Milbank

Financial Restructuring Group

Client Alert

UK government passes new legislation introducing significant changes to UK restructuring and insolvency regime

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Key Contacts

Jacqueline Ingram, Partner
+40 20.7615.3251
jingram@milbank.com

Kate Colman, Associate
+44 20.7615.3143
kcolman@milbank.com

On 26 June 2020, the Corporate Insolvency and Governance Act (the "**CIGA**") entered into force. We summarised the key terms of the proposed legislation in our previous client alert (*link to previous alert*).

The CIGA introduces some very significant reforms to the restructuring and insolvency framework in the UK, intended to deal with the near term-issues caused by the economic consequences of the Covid-19 pandemic and also overhaul the wider legislative framework.

Permanent reforms

Moratorium

The provisions around the moratorium are largely unchanged from those previewed in the draft legislation. The moratorium is intended to assist a company that is, or is likely to become, unable to pay its debts by creating breathing room for the company – with a payment holiday in respect of certain pre-moratorium debts, and a stay on legal proceedings and security enforcement during the moratorium period.

The moratorium is a "debtor-in-possession" procedure, leaving the company's management and directors to run the business, subject to the oversight of a "monitor". The monitor is an insolvency practitioner but, in this role, performs a light-touch supervisory function, essentially tasked with monitoring that it is and remains likely that the moratorium would result in the rescue of the company as a going concern.

The moratorium lasts for an initial period of 20 business days but is extendable by another 20 business days by the company. Further extensions beyond this period require creditor consent, or court intervention.

Following publication of the draft legislation, a number of concerns were raised in relation to the moratorium, both in terms of its scope and the ability for companies with more complex capital structures to benefit from its provisions.

One of the areas of concern is the exclusion from the "payment holiday" of debts or liabilities arising under a contract or other instrument involving financial services. The effect of this exclusion is that a company will not get payment relief in respect of obligations under "financial contracts" (loans, financial leases, guarantees or commitments, commodities contracts, securities contracts), securitisation transactions, derivatives or spot contracts, capital market investments or market contracts. The company would have to

keep all such liabilities current for the duration of the moratorium, otherwise the moratorium must be brought to an end.

The distinction between pre-moratorium debts which are and are not subject to a “payment holiday” is also relevant to what happens after the moratorium. If, following the moratorium, the company enters a winding-up or administration process, pre-moratorium debts which were not subject to the payment holiday (which would include debts of a financial nature as described above) are awarded priority (i.e. behind fixed charges but ahead of floating charge recoveries, preferential creditors and the “prescribed part” of floating charge recoveries which is paid to unsecured creditors). Priority is not granted where amounts fell due during the moratorium because of an acceleration or early termination of the relevant debt.

New scheme

The new scheme, also referred to as the “restructuring plan” or “cram-down scheme”, is another innovation which has garnered a great deal of interest within the restructuring community.

The new scheme is targeted at companies in financial distress – the company must have encountered, or be likely to encounter, financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern. The new scheme is intended to eliminate, reduce or prevent, or mitigate the effect of, any of those financial difficulties.

Introduced as Part 26A of the Companies Act 2006, the new scheme is modelled on the existing scheme of arrangement provisions, a fact which will bring a significant degree of comfort, as existing case law will, to a large extent, remain relevant. The key difference between the “old” and “new” schemes is that the new regime introduces a cross-class cram-down, allowing a scheme to be sanctioned even where one voting class has not approved the proposal at its scheme meeting, subject to certain conditions being met and the court’s sanction. Another notable feature is the removal of the numerosity test from the requisite majorities required to approve the scheme.

The cross-class cram-down feature opens a number of potential restructuring options, which were not possible under the existing scheme of arrangement provisions – including the possibility of creditor classes being able to “cram-down” dissenting shareholder classes but also, conversely, equity or junior creditor classes being able to “cram-up” more senior classes.

Dissenting classes are “protected” by a requirement that they receive no less than they would in the “relevant alternative” scenario (i.e. the most likely alternative for the company absent the scheme). Also, the scheme must have been approved by a class who would receive a payment, or have a genuine economic interest in the company, in the event of the relevant alternative. However, as noted in our previous client alerts on this topic, the CIGA does not include protections such as an absolute (or modified) priority rule so senior creditor classes could find themselves compromised while junior creditor classes (or equity) are left uncompromised. In addition, the question of what is the “relevant alternative” or who has a “genuine economic interest” could open the door to new, and potentially contentious, valuation disputes before the English courts.

A number of the features of the new scheme will be welcomed by the restructuring community as addressing failings of the old regime, which were often dealt with by sandwiching together different processes with consequent increased cost and complexity. However, concerns remain about the introduction of a number of concepts which lack significant judicial precedent, and which do not adopt some of the more developed protections which are a feature of other systems and procedures.

Insolvency termination clauses

The CIGA implements provisions restricting a supplier of goods or services to a company who is subject to an insolvency procedure from terminating that contract, or conditioning future performance on the payment of existing debts. The applicable insolvency procedures include the new moratorium and new scheme alongside administration, administrative receivership, liquidation and company voluntary arrangements.

However, the restriction would not apply in respect of a company proposing a scheme of arrangement under the “old” scheme provisions (i.e. Part 26 of the Companies Act).

Although similar provisions had been introduced in respect of “essential” suppliers in the context of administration, the provisions set out in the CIGA go further in terms of the range of suppliers and circumstances in which they would apply.

The restriction on termination clauses applies where the right to terminate arises because the company has become subject to the relevant insolvency procedure (so-called typical *ipso facto* clauses) and in respect of termination rights that arose (but were not exercised) prior to the commencement of the insolvency procedure. This means that if, for example, a supplier had the right to terminate due to non-payment before the company obtained the moratorium but had not acted on it, the supplier would be restricted from exercising that right once the moratorium came into effect. There is a list of excluded entities to which the suspension of termination rights would not apply, whether the entity was the company in distress or the contractual counterparty. This includes deposit-taking banks and investment banks or firms, as well as insurance companies. In addition, “financial contracts” again fall outside the scope of the restrictions As noted above, the definition of “financial contracts” is broad and includes loan agreements, financial leases, swap agreements and derivatives and capital market arrangements.

There are some protections for suppliers who are caught by the provisions, including an ability to apply to court to allow termination on grounds of hardship (or terminate with the consent of the Company or relevant office holder). There is also a temporary suspension with respect to small suppliers, which will last until 30 September 2020.

Temporary Covid-19 response measures

Wrongful trading

The suspension of liability in respect of wrongful trading has been extended under the CIGA from that contemplated by the Bill. The temporary suspension of a directors’ personal liability for wrongful trading was a cornerstone of the government’s proposals to support business adversely affected by the Covid-19 pandemic. Under the CIGA, the suspension will apply to trading between the period starting 1 March 2020 and ending 30 September 2020.

The wrongful trading provisions mean that directors of limited liability companies may become personally liable for certain business debts if they continue to trade when there is no reasonable prospect that the company would avoid going into insolvent liquidation or insolvent administration. The aim of the suspension is to encourage directors of businesses which have been hit by the economic turmoil caused by Covid-19 and resulting public health measures to try and work through the current circumstances without feeling obliged to file for insolvency. It is, however, important to note that this is a temporary and relatively limited suspension and directors’ other duties, such as fiduciary duties, will still continue to apply.

Winding-up petitions etc.

The second temporary measure suspends the ability of creditors to present winding up petitions and statutory demands. It is not a wholesale suspension, as petitions etc. are allowed where it is able to be shown that coronavirus has not had a financial effect on the company, or that the grounds for the petition would have arisen even if coronavirus has not had a financial effect on the company.

Like the wrongful trading provisions, this provision also has retrospective effect, with it being regarded as having come into force on 1 March 2020 and will last until 30 September 2020.

Key Contacts

London	10 Gresham Street, London, UK EC2V 7JD	
Nick Angel	nangel@milbank.com	+44 20.7615.3008
Jacqueline Ingram	jingram@milbank.com	+44 20.7615.3251
Karen McMaster	kmcmaster@milbank.com	+44 20.7615.3266
Yushan Ng	yng@milbank.com	+44 20.7615.3341
Sinjini Saha	ssaha@milbank.com	+44 20.7615.3814

Los Angeles	2029 Century Park East, 33rd Floor, Los Angeles, CA 90067	
Gregory A. Bray	gbray@milbank.com	+1 424.386.4470
Thomas R. Kreller	tkreller@milbank.com	+1 424.386.4463
Mark Shinderman	mshinderman@milbank.com	+1 424.386.4411

New York	55 Hudson Yards, New York, NY 10001	
Nelly Almeida	nalmeida@milbank.com	+1 212.530.5271
Matthew Brod	mbrod@milbank.com	+1 212.530.5460
Lauren C. Doyle	ldoyle@milbank.com	+1 212.530.5053
Dennis F. Dunne	ddunne@milbank.com	+1 212.530.5770
Evan R. Fleck	efleck@milbank.com	+1 212.530.5567

Samuel A. Khalil	skhalil@milbank.com	+1 212.530.5015
Tyson Lomazow	tlomazow@milbank.com	+1 212.530.5367
Dennis C. O'Donnell	dodonnell@milbank.com	+1 212.530.5287
Michael Price	mprice@milbank.com	+1 212.530.5577
Abhi Raval	araval@milbank.com	+1 212.530.5123
Eric K. Stodola	estodola@milbank.com	+1 212.530.5663
Jerry Uzzi	juzzi@milbank.com	+1 212.530.5670

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