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City of London Law Society Insolvency Law Committee response to the Insolvency Service consultation on continuity of supply of essential services to insolvent businesses

1 INTRODUCTION

1. The City of London Law Society ("CLLS") represents approximately 15,000 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.

2. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees. This response, in respect of the Insolvency Service consultation paper published on 8 July 2014 entitled "*Continuity of supply of essential services to insolvent businesses*" (the "**Consultation**") has been prepared by the CLLS Insolvency Law Committee. Members of the working party listed in the Schedule attached will be glad to amplify any comments if requested.

3. We have focussed in our response on matters of corporate insolvency, as this is the area where we have the greatest practical experience of issues relating to continuity of supply.

2 General Points

4. We welcome the proposal to extend the scope of Section 233 Insolvency Act 1986 ("**IA**") to "ordinary" businesses, so as to give them similar protections to those currently enjoyed (for example) by investment banks, as this removes a potential obstacle to successful business rescues. The proposed drafting of The Insolvency (Protection of Essential Supplies) Order 2014 (the "**Draft Order**") does, however, raise a number of concerns with the approach which appears to have been adopted in relation to the implementation of this proposal.

Conformity with similar legislation

5. Imposing a statutory restriction on the exercise of termination rights in contracts for the provision of essential IT and communications services is not a new concept. Similar provisions already exist in, for example, the Investment Bank Special Administration Regulations 2011 (SI 2011/245) (the "**SAR**") and the Financial Services (Banking Reform) Act 2013 (the "**FSBRA**").

6. Given this position, we believe that there is a strong argument that the wording of the Draft Order should be conformed as far as possible to the equivalent provisions contained in the

SAR and the FSBRA. We cannot see any obvious commercial or policy reason for applying different rules, or for offering different protections, depending on whether a supplier provides IT related services to a manufacturing company or to an investment bank. Inconsistencies between provisions intended to achieve the same objective may also persuade courts to infer a statutory intention which may not have been intended.

Priority of supplies made after the appointment of an administrator

7. One specific example of the general point made in the paragraph above relates to the treatment of supplies made immediately after the appointment of an administrator. The Consultation states that "*It is also important to recognise that supplies made to an insolvent business pursuant to these requirements will, in the case of administration, rank as an expense of the procedure.*"

8. Both the SAR and the FSBRA expressly provide that any expenses incurred by the relevant company in relation to the provision of a supply after the commencement of the administration should be treated as necessary disbursements under Insolvency Rule 2.67(1)(f). The Draft Order does not contain a similar provision, thereby potentially creating uncertainty as to whether supplies made immediately post administration would definitely constitute administration expenses, particularly where the administrator decides not to give the requested guarantee. In addition, it is not certain whether, assuming that payments in respect of that supply did constitute administration expenses, they would be treated as "*expenses properly incurred by the administrator*" under Insolvency Rule 2.67(1)(a) or "*necessary disbursements*" under Insolvency Rule 2.67(1)(f).

9. The inclusion of wording clarifying the position, using the precedents contained in the SAR and the FSBRA, would address both of these concerns.

Provision by the insolvency officeholder of a personal guarantee

10. While the proposed legislation must address the legitimate interests of suppliers, there are significant practical and commercial issues surrounding the proposal that the insolvency officeholder should, if required, provide a personal guarantee to the supplier in question within 14 days. We note in this respect that neither the SAR nor the FSBRA contains a requirement for the administrator to provide IT suppliers with a personal guarantee in such circumstances.

11. The existing Section 233 IA is comparatively limited in its scope, with the result that the insolvency officeholder would, at most, receive requests to provide guarantees to entities providing gas, electricity, water and communications services to the business. There is also no statutory deadline by which the form of such guarantees must be agreed.

12. The proposed new legislation would considerably extend the scope of Section 233. While a company will generally only have one water provider, it will often have a significant number of different IT suppliers, providing it with information technology, software, data storage and other IT related services.

13. Permitting a significant number of suppliers to demand a personal guarantee (the terms of which will vary from supplier to supplier) during the early days of an administration creates the risk that the administrators and their staff may be forced to spend a considerable amount of time and effort during the crucial initial days of the administration negotiating the terms of supplier guarantees.

14. This will, in turn, result in either (i) resources being diverted away from the performance of essential tasks which may determine the future of the business or (ii) the use of additional staff and advisers to deal with the negotiation of guarantees, which will, in turn, drive up the costs of the process. We believe that stakeholders would find both options unattractive.

15. Furthermore, once the form of guarantee is agreed, we have experienced a number of occasions on which an officeholder was required, given the restrictions imposed on them by the rules of their partnership, LLP or company, to go through a time-consuming internal approval process before a personal guarantee could be executed. This could prove problematic in the context of a 14 day deadline for the negotiation and execution of a guarantee.

16. Given the practical and logistical issues surrounding the proposed extension of the personal guarantee regime, we strongly believe that it would be appropriate, at this stage, to reconsider the question of whether an insolvency practitioner should be required to provide the personal guarantees contemplated by the Draft Order.

17. To put this point into context, Section 233 IA contemplated the insolvency practitioner being required to provide a personal guarantee because, at time when this provision was drafted, the relevant supplier would only have had an unsecured claim if it continued to make supplies to a company in receivership. Until the introduction of the current rules relating to administration expenses, there was a concern that this could also have been the case, had the company gone into administration instead.

18. Looking at the position today, the supplier's legitimate concerns should be satisfactorily addressed by the fact that it is made clear in the Draft Order that any post-administration supplies would automatically be treated as administration expenses, ranking in priority ahead of the administrator's own remuneration.

19. There may be exceptional cases in which the supplier's position would not be adequately protected by having the relevant liabilities treated as expenses of the administration (for example if it had reasonable grounds to believe that there would be insufficient realisations to pay even administration expenses), but we would anticipate that the supplier could, if such circumstances did arise, properly apply to court for permission to terminate the relevant contract under Section 233A(3).

20. We are aware that Section 93(3) of the Enterprise and Regulatory Reform Act 2013 requires the giving of a personal guarantee, but consider that this requirement is, for the reasons outlined above, unnecessary and that it could hinder the rescue process. We would therefore strongly encourage you to reconsider the approach and, if at all possible, to amend Section 93(3), so that the ability to request a personal guarantee is restricted to the utilities currently covered by Section 233 IA.

21. If, however, it is not possible to alter the requirement in Section 93(3), we would suggest that the Draft Order should make it clear that this requirement would be satisfied where the administrator provides a guarantee in the standard form which they or their firm customarily use in such circumstances. Alternatively, we would suggest that there may be merit in either:-

- providing a simple, short form, template guarantee for the purposes of Section 233A(4) (which we would be happy to assist, with other professional bodies, in developing), so that everyone knows what they will receive; or

- including a statutory guarantee mechanism, whereby the guarantee obligation could be satisfied by the administrator simply confirming in writing to the relevant supplier that he or she would treat themselves as bound by Section 233A(4).

22. This would, at least, minimise the time spent negotiating guarantees, particularly where the form proposed by the supplier contains provisions which an administrator would find unacceptable, given their role, or the proposed guarantee is not governed by English law, forcing the administrator to obtain advice from lawyers in the relevant jurisdiction. In any event, there should be no time restriction on when the administrators must give such a guarantee, given the number of things on which they have to focus in the early days of the administration.

3 Specific Questions

Question 1: Do you agree that the proposed amendments to Sections 233 and 372 will be effective in bringing on-sellers of utility and IT services within scope of the existing provisions?

23. The proposed changes should bring most on-sellers of utility and IT or services within the scope of Sections 233 and 372. There may, however, be some grey areas, where the question of whether or not the Draft Order applies depends on an analysis of whether the supply in question was part of the on-seller's business. Looking at the example cited in the Consultation of landlords who have the right to charge tenants for electricity, would it be part of the "business" of a member of a manufacturing group which owns a factory to provide electricity to another group member who has a sub-lease of part of that factory? The courts may have to adopt a purposive approach when considering, for these purposes, what amounts to the carrying on of a "*business.*"

Question 2 Do you agree that the amendments will be effective in preventing supplies made for wholesale purposes from becoming subject to the provisions?

24. We believe that the current wording should be effective in preventing supplies made for wholesale purposes from becoming subject to the provisions contained in the Draft Order, but believe that there may some merit in including an express provision to this effect in the Draft Order, to remove any possible ambiguity on this point.

Question 3: Do you agree that the proposed changes will be effective in bringing suppliers of IT goods or services within the scope of Sections 233 and 372?

25. The proposed changes should bring suppliers of IT goods or services within the scope of Sections 233 and 372. We are, however, concerned that the current wording of the Draft Order may limit the practical benefits of doing so, as it may be relatively easy for a supplier to work around the draft provision. Specifically:-

(i) A supplier which was concerned about operating under the new regime could simply provide for automatic termination of the relevant contract "*should any step be taken with a view to putting the company into administration",* thus pre-empting the "*enters administration*" wording currently in the new Section 233A(6)(a). One possible solution would be to include a provision in the Draft Order similar to that contained in the current SAR, which states that "*any provision in a contract between the investment bank and the supplier that purports to terminate the*

agreement if any action is taken to put the investment bank into special administration is void."

(ii) The words "*or to do any other thing*" appear in Section 233A(6)(b) but do not appear in Section 233A(6)(c), with the result that a supplier could (for example) include a provision in a contract giving it the right to increase the cost of supply, at its discretion, or to require the delivery of collateral, at any time after the company becomes insolvent. Increasing prices by reference to an event other than the company's entry into administration or a CVA, and then terminating the contract if the revised terms are not complied with by the administrator, would seem to be permitted under the current wording of the Draft Order.

(iii) Some suppliers have flexible tariffs and our members have experienced situations where suppliers have selected a high tariff within a permissible contractual range simply because the company was in administration. The words "*or to do any other thing*" are clearly intended to prevent such behaviour, but it may be worth making this point absolutely clear by the inclusion of words along the lines of "*including charging more than it would have done, had the company not entered administration*."

(iv) Under some IT agreements, the provision of supplies is discretionary. A framework agreement may, for example, permit the customer to make orders which the supplier "may" accept. If the customer went into administration, the supplier might simply decide not to supply. We do not consider that there is an easy drafting amendment to address this issue, as any attempt to regulate the manner in which a counterparty exercises a contractual discretion is, even if considered desirable in policy terms, likely to prove almost impossible to police.

Question 4 Do you agree with the proposed approach to specify types of IT goods or services that should be brought within the scope of Sections 233 and 372? If not, would a more generic definition of IT services be preferable?

26. We consider that the proposed approach of specifying types of IT goods and services that should be brought within the scope of Sections 233 and 372 is helpful, but are concerned that there could be arguments about whether a particular supply is caught by Section 233(3A), particularly if the supply in question is of an innovative new product or solution.

27. Given this position, there may be an argument for supplementing the current list of different types of IT related goods and services with a final, more purposive, sweep-up category such as "*agreements relating to the supply of information technology, the continued availability of which is essential for the continuation of the company's business*".

Question 5: Are there any other types of IT goods or services that you believe should be brought within the scope of Sections 233 and 372? (Please be as specific as possible

28. Please see our answer to Question 4 above.

Question 6: Do you consider that new Sections 233A and 372A will be effective in preventing suppliers of utility and IT goods and services from relying on insolvency termination clauses?

29. Please see our answer to Question 3 above.

Question 7: Do you consider that new Sections 233A and 372A will be effective in preventing suppliers of utility and IT goods and services from demanding 'ransom' payments as a condition of continuing supply?

30. Please see our answer to Question 3 above.

Question 8: Do you believe that the safeguards provided for suppliers are adequate?

31. Please see our general comments in relation to both the priority of supplies made after the appointment of an administrator and the provision by the insolvency officeholder of a personal guarantee. For the reasons stated, we believe that the supplier's position should be sufficiently protected where any post-administration supplies are treated as administration expenses, ranking in priority ahead of the administrator's own remuneration.

Question 9: What, if any, exceptions should be provided from the ability to seek a personal guarantee from the insolvency office-holder as a condition of continuing supply?

32. Please see our general comments in relation to the provision by the insolvency officeholder of a personal guarantee.

Question 10: What impact, if any, do you believe the changes would have on the pricing of contracts in relation to utility supplies/IT goods or services?

33. We are not in a position to make an informed judgment on this point, as it will depend on the commercial importance which individual suppliers attribute to insolvency related termination rights.

Question 11: Can you foresee any practical difficulties arising from the proposed changes?

34. **Nature of breach**: The Draft Order effectively removes the right to terminate in respect of any event of default (whether or not insolvency related) that occurred before the company entered into administration. This is clearly intended to ensure that a counterparty cannot rely on a pre-administration payment default to exert leverage, but it does mean that a company which has fundamentally abused the terms of (say) a computer software licence can carry on using that software. We would therefore propose that Section 233(6)(c) should be amended, by replacing the words "*an event*" with the words "*payment default*", so as to distinguish other defaults.

35. **Multiparty contracts**: The Draft Order appears to assume that a contract for essential services, such as IT, will be between the supplier and the company in administration. In practice, IT services may be supplied under one contract to a number of different group companies. The relevance of this point is that Section 233A(6)(c), as currently drafted, prevents a supplier from terminating a contract where a termination right has arisen pre-administration as a consequence of the conduct of an entity other than the company in administration. It would seem an odd result if a customer who had fundamentally breached a multiparty contract was able to require a supplier to continue performing that contract, simply because another customer had gone into administration. One potential solution would be to provide in the Draft Order that it does not restrict the supplier's right to terminate the supply to any entity other than the company in administration.

36. **Mixed contracts**: Larger IT agreements may relate to a large range of services, including software maintenance, software development and hosting. Section 233, as currently drafted, would appear to catch any such contract, as long as one of the services provided under it was listed in Section 233(3A). One potential solution would be to provide in the Draft Order that, where both essential and non-essential supplies were provided under the

same contract, the supplier would not be prevented from terminating the supply of those goods and services which are not listed in Section 233(3A).

4 Other Points

Relationship with existing legislation

37. As Section 233 IA was incorporated into the SAR, it would follow that, if the Draft Order were adopted, there would be two separate (and contradictory) provisions dealing with the continuity of essential IT services to investment banks, namely the bespoke provisions currently contained in the SAR and those being incorporated as a result of the proposed amendment to Section 233. We would suggest, in the interests of clarity, that it be made clear which rules would apply to an investment bank, our preference being that the existing provisions contained in the SAR should remain in place.

Bank payment systems:

38. Section 233(3A)(c) of the Draft Order could be read as requiring a bank to continue processing BACs payments requested by the company before it went into administration. We believe that there should be a clear carve-out for BACs payments which have not been expressly authorised by, or on behalf of, the administrator, as it is not in the interests of any stakeholder for a bank's standard procedural protections to be overridden in such circumstances.

Impact of the Draft Order on swap termination and netting provisions:

39. While it is not immediately apparent how any of the essential services covered by the Draft Order could fall under an ISDA Master Agreement, it may be worth confirming with ISDA that a netting safe harbour would not be required in this case.

Foreign law contracts:

40. The territorial scope of the Draft Order is unclear, particularly where the relevant contract for the supply of services is not governed by English law and the party exercising any termination right was located outside the United Kingdom. The Draft Order provides that an insolvency related termination right "*would cease to have effect*", but what would happen where a contract governed by New York law, and subject to the exclusive jurisdiction of the New York courts, was terminated by a counterparty located in New York because of a pre-insolvency payment default? The company in administration might potentially be able to sue the supplier in the New York courts for breach of contract, but this would seem an unattractive option for a company which urgently required the provision of essential supplies.

Extension to CVAs.

41. The Draft Order extends the scope of Section 233 to termination rights linked to CVAs. While understanding the logic underlying this proposal, we question how often it would be relevant in practice, as the restriction is on termination rights linked to the approval of the CVA. In our experience termination rights are generally exercisable by reference to a company proposing a CVA, given that the obligation to pay for any ongoing supplies would not have statutory priority and could be written off under the terms of the CVA in question.

6 October 2014

THE CITY OF LONDON LAW SOCIETY
INSOLVENCY LAW COMMITTEE

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