Changes to the UK Insolvency Regime – The New Moratorium

Impact on Secured Lenders

UK – 29 June 2020

On 26 June 2020 the Corporate Insolvency and Governance Act (the Act) received Royal Assent. The Act makes both temporary and permanent changes to the UK insolvency laws.

As part of these measures, a 'new debtor-in-possession moratorium' has been introduced to existing legislation that enables companies to have a minimum 20 business days breathing space without threat of creditor action. Under the moratorium, the day-to-day running of the business remains in the directors' control, under the supervision of a licensed insolvency practitioner (the monitor) and subject to certain restrictions.

(Lack of) Control Over the Process

The moratorium lasts for 20 business days and can be extended for a further 20 business days by the directors and for up to 12 months with creditor (or court) consent. However, the required creditor consent for these purposes is from creditors whose debts fall outside of the moratorium. As set out below, debt arising from loan agreements and other finance documents still needs to be paid during the moratorium. Lenders would therefore be unlikely to form part of the voting class of creditors, and would not be able to vote down any requests for an extension for up to 12 months.

Will Lenders Still Get Paid?

A company subject to a moratorium is given breathing space from "pre-moratorium debts" that have fallen due from which the company has a "payment holiday" (whether due before or during the moratorium). This catches, amongst other things, trade creditors.

However, there are certain debts that the company must pay during the moratorium and failure to do so may cause the monitor to terminate the moratorium (and/or prevent the directors from seeking an extension of the moratorium). This includes debts and other liabilities arising under a contract or other instrument involving financial services. This means that the usual capital and interest payments due to lenders will still be payable (unless otherwise agreed with the lender).

Enforcement Restrictions

Although lenders' debts will still need to be paid during the moratorium, the restrictions may significantly impact the enforcement options available to lenders. Lenders may well wish to factor the following in to their credit and operational procedures to enable them to deal with the risk of a hostile monitor appointment by the company's directors:

- The moratorium suspends a QFCH's ability to crystallise its charge or appoint an administrator.
- Certain floating charge provisions enhancing a QFCH's rights may be void (e.g. provisions providing for crystallisation of a floating charge- whether automatic or following notice, and restrictions on the disposal of property).
- Under the moratorium, charge holders are unable to enforce security without court consent.

Other Security Risks

A company cannot dispose of property subject to fixed charge security without court consent. However, directors may apply to the court to dispose of property as if it were not subject to the fixed charge. There are provisions providing fixed charge holders with compensation for their loss of rights (effectively reimbursing the lender for what the court thinks the property would be worth in the open market), but this effectively enables a restructuring package to ignore the security and could result in fixed charge holders being put at a significant disadvantage, with a loss of rights and value (particularly in a potentially depressed market).

For floating charge assets, a company can either (a) deal with assets in accordance with the terms of the floating charge instrument; or (b) obtain consent of the court to deal with the assets in another way. As the floating charge cannot be crystallised, floating charge assets can usually be disposed of in the ordinary course of business (which we expect would be in accordance with the terms of the floating charge instrument), potentially materially depleting the assets available to a lender ahead of any post-moratorium enforcement. Once assets have been sold, lenders will have a floating charge over the proceeds of sale, but usually will not be directly entitled to the proceeds (and cannot enforce the charge to obtain payment).

Lenders should therefore review the terms of their security and facility to consider whether the restrictions and controls provide adequate protection, in particular how and when companies can dispose of assets and fine tuning the definition of a disposal of assets in the "ordinary course of business" (e.g. should consent be required for a bulk stock sale).

Whilst such controls are not ordinarily as important, the inability to crystallise a floating charge or otherwise enforce security during a moratorium, may mean that restrictions need to be tighter to retain some control and dialogue with companies in the event of a moratorium (whilst still enabling the company to trade effectively).

Finally, lenders should also be comfortable that fixed charge security will withstand scrutiny and is not vulnerable to challenge as a floating charge. The risk of fixed charge assets being treated as floating charge assets could be substantial, as the assets could be sold without court consent and the proceeds of sale (and other compensation) would not be required to be paid to the lender. Lenders should therefore audit their charges and ensure that appropriate levels of control are exerted over fixed charge assets. For example, if taking a charge over plant and machinery, ensuring it is properly scheduled to the debenture, there are restrictions on disposal and valuable items are plated. Similarly, if a lender intends to create a fixed charge over debts (as opposed to an assignment), they will need to ensure that the receipts are paid into a blocked account and other appropriate controls are both in place, and enforced.

What Options are Open to Lenders?

Although a QFCH cannot appoint an administrator during the moratorium, the moratorium will automatically terminate upon directors filing a notice of intention to appoint administrators. At that point, the QFCH would be able to exercise its powers as usual and regain control of the appointment process by appointing its own nominated insolvency practitioner as administrator, if it was not comfortable with the directors' choice.

The directors will not be able to extend the moratorium unless they confirm that all debts that have fallen due in the moratorium, or pre-moratorium debts that are not caught by the payment holiday (i.e. potentially bank debt), have been paid. In addition, the monitor must bring the moratorium to an end if they are of the view that it is no longer likely that the company can be rescued as a going concern.

Entering into a moratorium, will in many cases constitute an event of default under facility and security documents that will automatically accelerate the entire debt. Even in those cases where acceleration is not automatic, it may be open to lenders to issue a notice accelerating their debt to make it payable on demand during the moratorium period and thus regain some control given the company is unlikely to be able to pay. If the entire debt is accelerated it becomes due and payable during the moratorium period. As a consequence, if the company cannot pay (which is likely to be the case the vast majority of the time) the monitor will either have to bring the moratorium to an end (as they would unlikely be able to continue to believe that the company could be rescued as a going concern) or the company will have to negotiate with the lender to agree a stay.

There were amendments proposed to remove lender's ability to accelerate their debt during the moratorium as the Act passed through Parliament, but these were not passed (although see below regarding priority of accelerated debt).

If a stay cannot be agreed, then acceleration could enable the lender to re-take control of the process via an administration appointment or other enforcement process once the monitor (as they will have to) terminates the moratorium.

In addition, the following options seem to remain open to lenders:

- The Act also introduces *ipso facto* provisions preventing termination of contracts upon insolvency (please see our blog on this here). However, financial services providers are generally exempt from these restrictions. Therefore lenders could cancel non-committed facilities (e.g. overdraft and invoice discounting) and may also be able to rely on provisions in the facilities to, for example, charge default interest, carry out additional audits or impose an independent bank review (which would be payable as moratorium expenses).
- Lenders may be able to obtain additional security for additional lending (subject to obtaining the monitor's consent).
- Lenders can challenge the conduct of the directors or the monitor at court, which may result in the reversal of detrimental decisions.

How will Lenders' Debts be Ranked in a Subsequent Insolvency?

The Act makes consequential amendments to existing insolvency legislation to alter the priority of distributions, where a company enters into administration or liquidation within 12 weeks of the moratorium ending. The amendments rank moratorium debts and pre-moratorium debts that should have been paid during the moratorium (i.e. bank debt) ahead of preferential creditors, the usual administration/liquidation expenses and floating charge distributions.

However, as the Act passed through Parliament, concern was raised about the ability to accelerate debts as this effectively gave the lender (a) the power to end the moratorium and (b) provided them with a fixed charge-like security, allowing what may ordinarily be a floating charge recovery in a subsequent insolvency to rank ahead of administration expenses and preferential creditors, for example. Therefore, this priority has been amended. Any bank debt that would've been due and payable during the moratorium still gets "super-priority", but to the extent that any debt was only due in the moratorium as a result of the acceleration, this no longer gets super-priority and will be recovered at the floating charge stage of the asset distribution (as normal).

The provisions in the Act do not provide for the ranking within this class, instead making provision for changes to be made to the Insolvency Rules to govern the priority within this category. In the meantime, the Act introduces temporary provisions that provide for the order of priority for debts payable under the moratorium to be paid in a subsequent administration or liquidation. Lenders' debt would rank ahead of the monitor's remuneration and expenses, but behind suppliers who are covered by the "ipso facto" provisions and employment-related costs. This would appear to be a significant disincentive for secured lenders to continue to support the company and provide working capital funding during the moratorium.

In addition, (1) CVA proposals submitted within 12 weeks of the moratorium ending cannot provide for debts payable during the moratorium to be paid otherwise than in full and (2) any restructuring plan applied for within 12 weeks of the moratorium ending, cannot compromise moratorium expenses (or pre-moratorium debts without a payment holiday) without first obtaining consent of each of these creditors. However, these provisions do not apply to the extent that bank debt was only due in the moratorium as a result of acceleration.

Other Changes to UK Insolvency Laws

In addition to the introduction of the moratorium, the Act introduces other changes to the UK insolvency regime, including:

Protection of Supplies to Enable a Company to Continue Trading

This new provision prevents suppliers of goods and services from terminating a contract because of an insolvency event and potentially jeopardizing the rescue of a business. This applies in all existing UK insolvency procedures (including administrations, CVAs and liquidations) as well as the new moratorium.

New Restructuring Plan

This new insolvency tool enables companies to propose a plan that (subject to obtaining the requisite consent and court approval) will bind all creditors, including dissenting and secured creditors, whether or not they vote in favour of the plan, through the use of "cross-class cram down."

Temporary Suspension of Wrongful Trading

The Act introduces measures to temporarily and retrospectively/relax liability for wrongful trading under sections 214 and 246ZB of the Insolvency Act 1986. The intention behind this measure is to allow directors to ensure that their businesses continue through the COVID-19 pandemic without fear of personal liability for wrongful trading. For a more detailed overview of these measures, please see our wrongful trading alert.

Conclusion

The new moratorium may prove to be a very useful tool for companies looking to restructure, but may prejudice the position of secured creditors. There are a number of steps that secured creditors may wish to consider taking in order to protect their position in case they are faced with a non-consensual moratorium.

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