The Response to Covid-19: Likely Corporate Insolvency Reforms and their Merit

1. Countries around the globe have been grappling with the fallout from the Covid-19 pandemic. Amongst many issues the crisis has thrown up is the issue of how to deal with companies which suffer from solvency issues as a result of the pandemic, or government measures taken in response to the pandemic. The response of different jurisdictions has varied, as has the speed of the response. This article looks at the UK’s likely response and how it compares to other jurisdictions.

   The UK Announcement

2. On 28 March 2020 the Business Secretary, Alok Sharma, announced a series of measures said to be in response to the Covid-19 pandemic. It was claimed that “[the] measures will also reduce the burden on business, giving bosses much-needed breathing space to keep their workers employed and their companies going.” The headline-catchy suspension of directors’ personal liability for wrongful trading was accompanied by reference to other reforms which were said to be the implementation of plans announced in August 2018 to introduce new restructuring procedures.

3. One might be forgiven for thinking that these measures would be rather urgent and yet over 3 weeks later there has been little by way of clarification or action. In that period Caruluccios, Debenhams, Oasis and Warehouse, and no doubt many others, have fallen into administration. It is to be hoped that Parliament’s return from recess on 21 April 2020 will provide new impetus to this time-sensitive issue. The issue of personal bankruptcies is also yet to be addressed.
Wrongful Trading

4. The UK government has announced that it intends to suspend directors’ personal liability for wrongful trading for a period of 3 months backdated to 1 March 2020. There is plainly scope for the extension of this initial period depending on how the lockdown and the emergence from lockdown progresses.

5. It is worth remembering that wrongful trading applies where directors knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent administration or liquidation and where the directors failed to take every step to minimise the loss to creditors from that point onward. Its suspension, with the professed aim of enabling directors to “keep their businesses going without the threat of personal liability”, might suggest that directors have carte blanche for 3 months to trade insolvent without regard to the creditors in the hope of trading out of insolvency in the medium or long term.

6. Yet wrongful trading is not the only grounds for personal liability of directors in circumstances in which a company cannot avoid insolvency and the interest of the creditors are disregarded. Both the common law duty identified in Liquidator of West Mercia Safetywear v Dodds [1988] BCLC 250 and the director disqualification provisions in the Company Directors Disqualification Act 1986 occupy similar territory. The former imposes a duty on directors trading whilst insolvent to have regard to the interests of the creditors rather than the shareholders. The latter provides for disqualification as a director in various cases, including where the director’s conduct as a director of a company which has become insolvent renders him unfit to be concerned in the management of a company. A director may be ‘unfit’ due to misfeasance which could catch directors trading insolvent without regard to the creditors.

7. Even if a director can tread the line between knowingly insolvent trading and compliance with his common law and other duties, it is likely that the fact of insolvent trading would expose a director to other grounds for personal liability. The most obvious risk comes from preference payments: determining which suppliers to pay and which to forego would not simply be a commercial decision but could impact upon a director’s personal liability further down the line if the company ultimately falls into an insolvent liquidation or administration. Directors
would be well advised to document the reasons for their decision making in these troubled times.

The Other Likely Reforms

8. On 26 August 2018, following a consultation on insolvency and corporate governance commencing in March 2018, the government announced a series of intended reforms to insolvency legislation. The reforms were lauded as wide-ranging and comprised 3 main proposals: (1) a new moratorium procedure, (2) a new standalone restructuring plan, and (3) the prohibition of most ipso facto clauses. These look like the foundations for the reforms announced by the UK government in response to the Covid-19 pandemic.

The New Moratorium Procedure

9. The new moratorium procedure is intended to be modelled approximately upon the moratorium applicable in administrations with the moratorium being triggered by filing the necessary papers at court (similar to the case when appointing an out-of-court administrator). The papers would include the statement of the monitor (a qualified insolvency practitioner) that the company met the eligibility criteria for the moratorium. The initial 28 day period could be extended by a further 28 days by the monitor or beyond the 56 day period if 50% of both secured and unsecured creditors by value consent.

10. The moratorium would be available to companies which would become insolvent if action is not taken and in circumstances where rescue is more likely than not to be the result. It would not be available to companies which were already insolvent. Companies must be able to meet its current and new obligations falling due in the course of the moratorium. It is worth noting that this formula was announced in the August 2018 Government Response and was not consulted on originally.

11. The UK government’s express aim in accelerating these reforms is to provide distressed companies with breathing space to restructure or compromise their liabilities enabling the company to emerge as a viable trading entity at the end of the moratorium. Yet the dual eligibility requirement – that (i) the company would become insolvent if action is not taken and (ii) the company is able to meet its current and new obligations during the period of the moratorium - begs the
question of when the moratorium would actually be used in practice. If the distressed company is not under creditor pressure and is able to meet its current and new obligations then it is unlikely to need a moratorium. Conversely, if the company is under creditor pressure and requires a moratorium, it is likely that the creditor pressure stems from an inability to meet current and new obligations. It is difficult to see that this conundrum would be any less real to Covid-19 distressed companies.

12. It may be that the UK government has had time to reflect on the dual eligibility criteria since August 2018, particularly as it did not form part of the initial proposals. Or it may be that the detail in the drafting removes the cause for concern. Extending the moratorium period from 56 days may also be sensible to provide companies with time to assess the full fallout from the Covid-19 pandemic. Otherwise the impact of the new moratorium is likely to be minimal.

The New Restructuring Plan

13. The most significant of the 2018 Proposals is the new restructuring plan. Modelled on the scheme of arrangement, proposals would need to be circulated and filed at court. There would be an initial court hearing to consider whether to put the proposal forward for a vote and to approve the composition of voting classes. The company would then need to circulate information – likely to be akin to an Explanatory Statement - and hold the vote. If approved, there would be a second court hearing to consider whether to sanction the restructuring plan.

14. However, unlike the scheme, there would be no requirement for every class of voters to meet the voting threshold. Instead, it would be sufficient to approve the plan if one of the adversely affected classes voted in favour, whether a class of secured or unsecured creditors. It is likely that the numerosity test (whereby 50% of the number of voting creditors must approve a scheme) would be replaced by an ‘unconnected party’ test. The detail of this test has yet to be clarified but it may well work like the similar CVA test whereby a plan is carried unless there is a negative vote of 50% of unconnected parties. The overall requirement of 75% of voting creditors or members by value will be familiar to those constructing schemes of arrangement.
15. To mitigate the unfairness of cross-class cram down and the risk that a junior class could bind a senior class to a restructuring plan against the latter’s interests, any cross-class cram down would apply an absolute priority rule similar to that in US Chapter 11 insolvencies. The APR would mean that the claims of a class of creditors must be paid in full before any class of creditors junior to that class may receive or retain property in satisfaction of their claims, unless the more senior class consents to a departure from this principle. In practice it would protect a senior dissenting class from a cross-class cram down by a more junior class. However, the absolute priority rule would in fact not be absolute: the Court would have discretion to waive the APR if necessary to achieve the aims of the restructuring and it would be just and equitable in the circumstances.

16. The scheme of arrangement has broad support within the UK and is admired beyond, being used by non-UK companies who have a sufficient connection to the UK. However it has tended to be used to restructure one class of creditors at a time (often financial) because of the inability to drag non-approving classes of creditors along with the rest. Where multiple classes of unsecured creditors are involved, the CVA has usually proven to be the most effective tool but that does not bind secured creditors. The restructuring plan with its cross-class cram down applying to both secured and unsecured creditors opens up the possibility of dealing with multiple classes of creditors. It also provides a means of binding dissenting classes of creditors, and in particular those who are ‘out-of-the-money’ anyway.

17. The restructuring plan may be a significant help to Covid-19 distressed companies facing a balloon of deferred liabilities of multiple types from the crisis. Many, especially in the retail, hospitality and travel sectors, are very unlikely to make up lost revenue once the crisis ebbs. To remain viable they will need wide-ranging debt relief and the restructuring plan adds to the means to make that possible.

Ipso Facto Clauses

18. The government initially proposed an extension of the ‘essential suppliers’ system whereby essential suppliers would be designated on a case-by-case basis and those suppliers would be prohibited from terminating or varying their contracts during a moratorium, CVA or administration. This proposal was widely criticised so
the August 2018 Government Response instead indicated an intention to prohibit the enforcement of termination clauses by a supplier in contracts for the supply of goods and services that apply when a company enters a formal insolvency process or becomes financially distressed. Finance providers and licences issued by public authorities would not be covered by the prohibition. Contractual licences would be. The scope of any exemptions will be crucial to the success of the ipso facto prohibition in ensuring business continuity.

19. A widespread problem faced by companies who seek a CVA or administration, or likely would face if seeking a new moratorium, is the triggering of ipso facto clauses in their contracts. Even where companies are continuing to pay the individual supplier, the financial position of the company or the insolvency event triggers the termination of the contract. In many cases this destroys any hope of a rescue and pushes the company into a terminal administration or insolvency.

20. To mitigate the hardship caused to some suppliers by the prohibition of ipso facto clauses, the government has also proposed that suppliers would be able to apply to the court to enforce their termination clauses in cases of undue financial hardship. It is anticipated that the court would consider whether compelling the supplier to supply would cause it to be more likely than not to enter an insolvency procedure, and whether exempting the supplier would be reasonable in all the circumstances having regard to the effect of non-supply on the debtor company and its prospects of rescue.

21. The scope of the clauses caught by this ipso facto prohibition is unclear. Whilst many termination clauses apply in cases of a company entering into a formal insolvency procedure, many are much broader in application and apply upon the happening of events which often precede a formal insolvency procedure. Provided the ipso facto prohibition is broad enough to catch most workarounds, it will clearly assist distressed companies reliant upon suppliers to continue trading and buy them the breathing space to attempt a restructure or renegotiation of debt.

22. However, it is worth noting that the proposed prohibition only relates to supplier contracts – so-called ‘downstream’ contracts. As currently formulated, no prohibition would apply to ‘upstream’ contracts thus companies carrying on business predominantly through key customer contracts would still be vulnerable
to the frustration of any rescue events due to the continued application of ipso facto clauses.

**Reforms in Other Jurisdictions**

23. Although all countries are facing similar public health emergencies with consequent economic hardship to many businesses, the range of legislative response has been significant. Other jurisdictions have variously proposed measures including the following:

- Suspension of director liability for insolvent trading
- Suspension of filing obligations
- Restrictions on creditor rights to trigger insolvency filings, ranging from increasing the minimum thresholds for stat demands to a total moratorium

24. These are all temporary in nature and, perhaps as a result, many go much further than the UK proposals (as articulated in 2018, although it remains possible that the government will have significantly revised them). A closer look at some other jurisdictions is set out below.

25. On 7 April 2020 the Singapore government passed a number of measures aimed at varying the insolvency landscape to deal with Covid-19. Some of these are similar to those enacted in Australia but others go beyond in their reach. The measures include, in relation to certain contracts including construction and supply contracts, contracts for the provision of goods and services for events or the promotion of tourism:

- The thresholds for bankruptcy and winding-up were raised from S$15,000 and S$10,000 to S$60,000 and S£100,000 respectively.
- The period for making payment on a statutory demand has been extended from 21 days (in the case of individuals) and 3 weeks (in the case of business) to 6 months.
- Contracting parties under a Scheduled Contract (defined broadly and including a tourism-related contract, an event contract, a construction contract or supply contract, a lease or licence of immoveable property, a loan or hire =-purchase agreement) are prohibited from filing court and
insolvency proceedings for schemes of arrangement, judicial management and winding up and from enforcing security over immovable property and moveable property used for the purposes of a business or trade for 6 months. The prohibition only applies if the debtor’s inability to perform is to a material extent caused by a Covid-19 event.

- Directors are temporarily relieved from personal liability for insolvent trading in circumstances where the debt is incurred in a company’s ordinary course of business during the relief period and before the appointment of a judicial manager or liquidator.

26. In New Zealand the government intends to introduce a ‘safe harbour’ 6 month period for directors. Decisions to keep trading and take on new obligations will not result in breach of companies or insolvency duties provided that, in the good faith opinion of the directors, the company is or is likely to face significant liquidity problems in the next 6 months due to Covid-19 and will more likely than not be able to pay its debts within 18 months, and provided that the company was able to pay its debts on 31 December 2019.

27. In Germany legislative measures to vary the insolvency regime are extensive and include:

- The obligation to file for insolvency has been suspended until 30 September 2020 provided that the insolvency was caused by the effects of the spread of Covid-19 and there exists a prospect of remedy of an existing cash flow insolvency. If the company was not cash-flow insolvency as at 31 December 2019 it is presumed that this criteria is met.

- Payments made in the ordinary course of business to, for example, maintain or resume business operations or to implement a restructure, are deemed to be carried out with the due diligence of an ordinary and conscientious director.

- The repayment until 30 September 2023 of new loans granted during the suspension period, and of security in respect of such loans, is deemed not to disadvantage creditors.
• If a creditor applies for the opening of insolvency proceedings between the effective date of the law and the date three months after the effective date, the opening of insolvency proceedings requires that the reason for the opening of insolvency proceedings already existed on 1 March 2020.

28. In France legislators passed a range of measures on 23 March 2020, which may have retrospective effect to 12 March 2020, to deal with the Covid-19 pandemic. Measures include:

• For the period until 3 months after the cessation of the health emergency (as defined in the legislation), the relevant date for assessing a debtor’s state of cessation of payments n (i.e. illiquidity) is 12 March 2020. In practice this means that if a debtor is solvent on 12 March 2020 but becomes illiquid thereafter, during the relevant period it will not be considered illiquid or be obliged to file for insolvency.

• The extension of minimum periods applicable to conciliation procedures.

29. On 6 April the Russian government introduced a 6-month moratorium on insolvency filings and debt recovery enforcement action by creditors. The moratorium applies to certain debtors, including strategic and systemically important companies and companies operating in the industries which have suffered most from Covid-19 (as listed by the government).

30. In Italy the legislature has introduced a moratorium on bankruptcy filings submitted to court between 9 March and 30 June 2020 save in a small number of exceptional circumstances. Fresh shareholder loans are no longer subject to subordination and various deadlines for complying with composition or restructuring plans have been extended.

31. As can be seen from the above snapshot look at other jurisdictions, the UK is an outlier in its modest proposals for reform. The UK has focused on long-term permanent changes rather than short-term, urgent relief for businesses during the pandemic. In particular, whilst many countries have imposed statutory temporary moratoriums or the equivalent on new insolvency or enforcement measures, the UK has largely left it to the individual directors and creditors to devise a case-by-case solution.
Conclusion

32. All the indications are that the UK government is going to blow the cobwebs off the 2018 Proposals, throwing in a temporary suspension of the wrongful trading provisions for good measure. It is questionable whether any of these likely reforms will achieve their purpose of reducing the burden on business and giving companies breathing space to keep their businesses going. Directors will continue to owe duties to the general creditors rather than the company in impending insolvency situations. They will continue to be exposed to personal liability when making invidious decisions about which suppliers to pay to ensure the continuation of the business. The moratorium’s requirement that companies be able to meet current and new obligations probably discounts it from use by the vast majority of Covid-19 hit companies and the restructuring plan is unlikely to be of great utility to the SMEs or urgent cases.

33. Governments in other jurisdictions have led the way with sweeping and radical changes to insolvency legislation. Although the drafting has yet to be seen, it seems unlikely that the UK government’s proposed reforms will come close to matching the rhetoric or the anticipated successes of other jurisdictions in ensuring business continuity. Covid-19 will lead to an almost inevitable increase in English insolvencies and the focus will turn to the courts to determine whether the requirements for personal liability are met in the unusual circumstances of Covid-19 or whether directors will be granted a large amount of latitude.

Helen Pugh
Barrister
3 Hare Court
+44 (0)20 7415 7800
Temple
EC4Y 7BJ