THE CITY OF LONDON LAW SOCIETY

4 College Hill
London EC4R 2RB

Telephone 020 7329 2173
Facsimile 020 7329 2190
DX 98936 – Cheapside 2
mail@citysolicitors.org.uk
www.citysolicitors.org.uk

21 October 2010

Muhunthan Vaithianathar
Policy Directorate
The Insolvency Service
Zone B, 3rd Floor
21 Bloomsbury Street
London
WC1B 3QW

Dear Mr Vaithianathar

Re: Consultation document on proposals for a restructuring moratorium

I write to enclose the response of the City of London Law Society's Financial Law Committee to the above consultation document, which has been prepared from the perspective of the effect on companies and their financial creditors.

The Committee strongly supports the aim of encouraging the rescue culture and welcomes the proposals as an attempt to improve the choice of tools available for achieving a company rescue. It is pleased that the consultation document addresses a number of concerns expressed by the Committee in its previous paper of September 2009 and adopts some of its suggestions. However, the proposals need to be developed in greater detail and give rise to a number of potential issues. The comments of the Committee's working party on these issues are set out in the attached response.

If the proposals are taken forward, further consultation with stakeholders will be essential. Members of the working party would be glad to attend a meeting with you and your colleagues to discuss the issues involved.

If you wish to arrange a meeting or to discuss any aspect, please contact Geoffrey Yeowart or another member of the working party.

Yours sincerely

David McIntosh

Chair

CLLS

Encl..

The City of London Law Society

4 College Hill
London EC4R 2RB
Tel: 020 7329 2173
Fax: 020 7329 2190
www.citysolicitors.org.uk

Response of the City of London Law Society's Financial Law Committee to the consultation document "Proposals For a Restructuring Moratorium" issued by The Insolvency Service in July 2010

INTRODUCTION

1. The Committee appreciates the opportunity to respond to the above consultation document. Our comments are divided into two parts. Part 1 of this paper sets out our general comments on the proposals while Part 2 addresses the specific questions raised in the consultation document. Although the consultation concerns laws throughout the UK, our response is limited to matters of English law. Details about the City of London Law Society, the Committee and the membership of its working group appear in Part 3.

2. For brevity the abbreviations "**IA 86**" and "**IR 86**" are used to mean the Insolvency Act 1986 and the Insolvency Rules 1986.

PART 1

GENERAL COMMENTS

3. We welcome the proposals as a serious initiative to improve the choice of tools available for achieving a company rescue while trying to strike a fair balance between the interests of debtors and creditors. The consultation document addresses a number of the concerns expressed in our previous paper of September 2009 and adopts some of the suggestions made by us. However, the proposals need to be developed in greater detail and give rise to a number of potential issues. Our comments on these are set out below.

4. It is essential, in our view, that the new regime should neither tip in favour of debtors the existing finely struck balance between the interests of debtors and creditors nor result in UK insolvency law becoming over-complicated. If the proposals are taken forward, further consultation with stakeholders will be essential before a Bill is introduced.

Flexible framework

5. We agree that the new regime be made sufficiently flexible to be capable of use with a company voluntary arrangement ("**CVA**"), a scheme of arrangement under section 899 of the Companies Act 2006 (a "**Scheme**") or a contractual multi-creditor work-out of the kind described in our paper of September 2009. In addition, there seems to be no reason why the new regime should not supersede Schedule A1, 1A 1986, thus avoiding two parallel moratorium regimes for small companies. Two regimes could be subject to somewhat different requirements and give rise to somewhat different effects. If, notwithstanding this suggestion, the small company moratorium procedure is retained, Schedule A1 may require consequential amendment to ensure consistency with the new legislation.

6. The practice adopted by companies in certain cases of obtaining an interim moratorium[1] by filing for but not obtaining an administration order (and then renewing it) suggests that there may be a need for a moratorium procedure.[2]

7. In order to achieve cross-border recognition within the European Union ("**EU**") other than Denmark, it is desirable that the new moratorium regime be included as an "insolvency proceeding" in Annex A to Council Regulation (EC) No 1346/2008 on insolvency proceedings (the "**EC Insolvency Regulation**") as and when it is possible to amend Annex A.[3] It would have to be recognised that, although the moratorium would prevent winding up proceedings in the UK, it would not necessarily have that effect in other EU jurisdictions where winding up might be permissible under the EC Insolvency Regulation as a secondary proceeding.

8. The statutory purposes of administration might need to be reviewed, given that a company could enter administration after a moratorium had failed and ended prematurely. The primary purpose of an administration is to rescue the company as a going concern. If a moratorium has failed, the rescue of the company as a going concern may no longer be possible and the administration may need to be conducted for a different purpose.

Qualifying floating charge holders

9. We consider that a qualifying floating charge holder within the meaning of paragraph 14, Schedule B1, IA 86 (a "**QFCH**") should have similar protection to that available in relation to the appointment of an administrator.[4] The company should be required, before applying to the court for a moratorium, to give at least five business days' notice in writing to the QFCH unless the QFCH has consented to the moratorium. This would give the QFCH the opportunity, if it chose, to appoint an administrator before the five business day period had expired.[5] In addition, when deciding whether the eligibility tests have been satisfied, the court should take into account whether the QFCH has consented or otherwise supports the application for the moratorium. The QFCH should be entitled to be heard by the court on the question of the choice of insolvency practitioner (**"IP"**) to act as

1 Paragraph 44, Schedule B1, IA 86.

2 The fact that no administrator is appointed within the prescribed period of 10 days does not prevent a fresh notice of intention to appoint from being filed, resulting in a fresh 10 day appointment period. This could give rise to a potential abuse as an unscrupulous individual or group of individuals could engineer a continuing moratorium by filing repeated notices of intention to appoint, but the court would have powers to treat this as an abuse and act accordingly: Re *Cornercare Limited* [2010] EWHC 893 (Ch).

3 The Procédure de Sauvegarde introduced in France in 2006 has been added to Annex A.

4 See paragraph 15(1) and 26(1), Schedule B1, IA 86.

5 C.f. paragraphs 26(1) and 28(1), Schedule B1, 1A 86. A QFCH would also be entitled to appoint an administrative receiver in the cases referred to in section's 72B to GA, IA 86, but we assume that a company which is a party to such an arrangement would be ineligible for the proposed restructuring proposal.

the monitor. There should be nothing that would prevent the floating charge held by the QFCH crystallising before the moratorium comes into effect[6].

Eligibility for a moratorium

10. We agree that there should be excluded from eligibility:

    (a) companies of the type which are ineligible for a small company moratorium under paragraph 2(2) (b) to (d) and paragraph 4 in Schedule A1, IA 86, except that the exclusion under paragraph 4C of a company which has incurred a liability under an agreement of £10 million or more should be removed for those companies (but, if the small company moratorium regime is to remain, be retained for small companies);

    (b) a company which is party to a transaction described in section 72B to GA, IA 86 (the exceptions to the prohibition of appointment of an administrative receiver);

    (c) a banking institution which falls within the scope of the special resolution, bank insolvency and administration regimes introduced by the Banking Act 2009 (this includes UK deposit-taking institutions but also extends to a parent undertaking of such an institution incorporated in the UK).

11. When the proposed Investment Bank Special Administration Regulations 2011 come into force, we assume that investment firms which fall within the scope of the regime created by those Regulations will be excluded from the moratorium. Alternatively, if it was decided that investment firms should be eligible for the moratorium where, in the case of a regulated firm, its entry into the moratorium had been approved in advance by the regulator, special provisions for investment firms might need to be included, for instance, to safeguard client assets.[7]

12. We consider that an insurance company liable to be wound up under the IA 86 (including, for these purposes, where a company is to be treated as liable to be wound up under regulation 5(1) of the Insurers (Reorganisation and Winding Up) Regulations 2004 in relation to the promulgation of a Scheme) should be eligible for a moratorium, provided that where it is regulated its entry into the moratorium had been approved in advance by the regulator. The use of Schemes by insurance companies which need to restructure is well-established.

13. We welcome the acceptance[8] of the suggestion made in paragraphs 30 and 31 of our paper of September 2009 that the definition of "capital market arrangement" be updated to reflect the changes made in 2003 to paragraph 1(1) of Schedule 2A, IA 86[9].

14. We suggest that a special purpose vehicle which is used as a financing conduit in a specialised lending arrangement described in Appendix 1 should also be excluded from eligibility for the reasons explained in Appendix 1.

15. It is also important for the reasons explained in paragraph 21 of our previous paper that the moratorium should not affect rights created by, or property subject to, any one or more of the following:

---

6 C.f. paragraph 13, Schedule A1, 1A 86.

7 HM Treasury consultation document "Special administration regime for investment firms" September 2010.

8 Paragraph B4, Annex B, of the consultation document.

9 The Insolvency Act 1986 (Amendment) (Administrative Receivership and Capital Market Arrangements) Order 2003.

(a) a market contract, market charge, default proceeding, margin or default fund contribution under Part VII of the Companies Act 1989;[10]

(b) a money market charge under the Financial Markets and Insolvency (Money Market) Regulations 1995;

(c) a system-charge under the Financial Markets and Insolvency Regulations 1996;[11]

(d) a collateral security charge, transfer order or netting under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the "**Settlement Finality Regulations**");[12]

(e) a financial collateral arrangement or close out netting provision under the Financial Collateral Arrangements (No. 2) Regulations 2003[13] (the "**FCA Regulations**");

(f) a capital market arrangement or other arrangement protected by sections 72B to GA, IA 86.

16. We do not agree with the proposal in the consultation document[14] that a company should be ineligible for a restructuring if it is a subsidiary of a company whose centre of main interests ("**COMI**") is in another EU member state and is in the process of being wound up under a procedure recognised in the EC Insolvency Regulation or the Cross-Border Insolvency Regulations 2006 (the "**Cross-Border Regulations**"). While a parent company incorporated outside the UK with a non-UK COMI should normally be excluded, a subsidiary with a UK COMI should be eligible for a moratorium. In other words, the eligibility test should be applied on a company by company basis and a company should not be excluded simply because it has a foreign parent company with a non-UK COMI. We recognise that the position is different where a UK subsidiary of a foreign company subject to proceedings under the Cross-Border Regulations has a non-UK COMI.

17. We agree that it would be useful for the Secretary of State to be given a power to add to, modify or remove existing exclusions by statutory instrument, as in the case of section 72H, IA 86.

Qualifying conditions

18. We agree that a moratorium ought to be granted (or extended) only if the court is satisfied that the company has demonstrated that:

(a) there is a reasonable prospect that a compromise or arrangement can be agreed with creditors; and

10 Market charges are relied upon by recognised clearing houses such as Euroclear UK & Ireland Ltd, LCH. Clearnet Ltd, ICE Clear Europe Ltd and European Central Counterparty Ltd.

11 System-charges in the form of floating charges over securities in CREST are taken and heavily relied upon by CREST settlement banks, the key providers of the intra-day liquidity to CREST members required to enable the CREST system to operate. The daily average value of securities moving through the CREST system in March 2010 was in the order of £1,442 billion, while the daily average value of cash moving through CREST was in the order of £908 billion, including self-collateralising repo transactions: see the market performance statistics for Euroclear UK and Ireland on www.euroclear.com. CREST settlement banks assume their exposures, in the great majority of cases, in reliance on floating charges from CREST members over their securities and other entitlements in CREST.

12 Collateral security charges are relied upon by designated systems such as CHAPS Sterling, CHAPS Euro, the Continuous Linked Settlement (CLS) System, BACS, the Cheque Clearing System, the Credit Clearing System, LCH. Clearnet Ltd and CREST.

13 The Regulations referred to in paragraphs 15(c) & (d) are due to be amended to implement Directive 2009/44/EC not later than 30 December 2010

14 Annex B, paragraph B2.

(b) the company is likely to have sufficient funds to carry on its business during the moratorium period.

19. We agree with the example given in paragraph 3.16 of the consultation document that condition (a) might be satisfied at the pre-proposal stage by demonstrating support in principle for some form of compromise from secured creditors (and, if there is more than one class of secured creditor, the senior secured creditors) and any other major creditors whose co-operation is essential to ensure that the proposed restructuring is successful (the **"relevant creditors"**)[15]. At this stage the terms of a compromise will probably not have been fully worked out and agreed. We suggest that, in these circumstances, it ought to be sufficient, for instance, for the relevant creditors to have entered into a standstill agreement with the intent of giving the company a breathing spacing in which to develop and implement a restructuring plan.

20. In order to satisfy condition (a), we consider it essential that support has been obtained by the company from its relevant creditors including secured creditors and any QFCH. In determining whether condition (a) has been satisfied, we suggest that the new legislation specifically state factors which the court must take into account, including whether the moratorium application is made with the support of the relevant creditors. The requirement for such support in the qualifying conditions should be stated in general terms and not be over-specific, since circumstances may vary considerably from case to case and there may be different ways of demonstrating that condition (a) is satisfied.

21. Further consultation would be necessary on the question of what level of consent would be required from the relevant creditors, in order to strike the right balance. The consent of a QFCH and a lender providing continuing facilities during the moratorium period should be required in any event. The position of secured creditors whose security cover might be eroded by the moratorium would also need to be carefully considered. In the case of other relevant creditors, it may be feasible to act only through a prescribed majority in value, in order to avoid a minority of relevant creditors having a potential blocking power.

---

15 Practical guidance on the choice of relevant creditors is given in "The Statement of Principles for a Global Approach to Multi-Creditor Workouts" issued by INSOL International (2000) which states at pages 6 to 7 that: "The main objective of the global approach is to assist in the process of rescue or orderly workout. Accordingly, the approach should ideally be applied to all creditors whose co-operation is needed in order to make any attempted rescue or workout succeed. On the other hand, there is usually merit in limiting the number of participants to the minimum necessary to see that objective achieved. Taking these two ideals together, it is necessary first to identity the classes of creditors which need to be included in the process and then to decide which creditors in the affected classes are to be included.

With banks and other financial institution creditors, it is usual to include all the financial creditors in the class regardless of the size of their exposure or the nature of their facilities (unless their exposure is so negligible that it is clear that their inclusion would serve no practical purpose or their position is such that they are not required to assist, and cannot frustrate, the process)....

Where it is proposed to include creditors who fall outside the traditional categories of financier in the rescue process, the argument for including all creditors within a class diminishes and it is usually simply a question of deciding whether or not the particular non-financial creditor has to be included to enable the rescue to progress.

Where bonds or traded debt are involved in the rescue process it is seldom possible to involve all the bond or debt holders. Quite often ad hoc committees are formed by some of the debt holders. As these debt holders usually have the same economic interest as other holders their views are likely to be representative and they are therefore able to make an important and helpful contribution to the process...

With the increasing use of credit insurance and credit derivatives, it is not uncommon to discover that, in addition to the creditors of record, there are other parties whose consent or involvement will be necessary for any rescue or workout proposal to succeed. Wherever practical, an early disclosure of such situations should be made by the creditors of record to the other relevant creditors.

Where the identity of relevant creditors changes during the process (e.g. through the trading of debt) the successors should participate in and be included in the process in the same way as the original creditor."

22. In order to satisfy condition (b), the company must be able to demonstrate that the business will generate sufficient cash flow available for the free use of the company during the moratorium period or that the company has sufficient unutilised facilities available from its bankers which they have agreed to maintain during the moratorium period, to pay its liabilities, whether incurred before or during the moratorium, in its ordinary course of trading. Where a company has entered into a standstill agreement with its bankers, this will normally provide for continuing facilities to be provided by one or more of its bankers during the standstill period. Again, we suggest that this requirement for the support of relevant creditors be stated generally (and not too specifically) as part of the qualifying condition.

23. As in the case of a "small company" moratorium under Schedule A1, IA 86, the monitor should be required to confirm in writing at the time of the court application that, in his view, both conditions (a) and (b) are satisfied, based on the information available to him.

24. The statutory safeguards must be such that the existing balance between the interests of debtors and creditors should not be upset by the new regime. The aim of the new regime should be to strengthen multi-creditor workouts by introducing statutory machinery to ensure that restructuring proposals supported by the great majority of financial creditors can be successfully implemented, even if opposed by a minority. It would be a mistake, in our view, for the new regime to be devised and used as an equivalent to Chapter II of the US Bankruptcy Code for the reasons explained in paragraphs 2 to 4 of our paper of September 2009.

Scope of the moratorium

25. The moratorium should be no wider in scope than in the case of an administration or a small company CVA in terms of the restrictions which apply to steps being taken against the company. In those cases the moratorium operates to prevent any steps being taken to enforce any security over the company's property or to repossess goods in the company's possession under any hire-purchase etc. agreement, or to commence or continue any proceedings, execution or other legal process or the levying of distress against the company or its property, except with the consent of the administrator or nominee or the leave of the court.

26. The existing form of moratorium does not prevent a creditor exercising a contractual right to terminate or suspend the performance of further obligations under a contract where it is expressly entitled to terminate or suspend performance on the occurrence of a specified event of insolvency (sometimes referred to as an "ipso facto" clause). Such rights are relied upon as an important safeguard in a wide range of transactions and are included in innumerable contracts (albeit in differing terms)[16]. Similarly, it is generally considered that the existing moratorium does not prevent a creditor from exercising a contractual right to net or set off mutual debts owing between the company and that creditor. We would have serious reservations if it were proposed to make the moratorium more restrictive. We recognise that continuity of the supply of gas, electricity, water and communication services should nevertheless be capable of being preserved on the same basis as applicable under section 233, IA 86. We recognise that there may be a case for extending this exception to key providers of IT services who would otherwise be able to hold the company to "ransom" by threatening to cut off further supply.[17]

[16] Paragraphs 46 and 47 of our previous paper

[17] Paragraph 48 of our previous paper

27. The moratorium should permit a shareholders' meeting to be held for the purpose of voting on a CVA or Scheme or approving the company's accounts or, with the monitor's consent, to obtain a court order for the settlement of litigation.

Impact of the moratorium

28. We do not consider that the company should be restricted during the moratorium period from paying pre-moratorium debts where authorised by the court or the monitor. We suggest that:

    (a) the court order should not be made unless the court is satisfied that there are likely to be sufficient funds available to pay debts to creditors in the ordinary course of trading, whether those debts arose out of obligations incurred before or during the moratorium;

    (b) the court order should permit payments of debts incurred by the company in the ordinary course of trading;

    (c) the monitor should be able to authorise payments even if not specifically permitted by the court order granting the moratorium.

29. It is stated in the final bullet point of paragraph 4.20 of the consultation document that an officer of the company would be liable to a fine or criminal sanction for "entering into certain financial market transactions whilst the moratorium is in force". We assume that this is intended to cover derivatives and other similar products entered into for the purpose of speculation and not for an essential business purpose. It may well be in the interests of the company to enter into an interest or currency rate hedging arrangement. We suggest that the company be permitted to enter into financial products where authorised by the court or the monitor.

30. We do not consider that there should be any criminal sanction on the directors if, without the permission of the court or the monitor's consent, they cause the company to pay a pre-moratorium debt or to enter into a financial market transaction. A civil law remedy should be perfectly adequate. For instance, if the creditor or counterparty was aware of the moratorium, the creditor who has received an unauthorised payment should be liable to make repayment, or an unauthorised financial market transaction should be capable of being set aside.

31. It is stated in paragraph 4.21 of the consultation document that, in the event of a moratorium being ended prematurely and being followed by an insolvency procedure (other than a compromise proposal), the start of the moratorium will be deemed to be the "onset of insolvency", so that prior transactions may be investigated by an IP. Care will need to be taken to ensure that transactions carried out by the directors between the commencement of the moratorium and the commencement of the administration or liquidation may also be set aside if they amount to preferences or transactions at an undervalue etc. While fixing the onset of insolvency at the commencement of the moratorium allows for a longer period of relation back, it is important that all transactions entered into by the directors between the commencement of the moratorium and the commencement of the administration or liquidation are liable to avoidance if they amount to preferences or transactions at an undervalue etc.

Moratorium debts and floating charges

32. We note the proposal that debts outstanding when the moratorium ends that arose out of obligations incurred while the moratorium was in force would, in terms of priority, rank behind any fixed charge on the company's assets, but ahead of other claims including those relating to expenses of the subsequent

procedure, and the claims of preferential creditors, floating charge holders, and unsecured creditors for non-moratorium debts.

33. Although we welcome the preservation of the priority of fixed charges, we foresee that the proposed ranking of floating charges behind moratorium debts is likely to be a concern for lenders. Innumerable banking facilities are secured by debentures containing fixed and floating charges. A substantial part of the business of a typical trading company will be capable of being charged only by way of floating charge, where the company is to remain free to deal with its assets in the ordinary course of business. In particular, unless the book debts of a company (on which it will depend for its cash flow) are paid into a blocked account controlled by the chargee, a charge over those books debts could operate only as a floating charge following *Agnew -v- Commissioner of Inland*[18] and *Re Spectrum Plus Limited*[19].

34. If moratorium debts were to have priority over floating charges, this could erode the security cover available under debentures to secured bank creditors. This could have implications for the pricing of future bank facilities generally. It might also lead to the greater use of factoring arrangements under which the financier acquired legal title to book debts instead of relying on a floating charge. These concerns would be lessened (but not entirely eliminated) if (i) a QFCH were able to prevent the moratorium by appointing an administrator as suggested in paragraph 9 above and (ii) a company could enter into a moratorium only with the prior approval of its secured creditors (or a prescribed majority of them) as suggested in paragraph 20 above.

35. We consider that, if the above proposal were adopted, there would be a case for a floating charge created on or before an appointed date being "grandfathered" and not capable of having its priority altered. A similar approach was adopted when the prohibition on the appointment of administrative receivers and the requirement to share a "prescribed part" of floating charge realisations with unsecured creditors were introduced by Part 10 of the Enterprise Act 2002.[20] If the new legislation were to apply to existing floating charges, this would be contrary to basic principle, since the legislation would then have retrospective effect by derogating from existing proprietary interests. We also consider that the implementing legislation should not come into force until a reasonable time had been given for creditors to evaluate the implications.

36. If the above proposal was adopted, it would also be important to ensure consistency in the treatment of administration, liquidation and moratorium expenses. For instance, we suggested that a floating charge holder should have a statutory right to recoup, out of any unencumbered assets of the company becoming available for payment to general creditors, all moratorium, administration and liquidation expenses previously paid out of floating charge assets and not otherwise refunded to it. A floating charge holder already has a statutory right of recoupment[21] in respect of preferential debts paid out of floating charge assets. In our view, this right should be extended to cover both moratorium debts and administration and liquidation expenses paid out of floating charge assets.[22]

---

18 [2001] BCC 250, PC

19 [2005] UKHL 41

20 See sections 72A(4) and 176A(9), IA 86; the Insolvency Act 1986, Section 72A (Appointed Day) Order 2003; and the Insolvency Act (Prescribed Part) Order 2003.

21 Section 40(3), IA 86, and section 754(4), CA 2006.

22 Similarly, a safeguard exists for floating charge holders, or the court, to agree the quantum of certain litigation expenses which may be paid by the liquidator out of floating charge assets. We have previously suggested that serious thought be given to introducing a similar safeguard in relation to administrations, so

37. The claim of a participant or central bank to "collateral security" is required under the Settlement Finality Regulations to be paid in priority to the expenses of a winding up and the remuneration and expenses of an administrator[23]. Such a claim should also be given priority over moratorium expenses. We also consider that, where a "security financial collateral arrangement" (within the meaning of the FCA Regulations) is taken in the form of a floating charge, the claim secured by that charge should be paid in priority to moratorium expenses for the reasons explained in the paper to be submitted by our Committee to HM Treasury in response to its consultation paper (August 2010) on the implementation of Directive 2009/44/EC on settlement finality and financial collateral arrangements (a copy of which will be available on request).

38. It is unclear whether overdraft and revolving credit facilities would be excluded from the above proposal or whether running accounts would need to be ruled off and new accounts opened in order to prevent pre-moratorium debts being turned over and discharged by operation of the Rule in Clayton's case.

Moratorium debts and rights of set-off

39. We consider that, where a creditor has a pre-existing right of set-off (whether contractual, equitable or otherwise) arising out of arrangements existing on commencement of the moratorium, that creditor should be entitled to exercise that right, whether during or after the moratorium period, against pre- and/or post-moratorium debts as it may choose.

40. Care will also need to be taken to avoid a conflict with the statutory set-off rules applicable in administration under Rule 2.85 and in liquidation under Rule 4.90, IR 86. In its paper of November 2007, the Financial Markets Law Committee (the "**FMLC**") recommended that the cut-off times set out in Rule 2.85 (2) be amended so that debts incurred after commencement of administration but before the administrator gave notice of intent to make a distribution to creditors (pursuant to Rule 2.95) should no longer be excluded from statutory set-off. If Rule 2.85 (2) is amended in this way, a similar approach should be taken in relation to the moratorium procedure where it is followed by an administration, so that debts arising from obligations incurred during the moratorium period should not be excluded from set-off under Rule 2.85 (2).

Period of the moratorium

41. It is suggested, in paragraph 3.6 of the consultation document, that the period of the moratorium should be limited, initially, to a maximum of three months, but that this period should be extendable by up to a further three months or longer if needed to be formally approved in accordance with the relevant statutory procedures applicable to a CVA or Scheme.

42. The Government states that it is one of their objectives in establishing the new moratorium procedure that it should assist in allowing a viable business to secure a negotiated restructuring without forcing it into a formal insolvency process – "an outcome that is likely to damage the company and put jobs at risk" (paragraph 2.6 of the consultation document). If the moratorium procedure is to be used in large, complex cases, we suggest that the court should have a discretion to permit the moratorium to continue in such cases for longer than a maximum of six months,

---

that an administrator could not incur significant litigation expenses without the approval of a floating charge holder if those expenses would otherwise deplete the floating charge realisations available to the floating charge holder. We consider that, as a matter of principle, the same approach may be appropriate in relation to a moratorium: see the Response dated 22 September 2006 submitted by the CLLS Financial Law Committee to the Insolvency Service on the implementation of Section 176ZA, IA 86.

23 Regulation 14(6) of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999.

particularly where there are numerous different stakeholders with different and conflicting negotiating positions. We consider that the duration of a moratorium under the new restructuring regime in such a case should be no shorter than the duration of an administration moratorium. It would defeat the purpose of the new regime if companies chose administration instead for the sole reason that the latter offered a longer moratorium period. Therefore, subject to the qualifying conditions being adequate, we suggest that, in the case of very large businesses, the period should be the same as applies in administration, namely one year, extendable for a specified period not exceeding six months by consent[24]. "Very large businesses" could be defined by reference to turnover, balance sheet total or number of employees, or a combination of these[25]

43. For these large businesses, the maximum period of the moratorium would be the longer of (a) the period applicable to other companies as set out in paragraph 3.6 of the consultation document, and (b) the period of one year, extendable for a specified period not exceeding six months by consent, as applies in administration.

44. The consultation document explains that, where a statutory proposal had been "developed", the moratorium could be extended to cover the period required for formal approval in accordance with the statutory procedures (paragraph 3.6). Guidance as to what is meant by "developed" is provided in paragraphs 3.19 to 3.21 of the consultation document.

45. In the case of a CVA, it is intended that it would need to be shown that "the" proposal had a "reasonable prospect of being approved and implemented" – a test taken from the procedure applicable under the small company moratorium procedure. We consider that this test is too restrictive. In the case of a small company it is more than likely that the proposal will have been formulated before the directors take any action to trigger the moratorium. If the new moratorium is to be a substitute for administration, it must allow for the proposal to be formulated during the course of the moratorium. It could well be the case that the directors of the company need an extension to allow the CVA process to continue before they can reach a view that there is a reasonable prospect of "the" CVA being approved and implemented; indeed, until the proposal has been approved at meetings of the shareholders and creditors, they can never be sure of this.

46. We suggest instead that it should be sufficient that the directors can form the view "that there is a reasonable prospect that ***a*** proposal may be approved and implemented", the crucial difference being that there should not need to be agreement on a settled proposal at the time that the directors apply for the extension.

47. In the case of a Scheme, the consultation document indicates that the extension would be granted "provided that a court is willing to sanction the holding of meetings" (paragraph 3.21). Again, we consider that this test is too restrictive because it would seem only to permit an extension if the convening hearing had taken place and the court had made an order that the class meetings be held. In our view, an extension should be available at an earlier stage, provided that there is a reasonable prospect of "a" Scheme being approved at the class meeting and sanctioned by the court. Indeed, the test could be very similar to that we have suggested should apply in the case of the CVA (see paragraph 35 above).

---

[24] Paragraphs 76-78, Schedule B1, 1A 86.

[25] These are the same criteria that are presently applied in determining whether a company is a "small company"; although the amounts involved would need to be greater for larger companies: see paragraph 3(2), Schedule A1, 1A 86 and s.382(3) Companies Act 2006.

48. Whether the proposal is to be implemented through a CVA or a Scheme, we accept that the directors should be required to show that the company would be likely to have sufficient funds to carry on its business during the moratorium (paragraphs 3.20 and 3.21 of the consultation document).

Rescue finance

49. We understand that the "debtor-in-possession" financing proposal on which we commented in our previous paper[26] is not being pursued, with the result that a provider of rescue finance will in no circumstances be able to gain priority over a creditor secured by an existing fixed charge without the latter's consent, irrespective of whether or not the moratorium is followed by an administration or liquidation. We support this change in the proposals.

50. We consider that existing negative pledges should continue to be enforceable (and not be overridden) during the moratorium period for the reasons explained in paragraphs 81 to 84 of our previous paper.

51. We consider that the possibility that providers of new finance during the moratorium period could gain priority over existing floating charge holders (even if the new finance is unsecured) is likely to be a concern for lenders generally (see paragraphs 33 and 34 above).

Appointment and role of the monitor

52. We agree that the monitor should be an independent IP appointed by the court and that the monitor should be an officer of the court. As suggested above, a QFCH and other creditors should be able to be heard by the court on the question of the choice of the monitor.

53. The monitor should be required to satisfy himself (through his own independent assessment) that the qualifying conditions for a moratorium have been fulfilled and continue to be fulfilled. In performing his role, the monitor should also have regard to the need to safeguard the interests of existing creditors and creditors who incur new exposure during the moratorium period. Further, the monitor should have power to authorise payments during the moratorium period and to approve the types of debt which would rank as moratorium expenses to the extent not specifically laid down by court order or the Insolvency Rules.

54. Paragraph 4.13 of the consultation document states that monitors "would be accountable for their actions, which could be challenged by the directors, creditors or any other person affected". There is a risk that experienced IPs may not be willing to act as monitors if the new role is seen as having more responsibility than power. The monitor should owe duties to the company and its creditors but not to the company's directors or any other person. It should be expressly provided that the monitor should be entitled to call for relevant information from the directors and to rely upon the information so provided. This is necessary in order to ensure that the monitor can prepare his report in the short timescale available. We consider that a monitor should be liable only for proven negligence or wilful misconduct. The fees and expenses of the monitor (including any professional fees incurred in obtaining advice on the performance of his duties) should rank as a moratorium expense.

55. The monitor should have the power, if he chooses, to appoint one or more creditors' committees where he considers it appropriate to do so and the out of pocket costs of the members of any such committee should be a moratorium

[26] Paragraphs 57 to 65 of our previous paper.

expense (but they should not receive any remuneration unless this is specifically authorised by the monitor). The ability to consult a creditors' committee may be appropriate in large restructurings where there are different classes of creditor with competing claims.

56. In order to save costs, we suggest that, where a moratorium is combined with a CVA, the court should have a discretion to permit the same IP to act as both monitor and nominee. A separate question arises whether an IP appointed as monitor should also be eligible for appointment as administrator or liquidator if the moratorium failed or whether he would have a potential conflict of interest. If an IP was free to perform both roles, there might be concern that the IP could have a financial interest in the outcome. Equally, there might be significant benefits in appointing the same IP as administrator because he would already have a detailed knowledge of the company and its liabilities and be able to act without delay. Again, we suggest that the decision be taken on a case by case basis by the court or (if the appointment of administrator is being made by a QFCH) by the QFCH. The IP would also need to take into account any ethical guidelines laid down by the Insolvency Practitioners Association or other professional body.

Publicity

57. The consultation document states at paragraph 4.5 that the directors would be required to give formal notice of their intention to apply for a moratorium. The notice is important since paragraph 4.15 makes it clear that it is this notice that triggers the interim moratorium. It is unclear to whom notice would be given and how it would be given. It seems to be the IP who is responsible for notifying creditors and other parties of the start of the moratorium (see paragraph 4.11).

58. It is, in any event, essential that the existence of a moratorium should be publicly ascertainable immediately it commences. In addition to requiring the company to file notice at Companies House, we suggest that a central register should be established to record details of companies in respect of which moratoria applications have been received or moratoria have been granted or administration applications have been received or appointments of administrators made. We believe that this would be an important safeguard and that users would be prepared to pay a reasonable fee for searches of such a central file. Given the serious constraints on public resources, perhaps the possibility of a private sector entity being found to provide this service might be explored.

Safeguards for creditors

59. The unfair prejudice safeguard contemplated in paragraph 4.15 of the consultation document requires careful thought. We suggest that a creditor opposing the moratorium should be required to show that the moratorium would have an effect on him that was materially discriminatory when compared to the effect that the moratorium would have on other creditors.

Directors' obligations

60. We suggest that it be provided that, while a moratorium is in force, the directors should not be at risk under section 213 (*fraudulent trading*) or section 214 (*wrongful trading*), IA 86, unless and until it becomes evident that the qualifying conditions referred to in paragraph 14 above are no longer met. However, as stated in paragraph 31 above, the actions of directors during the moratorium period should continue to be subject to challenge under section 238 (*transactions at an undervalue*) and section 239 (*preferences*), IA 86.

UKLA

61. The Insolvency Service may wish to discuss with the UK Listing Authority ("**UKLA**") how the UKLA would view the grant of a moratorium in relation to a listed company and whether this would result in an automatic suspension of its listing.

Scottish law issues

62. We understand that the proposals give rise to a number of technical and other issues under Scots law and we assume that the Insolvency Service will be consulting The Law Society of Scotland on these points.

PART 2

RESPONSES TO SPECIFIC QUESTIONS

Q1: Do you agree with the expected costs and benefits of the proposals, as set out in the Impact Assessment? Are there other benefits or costs that you believe should also be considered?

63. The assessment of costs and benefits is necessarily speculative in nature. It seems likely that the new procedure would be most useful in the restructuring of larger, more complex companies where there might be one or more "hold out" creditors. However, the procedure might also be used in the case of medium sized companies where the amounts at stake are sufficiently substantial that the benefits of a moratorium would outweigh the costs of the court application and the remuneration and expenses of the monitor.

64. It should not be overlooked that existing forms of insolvency procedure can also be used to achieve a company or business rescue. The rescue of a viable business and the jobs that go with it is more important than saving the legal structure within which the business exists.

65. The proposals would, if implemented, also involve a cost in terms of the legal uncertainty which they would create until a body of case law was built up over a number of years on the application and effect of the new regime. In particular, legal advice would be required by lenders on the impact of the new regime. Legal opinions which cover enforceability of agreements in the event of a party's default or insolvency, would also need to address this issue. This cost cannot be quantified but is likely to be substantial.

Q2: Do you agree that in order to help safeguard creditors' rights, a company should not be eligible for a moratorium if there is an outstanding petition for winding-up unless it has a statutory compromise proposal (a scheme of arrangement or CVA) that it is ready to put to creditors?

66. We do not consider that the existence of a pending winding up petition should be an automatic bar to an application for a moratorium. We suggest that this be left to the discretion of the court. We agree with the statement in paragraph 3.13 of the consultation document that the availability of a moratorium should not be allowed to frustrate the process of a winding up petition being heard. However, the presentation of a winding up petition should not be used by a creditor for tactical reasons to prevent or delay a moratorium application or as a means of putting pressure on the company to give preferential treatment to the creditor.

Q3: At the pre-proposal stage, do you agree that the two proposed qualifying conditions provide the right balance in ensuring that a moratorium is only available to companies where the core business is viable but there is nevertheless a need to restructure their debts?

67. See comments at paragraphs 18 to 24 above.

Q4: Where a company has a proposal for a CVA or Scheme of Arrangement and wishes to apply for a moratorium (or extend the existing moratorium), do you agree that provided the existing statutory conditions are met the only additional qualifying condition that should apply is that the company is likely to have sufficient funds to carry on its business?

68. Yes, if the points made by us in Part I are adequately addressed, but not otherwise.

Q5: Do you agree that any extension of the moratorium during the period when a compromise proposal is still being negotiated should require a further court hearing?

69. Yes, although a further application to court would involve additional costs, we consider that this is an important safeguard. If an extension is to be granted, the court must be satisfied that the qualifying conditions will continue to be satisfied during the extension period.

70. Where an application is made for an extension of the moratorium period, it will help in ensuring continuity and cost-efficiency if this is heard whenever possible by the same judge who heard the original application.

Q6: We would welcome views on whether an additional court hearing should be required for the extension of a moratorium to cover the formal approval of a CVA proposal.

71. There are differing views on this question. Some members of the working party consider that an extension of the moratorium for any purpose should require the sanction of the court. Other members consider that a further court hearing should not be necessary provided that the qualifying conditions continue to be met.

Q7: Do you agree that the proposed role of the monitor, together with the rights of creditors and the obligations on the directors, strikes the right balance in safeguarding the interests of creditors and deterring abuse, without imposing disproportionate costs or impending the objectives of the moratorium?

72. Provided that the points made by us in Part 1 are adequately addressed, we believe that this would be the case, but not otherwise.

Q8: Do you agree with the proposals for treatment of moratorium debts in a subsequent CVA, and in any distribution undertaken in an administration or liquidation that immediately follows a moratorium?

73. Provided that the points made by us in Part 1 are adequately addressed, we agree with the proposals in paragraphs 4.24 and 4.25 of the consultation document, but not otherwise.

PART 3

THE CITY OF LONDON LAW SOCIETY AND THE FINANCIAL LAW COMMITTEE

74. The City of London Law Society ("**CLLS**") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

75. The CLLS responds to Government consultations on issues of importance to its members through its 17 specialist Committees. The Financial Law Committee is made up of experienced practitioners in the field of banking and financial law, drawn from firms operating in the City of London (and in many cases in other major financial centres worldwide) with substantial practices in the field of banking and financial law. A working party of the CLLS Financial Law Committee, made up of solicitors who are experts in their field, have prepared the comments above in response to the consultation document. The members of the working party comprise:

Geoffrey Yeowart	-	Hogan Lovells International LLP (Chairman of the working party and Deputy Chairman of the Financial Law Committee)
Dorothy Livingston	-	Herbert Smith LLP (Chairman of the Financial Law Committee)
John Naccarato	-	CMS Cameron McKenna LLP
Robin Parsons	-	Sidley Austin LLP
Prashanth Satyadeva	-	Clifford Chance LLP
Jeremy Walsh	-	Travers Smith LLP
Nigel Ward	-	Ashurst LLP

Financial Law Committee
City of London Law Society
20 October 2010

APPENDIX 1

SUGGESTED EXCLUSION OF SPECIAL PURPOSE VEHICLES USED IN SPECIALISED FINANCINGS

1. Entities which are special purpose vehicles used as financing conduits ("**Financing SPVs**") but which are not part of a capital markets financing (because, for example, the financing is provided through the loan markets) should be excluded from the new moratorium regime. The use of Financing SPVs is common outside the securitisation market. It shares the same aim of (i) purchasing assets in exchange for cash funded through debt borrowed by the Financing SPV and (ii) segregating its assets from the credit risk of the seller of the assets and any operating company which services its assets. Financing SPVs do not normally have employees or any operational business other than the conduct of borrowing and ancillary financing activities.

2. Under the Basel II regime[1], where a financial institution is using the internal ratings-based approach in assessing required regulatory capital for its balance sheet, there are five sub-classes of specialised lending within the categorisation of exposures to corporates: (i) project finance, (ii) object finance, (iii) commodities finance, (iv) income-producing real estate and (v) high volatility commercial real estate (the "**Specialised Lending Regime**").

3. To be classified within one of the categories of the Specialised Lending Regime, the financing must comply with the following requirements:

   (a) the exposure is typically to an entity (often a special purpose entity) which was created specifically to finance and/or operate physical assets;

   (b) the borrowing entity has little or no other material assets or activities, and therefore little or no independent capacity to repay the obligation, apart from the income that it receives from the asset(s) being financed;

   (c) the terms of the obligation give the lender a substantial degree of control over the asset(s) and the income that it generates; and

   (d) as a result of the preceding factors, the primary source of repayment of the obligation is the income generated by the asset(s), rather than the independent capacity of a broader commercial enterprise.

4. The intention behind the Specialised Lending Regime is to allow the relevant financial institutions to model regulatory capital requirements based on an assessment of the underlying assets and ring-fenced cashflows of the Financing SPV (with the intention being that factors such as the insolvency of the Financing SPV can be disregarded given that the Financing SPV is intended to be an insolvency remote vehicle).

5. If the Financing SPV were to default, the directors of the Financing SPV should not be able, if they chose, to frustrate the financier's access to the underlying secured collateral and cashflows by attempting to carry out a restructuring moratorium.

6. Further, apart from regulatory capital assessment of loans under the Specialised Lending Regime and due to the increasing use of ratings for loan instruments in the market (as opposed to bonds), it is important to ensure that there be no

[1] Similar requirements exist under section 4.5 of the FSA's Prudential Sourcebook for Banks, Building Societies and Investment Firms.

negative impact in the rating assessment of a Financing SPV's financing caused by the theoretical risk that such moratorium could be implemented. The perceived prejudice to ratings was a principal reason for the "capital markets exception" in the small companies moratorium and section 72B, IA 86, and this rationale should be equally relevant, given market development, to ratings of structured, ring-fenced financings which are funded otherwise than through the capital markets.

7. We therefore suggest that a Financing SPV be excluded from the new restructuring moratorium regime.

THE CITY OF LONDON LAW SOCIETY
FINANCIAL LAW COMMITTEE

Individuals and firms represented on this Committee are as follows:

Ms. Dorothy Livingston (Herbert Smith LLP) (Chairman)

R.J. Calnan (Norton Rose LLP)

M. Campbell (Clifford Chance LLP)

J.A. Curtis (Denton Wilde Sapte LLP)

J.W. Davies (Simmons & Simmons)

D.P. Ereira (Linklaters LLP)

M.N.R. Evans (Travers Smith LLP)

J. Naccarato (CMS Cameron McKenna LLP)

A. Newton (Freshfields Bruckhaus Deringer LLP)

R.E. Parsons (Sidley Austin LLP)

Ms J. Paterson (Slaughter and May)

S. Roberts (Allen & Overy LLP)

N.T. Ward (Ashurst LLP)

P.R. Wood (Allen & Overy LLP)(Emeritus)

G.B.B. Yeowart (Hogan Lovells International LLP) (Deputy Chairman)