

- 42 days, where the existing period is 21 days or fewer; or
- 12 months, where the existing period is three, six or nine months.

For further information on the extension of statutory filings for companies generally, please see our memorandum on this subject (available here).[25]

## VII. Financial Services

The regulatory response to the Bill has generally been positive, though the specific roles that the Financial Conduct Authority ("FCA") and the Prudential Regulation Authority ("PRA") will play in relation to the legislation remains to be seen.

The FCA considered the new provisions when the Bill was first announced and noted the necessity in providing specific provisions for the financial services sector in order to protect consumers and financial stability.[26] In particular, the FCA highlighted that certain (UK and equivalent overseas) financial services firms are excluded from the moratorium, suspension of supplier termination clauses and temporary suspension of wrongful trading provisions in the Bill. These include banks and banking group

[25] *See:* https://www.clearygottlieb.com/news-and-insights/publication-listing/covid19-uk-governments-latest-measures-to-support-uk-businesses/

[26] *See*: https://www.fca.org.uk/news/statements/financial-services-exemptions-forthcoming-corporate-insolvency-and-governance-bill.

companies, "investment banks",[27] investment firms, insurers, payments and e-money institutions, certain financial markets infrastructure[28] and securitisation companies.

In addition, the following are excluded from the scope of the moratorium:

- parties to a "market contract" or subject to a "market charge"[29] or subject to a "system charge";[30] and
- participants in a "designated system" or a company with property subject to a "collateral security charge".[31]

Where a regulated company is within the scope of the moratorium regime, the PRA's or FCA's written consent is required for the appointment of a monitor.

Furthermore, the operation of the suspension of supplier termination clauses is subject to operation of:

- Part 7 of the Companies Act 1989 (financial markets and insolvency);
- Financial Markets and Insolvency Regulations 1996;
- the Financial Markets and Insolvency (Settlement Finality) Regulations 1999;
- FCAR; and
- netting and set-off arrangements.[32]

The aim of these exclusions is to protect consumers and financial stability as well as to ensure that the UK's existing special insolvency regimes for financial sector firms remain effective.

The Cram-Down Scheme will be available to financial services firms, with certain safeguards including powers for the FCA and PRA to participate in proceedings. The Bill also includes a power for the Secretary of State to make regulations to exclude financial services companies from the scope of the Cram-Down Scheme.

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[27] Firms with one or more of the following permissions: (a) safeguarding and administering; (b) managing an alternative investment fund ("AIF") or undertaking for the collective investment in transferable securities ("UCITS"); (c) acting as trustee or depositary of an AIF or UCITS; (d) dealing as principal; or (e) dealing as agent.

[28] Namely: (a) operators of payment systems, infrastructure providers or infrastructure companies (within the meaning of Parts 5 and 6 of the Financial Services (Banking Reform) Act 2013); (b) recognised investment exchanges; (c) recognised clearing houses; and (d) recognised central securities depositories.

[29] Each as defined in Part 7 of the Companies Act 1989.

[30] Within the meaning of the Financial Markets and Insolvency Regulations 1996

[31] Both within the meaning of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999.

[32] Within the meaning given by section 48(1)(c) and (d) of the Banking Act 2009.