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Our ref

Your ref

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European High Yield Association Proposals

Dear Steve

I am writing as Chairman of the Financial Law Committee of the City of London Law Society ("CLLS") to comment on the above proposals.

The Insolvency Law Committee of the CLLS have shared with us their Chairman's letter of 17th January 2008, which expresses the view of the Insolvency Law Committee that a rule prohibiting reliance on contractual rights to terminate for insolvency as against an administrator would make a significant difference to the effectiveness of the insolvency process and advocates its early adoption. This was an element of the proposals made by the European High Yield Association ("EHYA") in its letter to the Treasury of 23 April 2007, on which we understand the Treasury have sought your views.

In other respects the Insolvency Law Committee regard the EHYA proposals as impractical, at least in the short term. While the Financial Law Committee agrees that the EHYA proposals, if they were to be adopted, would require both significant legislative time and extensive prior consultation, we do not consider that any of the proposals should be adopted at all, including that advocated by our colleagues in the Insolvency Law Committee.

The Financial Law Committee is strongly opposed to the adoption of a rule prohibiting reliance on contractual rights to terminate for insolvency and believes that this view would be widely shared in the national and international financial community operating in the UK. They regret that support has been given to this idea, which attacks the fundamental supremacy in English law of party autonomy and freedom of contract, without any consideration of the far reaching consequences for the financing of businesses or for the impact on businesses affected by such a measure.

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It would not be a simple matter to adopt any such rule and would require a detailed economic and legal impact assessment across all economic sectors, as well as the development of substantial "carve-outs" to protect the financial markets and systems and comply with EU law. At this time of credit squeeze a proposal that would effectively add to lending costs and impose substantial "domino" risk on the trading partners of any business in administration would only add to the difficulties facing our economy.

General Effects

To illustrate the issues:-

i.) As regards supplier contracts, if the insolvency termination provision cannot be relied upon, then suppliers (already facing potentially irrecoverability of unpaid invoices or outstanding loans) could be forced to perform (deliver goods or services, make loan advances) with no hope of payment/repayment, pending the occurrence of some other event justifying termination: if they do not, they themselves would be in breach of contract;

ii.) As regards customers, they may be bound by provisions (e.g. exclusivity) preventing the obtaining of alternative supplies or continue to be bound to make regular stage payments until some other right of termination or notice or for breach of contract emerges;

iii.) Agents would be placed in the "catch 22" position of having a duty to promote sales on behalf of a business that will probably not perform, yet be in breach of contract if they do not;

iv.) The rules relating to set-off and netting will be disrupted and become of uncertain application.

The risk of "domino" insolvency affecting, particularly, smaller suppliers and customers is obviously much increased. There will be a substantial change in the willingness of businesses to enter into contracts unless they contain relatively short notice periods.

Lenders also may be unwilling to commit funds on a long term basis or will seek higher returns for making such commitments.

There will be increased litigation around the rights to terminate contracts other than for insolvency: insolvency provisions are clear and simple and there is little argument about their application: this litigation cost will directly affect administrations and returns to creditors.

Exceptions and the Financial Markets

Complex exceptions will be needed to protect the advances that have been made, both in the UK (through Part VII of the Companies Act 1989 and subordinate legislation made under it) and at the European level (e.g. through the Settlement Finality Directive and the Financial Collateral Directive), to put in place laws that protect the integrity and efficient operation of the UK's financial markets. Those measures have extended protection from the potential invalidating or stay effects of applicable insolvency laws to:

- a market's or clearing house's "default rules";
- a designated system's "default arrangements"; and
- netting and security arrangements that support the operation of the UK's market's and market infrastructure.

All of these procedures are designed to minimise the systemic and other risks to a market, a system or its participants arising out of a participant's default. They also contemplate the absolute right of the market, system or non-defaulting participant to terminate a defaulting participant's participation, its market contracts or the credit/liquidity facilities made available to it in connection with its participation. Any proposal to interfere with such these clauses would require a detailed review to ensure its consistency not only with European laws, but also the paramount importance of protecting the stability of the UK's financial markets and supporting market infrastructure.

Other sectors may also have pressing needs for exceptions: in the USA, which protects Chapter 11 bankruptcies in this way, exceptions exist for a range of matters, including bank loans, subscription agreements, financial markets transactions, IP licences, agreements affecting aircraft and certain agreements affecting shopping malls. European Countries with these types of rules also have a wide range of tailored exceptions, as well as those imposed by EU law.

Steps to Introduce a Prohibition on Termination for Insolvency

Extensive consultation would be needed, both to ensure that certain contracts are exempted in the public interest and to recognise the legal obstacles to achieving a uniform approach to this issue:

- Cases where an administrative receivership is available would need to be exempt.
- All arrangements to which the Financial Collateral Regulations apply would have to be exempted from this rule to comply with European Law.
- Other key contracts for financial markets and system integrity e.g. market charges and system charges and those created in the Crest system would require exemption to ensure market and system stability. A detailed review would be required to ensure instability was not created in any of the major markets operating in the UK.

Systems with rules that interfere in with the exercise of contractual rights on insolvency in this way gather an ever increasing host of exceptions: these laws are messy and complex, as well as unfair to the trading partners who do not benefit from the exceptions. In short they have all the hall-marks of bad laws.

Once our rules had been complicated in this way, the effect would be to place on a diverse group of financiers, suppliers and customers, including all small business trading partners least suited to manage it, the burden of being tied into contracts and expensive resourcing and performance commitments, whether or not the administrators can perform.

Conclusion

In short, there are very significant effects for the wider economy, for the availability of credit, for the stability of the financial markets, for fairness and for the fundamental principle of freedom of contract which need to be weighed in the balance against the proposal.

We should bear in mind that the second, third and fourth biggest economies in the world after the US have recently upgraded their insolvency laws and none of them has introduced this stay. These countries are China, Japan and Germany: both Germany and Japan, like the EU, have major financial markets and in China Shanghai and Hong Kong (which follows current English law) have major financial markets.

The reasons for the proposal are not explained in the Insolvency Committee's letter. The EHYA argue for "an all-encompassing stay on actions" to prevent "value destruction". In our experience where there is a saveable activity this is quickly recognised and key trading partners can be kept on board. This is demonstrated in the successful administrations referred to by the EHYA as well as specialised administrations, such as Railtrack and the Metronet PPP administrations. In the majority of cases, however, by the time UK businesses reach insolvency, there is not a sound ongoing activity and there is no justification in increasing legal uncertainty for trading partners. Introducing substantial injustice for trading partners will not change that fact or produce a fairer position where there is a saveable business.

The UK legal, social and commercial system is not set up to follow that model. Existing agreements were negotiated in the current, completely different, regime and the parties would not be prepared to assume the additional risk. The EHYA produce no evidence to support the view that the increase in realisation of value from businesses in administration would be valuable enough to outweigh the additional burdens based on suppliers, financiers and customers. We have no confidence it could produce any benefits overall that would outweigh these burdens.

In view of the importance of this topic, I am sending copies to the Treasury and to the FMLC. We shall be very pleased to discuss the issues raised with you, if you would find this helpful.

Yours sincerely

Dorothy Livingston
Chairman,
Financial Law Committee of the City of London Law Society

CC. Joanna Perkins, Financial Markets law Committee, Bank of England

Paul Baker, HM Treasury