Corporate insolvency: bringing balancing to the force

Georgia Quenby examines the key features of the Corporate Insolvency and Governance Act 2020 (CIGA), which creates new tools to bring about company rescue and reconstruction in the UK.

The CIGA is widely heralded as introducing the most sweeping changes to UK insolvency law for a generation. It has introduced three main features into the laws of England & Wales, Northern Ireland and Scotland:

- a new freestanding moratorium into the Insolvency Act 1986 (IA86);
- a restriction on *ipso facto* clauses, also known as a restriction on supplier termination clauses; and
- a new restructuring plan procedure as part 26A of the Companies Act 2006 (CA 2006) to allow for arrangements and reconstructions of a company in financial difficulty (a new restructuring plan under the CA 2006).

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Temporary measures

In addition to the above there are a series of temporary measures, some of which modify entry criteria or effects of the three key new elements of the moratorium, the restriction on supplier termination clauses and the restructuring scheme, and some standalone temporary provisions. The standalone temporary measures: mitigate a director's potential personal liability for wrongful trading to the extent that the downturn in performance is Covid-19 related; make changes to the reporting requirements of companies; and prevent the presentation of most winding-up petitions.

This article focuses on the key features of the new restructuring plan and the use of the moratorium as a stepping stone to one of three rescue routes: a CVA, a restructuring plan or a recapitalisation. We don't have space to cover the temporary measures or the supplier termination restrictions here.

Purpose of the new permanent measures

The restructuring and insolvency landscape in the UK has long been regarded as secured lender-friendly, so much so that in 2002 the government introduced the Enterprise Act and modernised the administration regime. In the list of the three-tiered objectives of an administration of a company, the first objective for the administrators of a company was, and still is, to rescue the company as a going concern. It is an indicator of how rarely this first objective is achieved by an administration that the entry criteria to a moratorium include that the company is or is likely to become unable to pay its debts and that the proposed monitor believes that it is likely that 'a moratorium for the company would result in the rescue of the company as a going concern.'

The explanatory notes to the draft legislation were informative both as to the policy drivers and as to the expected use of both the moratorium and the new restructuring plan. The notes provide:

'The overarching objective of this bill is to provide businesses with the flexibility and breathing space they need to continue trading during this difficult time. The measures are designed to help UK companies and other similar entities by easing the burden on businesses and helping them avoid insolvency during this period of economic uncertainty.'

The notes go on to say that the purpose of providing breathing space to continue trading and avoid insolvency is met because the new laws:

'introduce greater flexibility into the insolvency regime, allowing companies breathing space to explore options for rescue while supplies are protected, so they can have the maximum chance of survival' and

'protect companies from aggressive creditor action'.

The same but different?

The new moratorium shares many features with the moratorium available to a company whose directors have filed a notice of intention to appoint administrators but a key distinction is that the new moratorium is a debtor-in-possession process, whereas once administrators are actually appointed the directors are no longer in control. This is also true of the new restructuring plan. So as a package what we have is a serious attempt by the UK government to create a debtor-in-possession restructuring toolkit, which will seem like a huge change to secured lenders who are accustomed to the administration and liquidation processes in which the incumbent directors' powers to bind the company cease immediately.

Both new processes are different in material respects from both their local and their American Chapter 11 cousins. The new processes build on prior experience and plug gaps in existing processes with the objective of creating a robust, business-friendly rescue culture by enabling debtor-in-possession reorganisation with the benefit of the breathing space produced by the moratorium.

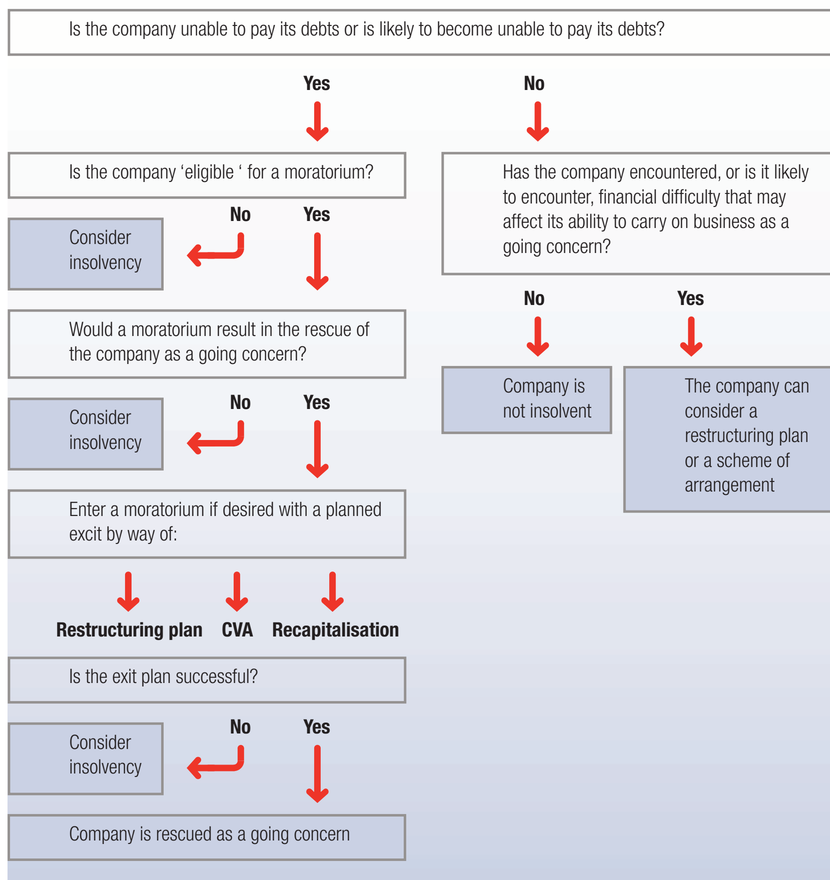
New moratorium v. administration moratorium	
Similarities	Differences
The monitor must be a licensed IP, free from conflicts of interest.	The holder of a qualifying floating charge cannot object to the identity of the monitor whereas they can select the administrators.
Company has 'breathing space' from its creditors to allow it to reorganise its business and explore its options for survival. No creditor can commence insolvency proceedings or enforce its security against a company that has the benefit of the new moratorium or the administration moratorium.	Directors remain in place in the new moratorium under the supervision of a monitor. Directors are disenfranchised upon the appointment of an administrator and the administrator takes full control of the company. No administrator can be appointed.
Similar to the 'out of court' administration route, a company can obtain the benefit of the new moratorium upon the presentation of the required legal paperwork at court.	The new moratorium prohibits creditors from crystallising floating charges and imposing any restrictions on disposals. The appointment of an administrator is typically, under a company's security documents, an event that causes a floating charge to crystallise into a fixed charge.
To enter the new moratorium and the administration moratorium, a company must be unable to pay its debts, or is likely to become so.	The new moratorium does not require the consent of (and provision of advance notice to) secured creditors. The appointment of an administrator (by a company or its directors) requires the qualifying floating charge holder to be given five business days' notice.
The monitor is required to end the new moratorium if he or she thinks that the moratorium is no longer likely to result in the rescue of the company as a going concern. An administrator must end the administration moratorium if he or she thinks that the administration can no longer achieve its purpose.	The new moratorium affords a company a 'payment holiday' for debts that fell due prior to, or during, the moratorium (subject to certain exceptions).
Suppliers are prohibited from invoking insolvency termination clauses in certain contracts with a company that is subject to the new moratorium or an administration.	The new moratorium lasts for an initial period of 20 business days, which can be extended for up to a year but only with the consent of the company's 'pre-moratorium creditors'. An administration lasts for an initial period of one year.

The new restructuring plan shares many features with a part 26 CA 2006 scheme of arrangement but again there are key differences, in particular with the inclusion of 'cross-class cram down'.

Restructuring plan v. scheme of arrangement	
Similarities	Differences
Both a restructuring plan and a scheme enable a company to compromise the rights of secured creditors, unsecured creditors and shareholders.	The restructuring plan includes a 'cross-class cram down', which means that, if certain conditions are met, the restructuring plan may be imposed on a dissenting class of creditors.
Both a restructuring plan and a scheme are court processes and require court approval. The court exercises a discretionary power to approve the terms of both a restructuring plan and a scheme – court approval is not a 'rubber stamp'.	The ability to cram down dissenting classes in a restructuring plan is likely to incentivise a company to propose multiple smaller classes to ensure that the plan succeeds, in contrast to the approach taken to class composition in a scheme.
The court processes for a restructuring plan and scheme are very similar and include a convening hearing and a sanction hearing.	A restructuring plan requires the approval of at least 75% in value of the voting creditors in each class. A scheme requires at least 75% in value, and a majority in number, of the voting creditors in each class.
Both a restructuring plan and scheme are available to domestic and foreign companies that can demonstrate 'sufficient connection' with England and Wales.	To enter a restructuring plan, a company must be experiencing, or be likely to experience, financial difficulties and the purpose of the restructuring plan must be to eliminate or reduce those difficulties.
If a company that is subject to the new moratorium enters into a restructuring plan or scheme, the new moratorium terminates once the restructuring plan or scheme is sanctioned.	Prohibition on *ipso facto* clauses in a restructuring plan.

Decision tree

The decision tree below indicates the likely choices and consequences facing a company in financial difficulty now that the moratorium and restructuring plan are available.



Moratorium

The new moratorium creates breathing space for the company by preventing creditors from taking any of the following action:

- enforcement of security;
- starting or continuing insolvency proceedings;
- crystallisation of floating charge or restricting disposals of floating charge assets;
- starting or continuing legal proceedings against the company (with some limited exceptions);
- repossession of HP/conditional sale/leased assets without permission of court; and
- forfeiture by landlords.

There is also an embedded incentive for a finance provider under a contract for financial services not to accelerate their debt, which is that they would lose a super-priority status in a subsequent insolvency if the moratorium fails in its objective of rescuing the company as a going concern.

Although most English companies are eligible for the protection of a moratorium, new schedule ZA1 to IA86 sets out a list of companies that are not eligible, for example banks, companies that have issued certain types of bonds, insurance companies, PPP companies and securitisation companies.

As a package what we have is a serious attempt by the UK government to create a debtor-in-possession restructuring toolkit, which will seem like a huge change to secured lenders.

The prospective insolvency test

The moratorium requires that the company and the prospective monitor agree that the company is unable or is likely to become unable to pay its debts, and that the moratorium would be likely to result in the rescue of the company as a going concern.

There is a clear intersection here between the legal nature of the condition and the view of the auditors of the company. In particular we expect the company to be focused on achieving sign off of its accounts on a going concern basis after the moratorium.

In combination, this will mean that the company, the monitor and the auditors will need rapidly to reach a consensus not just as to the company's operations during the moratorium (including, critically, as to funding of the business during the moratorium), but also as to the route out of the moratorium.

How and when does the moratorium start?

Usually entry into the moratorium will be an out-of-court process followed by notice to creditors.

Termination of the moratorium

The monitor can terminate the moratorium if the monitor thinks:

- the objective of rescuing the company as a going concern has been achieved;
- the moratorium is no longer likely to result in a rescue of the company;
- the company is unable to pay (i) moratorium debts or (ii) pre-moratorium debts for which there is no payment holiday, which have fallen due (the current obligations); or
- the monitor is unable to carry out its duties because the directors are not providing the necessary information allowing the monitor to carry out the role.

In going into the moratorium the company and its advisors will know what its current obligations are likely to be and these should be in the relevant short-term cash flow forecasts, along with any requirement for additional funding. This will almost certainly lead to negotiations with senior lenders, at least, upfront to ensure buy-in and the continued provision of finance, given that lenders are not required to provide new money to a company in a moratorium.

Payment holiday

The company has a payment holiday for pre-moratorium debts. 'Pre-moratorium debts' means debts that fell due prior to (or during) the moratorium. These are analogous to 'provable debts'. 'Moratorium debts' means debts incurred during a moratorium – eg rent, wages and expenses. These are analogous to 'expenses' and the government has suggested parties use the *Nortel* case as a guide in cases of doubt.

There are exceptions to the payment holiday for:

- debt incurred under financial services contracts (including loan and credit agreements and receivables purchase arrangements, but excluding accelerated debts);
- rent in respect of a period of use during moratorium;
- goods or services used during moratorium;

- monitor's fees and expenses;
- redundancy payments; and
- certain wages/salary payments.

Restructuring plan

The new restructuring plan shares heritage with the CA 2006 scheme of arrangement (Part 26 scheme), company voluntary arrangements under IA86 and a reorganisation under Chapter 11 of the US Bankruptcy Code. The government's explanatory notes make it clear that the new restructuring plan is deliberately similar to a scheme of arrangement and indicates that jurisprudence on matters such as class construction should be used to assist in determining creditor classifications in a restructuring plan.

The restructuring plan is inserted into CA 2006 but it is, nevertheless, a compromise or arrangement procedure specifically applicable to companies in, or anticipating, financial difficulty. This is a court-supervised procedure. An application is made to court to convene a meeting of creditors or shareholders (or the relevant classes of creditors/members), and a statement is sent to creditors/ members which:

- explains the effect of the proposed compromise or arrangement; and
- states any material interests of the directors (in any capacity) and the effect on those interests of the proposed plan.

The following conditions are specified in the legislation for availability of the restructuring plan:

- **Condition A**: 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; and
- **Condition B**: a compromise or arrangement is proposed between the company and its creditors, or any class or them, or its members, or any class of them the purpose of which is to eliminate, reduce or prevent, or mitigate the effect of, any of the financial difficulties which are affecting, or will or may effect, its ability to carry on business as a going concern.

The company, a creditor or a member can propose a plan, as can the administrators of a company. The plan can cover a wide range of restructurings and creditor and shareholder reconstructions, including acquisitions.

Voting

Classes are typically classified according to the following principle: a class is 'those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest'.

Once the classes have been confirmed there will be meetings of each class where the relevant creditors/members or relevant classes vote on the plan. The required threshold is 75% by value of those creditors/members (or relevant classes) present and voting whose rights are affected by the plan.

It is worth noting that creditors or members who do not have a 'genuine economic interest' in the company may be excluded from voting (which may include shareholders). This new feature enables out-of-the money classes of creditors to be excluded from the process, provided the court is persuaded that they do indeed have no such genuine economic interest.

There are certain 'special cases' who get protection, such as pre-moratorium financial creditors, who cannot be compromised or crammed down without their consent (even if 75% of their class voted in favour of the plan) if the restructuring plan is proposed within 12 weeks of the end of a moratorium. Generally, however, the conditions to cross-class cram down are that:

- **Condition A**: the court is satisfied that if the plan were to be approved, none of the members of the dissenting class would be any worse off than they would be in the event of the relevant alternative.
- **Condition B**: the plan has been agreed by at least 75% in value of a class of creditors/members who would receive a payment, or have a genuine economic interest in the company, if the relevant alternative were to occur.

> "The moratorium requires that the company and the prospective monitor agree that the company is unable or is likely to become unable to pay its debts."

The 'relevant alternative' is described as being whatever the court considers would be most likely to occur in relation to the company if the restructuring plan were not sanctioned. Given the 'financial difficulties' entry requirement it is reasonable to expect this will generally be an insolvency procedure and so an estimated outcome statement will provide a useful comparator for the court in making this determination.

The court has ultimate discretion whether to approve a plan but, if approved, the plan is binding on the company and all its creditors and members.

A failed moratorium?

If a company that has entered a moratorium is unable to be rescued as a going concern then the moratorium terminates. The rights of the creditors who have been stayed by the moratorium spring back into life and so if those creditors (whether they are secured or unsecured) have not supported the company's exit strategy or been compromised by a CVA or a restructuring plan then the company is likely to enter insolvency, whether voluntarily or involuntarily. It is this prospect of failure that will keep directors and monitors' feet to the fire in terms of having sufficient funding and a viable exit substantially advanced as they enter a moratorium.

The reality?

Stressed companies usually turn to their lawyers and accounts to seek restructuring solutions that have generally focused on the use of a CVA or a recapitalisation. Now that the restructuring plan tool is available, we expect those companies to explore whether that may be a suitable method for dealing with the cause of actual or anticipated financial difficulty, with the goal at the end to have a rehabilitated business whose accounts can be signed off on a going concern basis.

It may well be that a moratorium provides a suitable stepping-stone to one of these restructuring tools.

In all of these scenarios stakeholder buy-in will be the key to ensuring that a funded plan can be developed, negotiated and carried out without undue reliance on court intervention.

Conclusion

The pendulum has now swung away from the receivership or administrative receivership- and creditor-dominated decision making of the latter half of the 20th century towards a debtor-oriented rescue culture. The policy objective of enabling company rescue and encouraging debtor-in-possession reorganisation is clear, but creditors in exchange are receiving statutory protections provided that they do not destabilise a rescue in progress.

We can expect to see new implementing rules given the declared culture of anti-avoidance, and new jurisprudence developing the law in this area, especially given the wide powers for affected parties to apply to court during a moratorium and the court-supervision and sanction role in the new restructuring plan. While the scales may be intended to be in balance there could be a few more swings one way or the other on the way to true equilibrium. □

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