12 June 2020

Corporate Insolvency and Governance Bill Team
Department for Business, Energy and Industrial Strategy
1 Victoria Street
Westminster
London SW1H 0ET

Dear Sir or Madam

Corporate Insolvency and Governance Bill 2019-21

The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

On 20 May 2020, HM Government published the Corporate Insolvency and Governance Bill 2019-21 (the "**Bill**"). The Bill is intended to provide businesses with increased flexibility and breathing space to continue trading despite the challenges presented by the new coronavirus ("**COVID-19**") pandemic. 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. In this context, the FMLC would like to highlight a few concerns.

The first chapter of the Bill inserts into the Insolvency Act 1986 a new "standalone" moratorium of 20 days (extendable up to 1 year with creditor consent, or for a longer period with the court's permission) during which, amongst other things, no legal action, including the enforcement of security (except financial collateral) can be taken against a company to enforce debts without leave of the court. The first chapter also includes by way of amendment to existing insolvency legislation in schedule 3 of the Bill a new prioritisation of debts if a subsequent insolvency follows within 12 weeks of a failed moratorium. Whilst moratoria have been used in insolvency and resolution legislation to remove the pressure created by asset outflow and provide the management of the institution and the resolution authority with the necessary time to restructure it successfully, historically, concerns have been raised regarding their impact on the freedom to contract. In this case, the moratorium, while granting payment holidays to the company for certain pre-moratorium debts, does not include "debts or other liabilities arising under a contract or other instrument involving financial services".[1] This is an important exception. Difficulties and unintended consequences are highly likely to arise from legislation to introduce a moratorium—even for a very short period—in respect of complex financial arrangements in markets which are quite carefully intermediated and balanced. Similar concerns would arise in relation to provisions in Section 12 of the Bill to suspend the operation of termination clauses, were these applicable in a financial markets context. These too, however, benefit from comprehensive carve-outs for financial services providers and contracts. While the FMLC is grateful for the comprehensive attempt in the Bill to carve out financial services transactions from the new corporate rescue provisions, where the Bill uses terms and phrases from existing insolvency legislation, the FMLC considers it important to ensure that these are appropriate for fulfilling the purposes of the Bill.

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[1] The Bill also offers other exemptions relating to goods and services, rent, wages and salaries incurred during the moratorium

The accelerated timeline in which it is intended that the Bill pass through the legislative process means that it is impossible for the FMLC to examine the Bill with its usual scrutiny. Nevertheless, the FMLC would like to highlight some issues of legal uncertainty which arise from key provisions of the Bill. In addition, given the speed at which the legislation is proceeding through Parliament, the FMLC would recommend the insertion of a "sunset" clause or a provision for a prescribed review by Parliament of the operation of the legislation after a specified period of time.[2]

In Appendix I, below, the FMLC has set out certain aspects of the Bill to which market participants have drawn attention, because they give rise either to legal uncertainty or unintended consequences.

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me should you wish to arrange a meeting or if you have any questions.

Yours sincerely,

Joanna Perkins

Joanna Perkins
FMLC Chief Executive[3]

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[2] Section 44 of the Bill instead provides a power to make consequential provisions to amend, repeal, revoke or otherwise modify any provision over the next three years

[3] The FMLC is grateful to Claude Brown (Reed Smith LLP), Dorothy Livingston (Herbert Smith Freehills LLP), Jennifer Marshall (Allen & Overy LLP), and Sanjev Warna-kula-suriya (Latham & Watham LLP) for their assistance in drafting and reviewing this paper.

In view of the role of the Bank of England, the Financial Conduct Authority and HM Treasury in the drafting of this Bill, Rob Price, Karen Levinge and Peter King took no part in the preparation of this paper and the views expressed should not be taken to be those of the Bank of England, the FCA and HM Treasury.

Appendix I

New moratorium provisions

The Bill proposes a new "standalone" moratorium as well as a new prioritisation of debts following a failed moratorium.

The moratorium, is only available to companies where it is likely to result in the rescue of the company and a "return to business". It is, therefore, unsurprising that certain obligations remain to be paid and are not subject to the payment holiday. These comprise obligations incurred during the moratorium for goods and services; rent; wages, salary or redundancy payments; and liabilities arising under a contract or other instrument involving financial services.[4] As mentioned above, the financial services exemptions are crucial to the operation of the financial markets. It is unclear from the drafting, however, whether the exemptions to financial services also extend to any security in relation to those services, in particular in relation to floating charges.

Schedule 3 of the Bill proposes a new prioritisation of debts by which pre-moratorium financial services debts and other debts payable during the moratorium are included in the super-priority ranking in a subsequent insolvency if it follows within 12 weeks of a failed moratorium.[5] These include pre-moratorium claims related to financial services, but not pre-moratorium claims related to other goods or services.

To provide for circumstances where payments which ought to have paid during the moratorium, but have not been paid, however, the distribution contemplated by the Bill in a subsequent insolvency following a failed moratorium is very different from the current distribution of available assets in a corporate winding up, where, after the expenses of any prior administration (which could include rescue finance made available during the administration, tax and certain employee claims) and the expenses of the liquidation (including similar claims) secured claims would be met, then on a *pari passu* basis the claims of unsecured (and deferred) creditors, whether related to financial services or not, would be considered.

Several legal uncertainties surround the application of these sections to all pre- and post-moratorium financial services debts, whether secured, unsecured or deferred, all

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4 Section 1 of the Bill inserts into the Insolvency Act 1986 new "Part A1". This includes new section A18 which provides:

> In this Part a reference to pre-moratorium debts for which a company has a payment holiday during a moratorium is to its pre-moratorium debts that have fallen due before the moratorium, or that fall due during the moratorium, except in so far as they consist of amounts payable in respect of—
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> a) the monitor's remuneration or expenses,
>
> b) goods or services supplied during the moratorium,
>
> c) rent in respect of a period during the moratorium,
>
> d) wages or salary arising under a contract of employment,
>
> e) redundancy payments, or
>
> f) debts or other liabilities arising under a contract or other instrument involving financial services

5 See, for example, Schedule 3 paragraph 13 and paragraph 31.

of which appear to rank ahead of, and in priority to, preferential debts and existing floating charge security, and in the case of administration, the administrator's fees and expenses. For example, in relation to the proposed new order, clarity would be helpful on how assets secured for the benefit of other creditors are to be allocated or how funding would be made available in an administration if these financial debts and other super-preferred debts exceeded the recoverable value on the company's assets.

In particular, it is unclear whether any pre-moratorium claims related to financial services will include the full amount of financial services debts accelerated or closed out during the moratorium period or thereafter, as a result of a default which is not a payment default on the amounts due, given that acceleration or close out can occur for other reasons, such as entry into an insolvency process (the moratorium will be such a process) or failure to meet financial covenants.

In addition, given that many, if not most, debts secured by a floating charge are related to financial services, it would assist clarity if it were stated whether or not the express restrictions on enforcement relating to floating charges apply regardless of whether they secure financial services debts, or only where they do not.

Termination clauses in supply contracts

The Bill introduces a prohibition on termination clauses in supply contracts which entitle a Supplier to terminate where a customer (who is a company) suffers an insolvency event. Section 12 of the Bill will add new section 233B to the Insolvency Act 1986, which deals with the effect of Ipso Facto termination clauses in the event of the insolvency of the customer under a contract for the supply of goods and services. As mentioned in the letter above, these provisions do not affect the supply of financial services by authorised persons or financial contracts. In respect of goods and services, however, there remains a degree of uncertainty as to precisely how widely this will be interpreted.[6]

Suspension of wrongful trading provisions

When determining what contribution, if any, a director should make to a company's assets following a finding of wrongful trading, the Court must assume that a director is not responsible for any worsening of the financial position between 1 March and 30 June 2020. The Bill, however, excludes directors of certain companies involved in capital markets arrangements from the benefit of these provisions.[7] The FMLC notes that, whilst giving comfort to directors regarding their potential contribution under the statutory wrongful trading provisions, their other duties (and potential liability) still remain in place during this period—including, for example, their common law fiduciary duty to the company to have regard to the interests of creditors. The provisions may therefore may be of more limited effect then they at first appear.

Restructuring plans

Effectively an enhanced scheme of arrangement with similar broad scope, the Bill allows the court to impose a compromise on a company's creditors and shareholders,

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[6] Whilst finance leases are included in the exceptions to the prohibition on termination because a party has entered into insolvency proceedings, there is no express reference to operating leases for aircraft or bareboat charters. Whilst it can be argued that these may not be a supply of goods or services (which is undefined in the Bill), given the impact on the financing of aircraft and the extensive use of bareboat charters, greater clarity on this point would remove an area of uncertainty.

[7] Paragraph 13 of new Schedule ZA1 to the Insolvency Act 1986

including a cross-class cram-down. The compromise would need approval by the court and 75% of the creditors in each class (although the court can override rejection by one or more classes). The Bill's proposal in this area gives rise, however, to several questions, including those which arise following the failure of such a scheme.

Unlike, for example, Chapter 11 of the U.S. Bankruptcy Code, there does not seem to be an "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 any property in satisfaction of their claims. Similarly, it remains uncertain how the cram-down of shareholders in a listed company is meant to dovetail with requirements under the City Code on Takeovers and Mergers which has been developed in the U.K. to ensure fairness to shareholders and an orderly framework for takeovers.[8] Finally, the position of dissenting groups of creditors/shareholders is unclear, including whether they may put forward their own restructuring plans in response to the company's restructuring plan as the plan progresses towards approval.

Application of the moratorium and restructuring proposals to overseas E.U. companies

Schedule 1 to the Bill inserts a new Schedule ZA1 to the Insolvency Act 1986 regarding the eligibility criteria for companies which might be subject to the new moratorium and Schedule 9 to the Bill inserts a new section 901A(4)(b) of the Companies Act 2006 regarding the companies that can be subject to the new restructuring plan. With regards to an overseas company, the Bill proposes that such a company may be eligible to utilise the moratorium and/or restructuring plan procedures if it can demonstrate a sufficient connection with the U.K., even if the company's Centre Of Main Interests ("**COMI**") may be situated outside the U.K. (although the moratorium can only be obtained in respect of such a company with an order of the court). These procedures have not been limited to European companies with their COMIs in the U.K., which is a restriction that applies in the case of insolvency procedures listed in the Annexes to Regulation (EU) 2015/848 on insolvency proceedings (recast) (the "**Recast Insolvency Regulation**"), and, instead, the Bill uses the "sufficient connection" test that is currently used for a scheme of arrangement. (The restructuring plan is clearly based on the scheme provisions in Part 26 of the Companies Act 2006). Neither the moratorium nor the restructuring plan will be recognised across the E.U. under the Recast Insolvency Regulation during the Brexit Implementation Period but this is not a result of the eligibility criteria.[9] It is hoped that the moratorium would be recognised as an "insolvency proceeding" in any jurisdiction that has adopted the UNCITRAL Model Law on Cross Border Insolvency Proceedings and that the restructuring plan (as with a scheme of arrangement) will be recognised under Chapter 15 of the US Bankruptcy Code as a proceeding involving the "adjustment of debt".

Exclusion of parties to "capital markets arrangements" from moratorium and* ipso facto *provisions

The Bill's provisions on moratoria rely on a definition of "eligible company" which is subject to detailed exclusions in new Schedule ZA1. One of these exclusions is for "parties to a capital markets arrangement". A "capital markets arrangement" is, broadly, an arrangement involving a grant of security, a guarantee or investment in a derivatives contract.

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8 The Takeover Panel, *The Takeover Code,* available at: http://www.thetakeoverpanel.org.uk/the-code.

9 The FMLC has previously written about the impact of the U.K. withdrawal from the E.U. on the recognition of insolvency proceedings in the region. See FMLC, *Report: Cross-Border Insolvency Proceedings after Brexit* (25 August 2017), available at: http://fmlc.org/report-u-k-withdrawal-from-the-e-u-25-august-2017/

New Section A18 inserted by the Bill into the Insolvency Act 1986 deals with the effects of a moratorium and defines the debts to which it will apply. It provides that the moratorium will apply to debts arising from the supply of goods and services subject to the exceptions listed above, which include "debts or other liabilities arising under a contract or other instrument involving financial services". A contract of this kind is defined in new Schedule ZA2, which Schedule 2 of the Bill inserts into the Insolvency Act 1986. It includes a "capital markets arrangement" and the definition refers back to the definition in Schedule ZA1.

As noted in the letter above, Section 12 of the Bill also suspends the operation of *ipso facto* termination clauses in supply contracts, subject to comprehensive carve-outs for i) financial services providers and ii) financial contracts, which are defined in Parts 2 and 3 of Schedule 12, inserting a new Schedule 4ZZA in the Insolvency Act 1986, respectively. The definition of a "capital markets arrangement" in Part 3 of the Schedule refers back to the definition in Schedule ZA1.

The references to "capital markets arrangement" in Schedules ZA2 and 4ZZA are likely to be heavily relied upon by creditors in the financial markets seeking to avoid the impact of a moratorium or suspension as it would otherwise apply to financial contracts. In this context, it might be helpful to consider the history of the phrase "capital market arrangements", which was first introduced in the Enterprise Act 2001. One of the purposes of that Act was to restrict a secured creditor's ability to appoint an administrative receiver and instead to give priority to the collective administration regime for all creditors. This could, however, have a negative impact on certain types of securitisations if the security trustee was not able to appoint an administrative receiver where the security was granted in the context of a capital market arrangement. The definition of "capital market arrangements" was therefore focused on arrangements that involved the grant of security: if there was no security, it would not have been possible to appoint an administrative receiver even before the changes proposed by the Enterprise Act.

For the purposes of the payment holiday in the moratorium and the *ipso facto* provisions proposed in the Bill, there seems no obvious reason for requiring the presence of security and, consequently, drawing a distinction, as the definition of "capital markets arrangement" does, between secured or guaranteed bond debt on the one hand and unsecured unguaranteed bond debt on the other hand. There are a number of contracts which are protected (such as swap agreements and loan agreements) where the payments in question may be unsecured but to which the protections should be extended.

On the other hand, the effect of paragraph 13 of Schedule ZA1 is that having capital market debt that is excluded from the payment holiday, makes a company wholly ineligible for the moratorium process, which may be an unintended result as far as ordinary trading companies are concerned. This is no doubt to account for the operation of insolvency-remote vehicles ("**SPVs**"), which often issue debt of this sort and are not suitable for a moratorium. Many SPVs are, however, already excluded by paragraphs 12 and 15 of the Schedule. A wider definition of an SPV could be added to the ineligibility criteria in the Bill to avert the issue, since group holding or finance companies that have issued quoted bonds or other debt securities will often have provided for them to be guaranteed by the principal trading companies in the group.[10]

[10] Such a definition can be found in the Regulation 3(4) of the Business Contract Terms (Assignment of Receivables) Regulations 2018

The effect of paragraph 13 is that all principal companies in such a group would be ineligible for a moratorium, which may be an unintended effect.