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Dear Sir/Madam

RESPONSE OF CITY OF LONDON LAW SOCIETY – INSOLVENCY LAW COMMITTEE

INTRODUCTION

1. We refer to the Insolvency Service Consultation entitled "*A Review of the Corporate Insolvency Framework – A consultation on options for reform"* published in May 2016 (the **Consultation**). This response has been prepared by the City of London Law Society (CLLS) Insolvency Law Committee. The Policy Unit The Insolvency Service 4 Abbey Orchard Street London SW1P 2HT

2. The CLLS represents approximately 17,000 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.

3. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees. The CLLS Insolvency Law Committee, made up of solicitors who are expert in their field, has prepared the comments below in response to the Consultation. Individuals and firms represented on this Committee are set out in appendix 2.

4. Members of the CLLS Insolvency Law Committee would be happy to discuss or expand on any of the comments made in this response, if requested.

STRUCTURE OF OUR RESPONSE

5. The Consultation contains four proposals which, if implemented, could have a significant impact on the existing UK insolvency regime. These proposals raise a number of important issues, not all of which fall within the scope of the specific Consultation questions. We have therefore highlighted a number of key points arising from our detailed review of these proposals in the main body of our response. We have then set out in the Appendix our responses to the specific Consultation questions, but emphasise that these should be read in the light of this response as a whole.

SUMMARY

6. We very much welcome initiatives which are intended to ensure that the United Kingdom insolvency regime retains its competitive advantage in terms of efficiency and effectiveness and can see merit in further exploring and developing a number of the proposals contained in the Consultation.

7. In particular, we believe that the existing corporate rescue regime could potentially be improved by the introduction of a new statutory procedure which permitted the cramming-down of out of the money creditors without their consent. Such a measure could both increase the chances of a debtor company surviving as a going concern and reduce the need for senior secured creditors to implement a restructuring solution by way of a "pre-pack" sale. The proposals set out in the Consultation relating to the new cram-down procedure are, however, relatively high level, and will require further detailed consideration if they are to proceed and result in a procedure that is both robust and easy to apply.

8. While we agree that interference with the right of freedom to contract is "*only justified where absolutely necessary*",[1] we can see that the proposed extension of existing statutory restrictions preventing the use of ipso facto clauses to terminate "essential" contracts may prove a useful tool in dealing with "ransom" creditors. Further measures would, however, need to be put in place to ensure that the position of the relevant supplier was properly protected.

9. There is, however, a sense that this proposal, when combined with the impact of the recent extension of Section 233 of the Insolvency Act 1986,[2] marks a further step towards a general prohibition on ipso facto clauses. While this may offer a comparatively simple solution, it should only be adopted following a deliberate policy decision, rather than becoming the default position following a series of unrelated incremental statutory changes which result in different levels of protection applying, depending on the nature of the supply.

10. In addition, it may be necessary to specify that certain types of contract (for example interest rate and currency hedging agreements and undrawn overdraft facilities) cannot be designated as "*essential*" contracts, given the practical issues involved in ensuring that the position of the relevant counterparty would not be prejudiced.

11. The case for establishing a new pre-insolvency moratorium is, however, much less convincing. We have, in practice, experienced very few (if any) cases in which a viable and

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[1] Paragraph 8.10 of the Consultation

[2] Under the Insolvency (Protection of Essential Supplies) Order 2015 (SI 2015/989)

well managed business has failed as a result of the absence of a moratorium of the type proposed in the Consultation.

12. We would therefore not support the wider moratorium proposals contained in the Consultation. The limited benefits of having such a moratorium available as part of the insolvency "tool kit" are outweighed by both the potential costs involved[3] (which may make it too expensive for use by some SMEs) and concerns that the legitimate interests of creditors are not sufficiently protected by the proposals for a three month moratorium contained in the Consultation.

13. The suggested options for rescue financing raise a number of difficult and complex issues, particularly as there are often few, if any, assets of a distressed debtor which are not already encumbered by security. We would suggest that the key matter to address is to determine what is actually holding back potential participants in this market.[4] Possible structures for giving such funding priority already exist, but the market remains relatively inactive. It is those potential participants, rather than we, who are best placed to explain exactly what they require, in order to support a more extensive and bespoke DIP finance market than that currently operating in the United Kingdom.

14. Once those requirements have been established, it will be possible to judge whether it would be worth giving effect to them, or whether the possible benefits of establishing a DIP financing market would be outweighed by the probable negative impact that taking such steps would have on existing lending products and practices.

15. We would, however, emphasise the significant legal, practical and economic problems that would arise if any proposal were to emerge that gave rescue financing priority over existing fixed charge security. Any such proposal would give rise to significant disputes. It is unclear whether the UK courts would have the experience or capacity to deal with such disputes. In addition, any such measure would create market uncertainty if the benefit of taking fixed charge security were perceived as being devalued, such uncertainty resulting, at best, in increased costs for borrowers.

16. Overall, the proposed changes are fundamental in nature, being arguably the most significant proposals to reform UK insolvency legislation since the Enterprise Act. Those proposals which proceed will require further detailed consideration, both in their development and subsequent implementation.

17. We would strongly recommend, as part of this process, that any proposed legislative changes are made available in draft form to interested stakeholders and that, given the importance of what is being proposed, those stakeholders are given sufficient time to review and comment on that draft legislation before it is enacted.

SPECIFIC COMMENTS - A NEW CRAM DOWN REGIME?

18. We have previously recommended[5] that the Insolvency Service may wish to consider whether those who no longer have any economic interest in a business (for example

[3] Para 1.53 of the Impact Assessment notes that "*collectively the costs of producing a report, monitoring compliance for the period of the breathing space and getting legal agreement for the breathing space will cost between £0.24 and £2.245m per case*."

[4] The gradual emergence of a litigation funding market shows that the development of new types of funding is currently possible where there is a market led demand for such products

[5] In our response to the Insolvency Service consultation paper entitled "*Proposals for a Restructuring Moratorium*" published in July 2010

shareholders or “out of the money” junior creditors) should effectively still be able to veto a viable restructuring proposal which has the overwhelming support of those creditors who retain an economic interest in the business.

19. We therefore welcome the proposal that a statutory mechanism could be put in place, permitting the cram down/elimination of out of the money debt claims, whether secured or unsecured. This would:-

(i) limit the need for a company’s business to be transferred, often by means of a “pre-pack sale”, in order to deal with the claims of “out of the money” creditors, a route which in certain situations can be complex, value destructive and expensive; and

(ii) prevent the UK insolvency regime from being perceived, as a result of retaining a veto for out of the money creditors, as being friendly to “ransom” creditors whose actions may place a company’s survival, and the jobs of its employees, in jeopardy.[6]

20. We would, however, make the following specific points in relation to the proposed new procedure (which is referred to in this response as the “**Corporate Recovery Plan**”).

21. **Relationship with other procedures**: We would support the suggestion[7] that the Corporate Recovery Plan should be a stand-alone restructuring procedure which would sit alongside the existing rescue options and which could be used by the directors of any company which was, or was likely to become, insolvent or by an administrator or liquidator of that company. All companies, whether large, SME or otherwise, should be able to use this procedure, as long as they are not one of those listed in Para 9.23 of the Consultation.

22. We note the alternative suggestion that the new procedure could be incorporated into the existing CVA voting procedure. The major weakness of this procedure is that the rights of secured creditors cannot be affected without their consent. However, adopting this approach would introduce the concept of voting by class into a CVA, thereby limiting its main attraction, namely the flexibility afforded by having a “single class” creditor compromise and composition procedure.

23. We do not consider that the Corporate Recovery Plan should replace the existing, and successful, Scheme of Arrangement procedure as:-

(i) Schemes can be used in a wide variety of circumstances, for example to impose a claims bar date or to settle a class action, by any company, whether solvent or insolvent;

(ii) the use of Schemes is not limited, as would be the case with the new Corporate Recovery Plan (subject to the outcome of Brexit discussions), to companies with a Centre of Main Interests (“**CoMI**”) in the United Kingdom; and

(iii) one of the major attractions of a Scheme is that a company can decide which claims it wants to compromise. It is, for example, possible to cram down a class of junior secured creditors under a Scheme while keeping unsecured claims whole, provided that there is a valid commercial reason for doing so. A company can also ignore those classes of creditor that would not be affected by the proposed

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6 This perception may place the UK insolvency regime at a competitive disadvantage, given that proposed legislative reforms in a number of other Member States, including The Netherlands, are seeking to limit the rights of such creditors

7 In Paragraph 9.14 of the Consultation

restructuring. The proposed Corporate Recovery Plan does not appear, under the current proposals, to offer as much flexibility, although this point could be addressed by the inclusion of the measures discussed below.

24. **Terms of the Corporate Recovery Plan.** Paragraph 9.32 of the Consultation states that a Corporate Recovery Plan would be considered fair and equitable if, inter alia, junior creditors do not receive "*more on repayment than creditors more senior than them.*" It would follow that if a company had both junior secured creditors and unsecured operational creditors (whether suppliers, employees or customers), amounts owed to the latter would have to be written off before the claims of junior secured creditors could be crammed down using a Corporate Recovery Plan.

25. In practice, there may, in certain cases, be good commercial reasons why it would not be realistic to expect an unsecured creditor to write-off their debt, particularly where their ongoing support was of critical importance to the business going forward. One obvious example of this would be the supplier under an "*essential*" contract, whose claims would be likely to be unsecured.

26. Deviating from the absolute priority rule is not a step to be taken lightly, but we believe that there may be a case for giving the court the discretion, in exceptional cases, to sanction a Corporate Recovery Plan under which a junior creditor receives a greater recovery than a more senior creditor where (i) the ongoing support of that more junior creditor is critical to the viability of the debtor's business, (ii) the payment, and the rationale for making it, were fully disclosed and (iii) the relevant senior creditors were still better off than would otherwise have been the case.[8]

27. The absence of such flexibility could have the unintended consequence of making the Corporate Recovery Plan more attractive to finance vehicles (which are less likely to be dependent on the on-going support of more junior creditors) than to operating companies.

28. **Duration**: Paragraph 9.29 of the Consultation suggests that the Corporate Recovery Plan should "*last no more than twelve months*". It is not clear whether this would, for example, prevent the plan from being used to extend existing debt maturities for two or three years where payments fell due after more than 12 months (as often happens under an "*Amend and Extend*" Scheme of Arrangement). Would the debtor company have to go through the effort and expense of proposing a new plan each year, providing for a further extension? It would be a strange outcome if, as a matter of policy, a plan could write off a debt but it could not extend the maturity of that debt for 18 months.

29. **Shareholders**: While not expressly addressed in the Consultation, it would clearly be inequitable if any Corporate Recovery Plan could leave shareholders in the company with their existing equity, at a time when some or all creditor claims had to be compromised or written off. We therefore assume that the Corporate Recovery Process would follow the Australian model adopted in relation to voluntary administrations and Deeds of Company Arrangement, under which shareholder equity can be extinguished as part of a court approved restructuring process.[9]

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[8] This would be consistent with the approach adopted in relation to Schemes of Arrangement, where the treatment of creditors in Schemes including *Re PT Garuda Indonesia* and in *In the matter of (i) Stemcor (S.E.A.) Pte Ltd and (2) Stemcor Trade Finance Ltd*, has not always followed the absolute priority rule

[9] See Section 444GA of the Australian Corporations Act 2001 and the Mirabella and Nexus cases

30. **Voting**: It is proposed that, as with a Scheme of Arrangement, voting would be by classes, and the approval threshold would be the same as for a Scheme (the approval of 75% by value and more than 50% in number of each class being required).[10] We agree that voting should be by class, and that the class test should be the same as that used in relation to Schemes.

31. We would, however, question whether the numerosity test applicable to Schemes should be incorporated into the Corporate Recovery Plan, as our experience is that this test offers no significant creditor protection. It does, however, give dissenting creditors the ability to sabotage (and potentially destroy) a widely accepted and viable restructuring proposal though the simple expedient of splitting out their votes.

32. **Existing case law relating to Schemes**: Existing case law and practice established in relation to Schemes of Arrangement (for example cases covering class composition) should also apply to the new Corporate Recovery Plan, in order to avoid the risk of long established and accepted practices being challenged. While existing case law may not necessarily be treated as binding if the Scheme in question was not contested, developing an entirely new body of case law relating to the composition of classes or the holding of meetings would create unnecessary uncertainty while also being time consuming, expensive and potentially detrimental to creditors.

33. **Court approval**: Similarly, we believe that the role of the court in considering whether to approve a Corporate Recovery Plan[11] should be the same as the role of the court when sanctioning Schemes of Arrangement. The test currently applied by the court when deciding whether or not to sanction a Scheme works well and is widely understood. The same test should therefore apply to a Corporate Recovery Plan, thereby avoiding uncertainty and possible attempts to "play the system" as stakeholders gain familiarity with its operation in practice.

34. **Valuation**: As noted in the Consultation, valuations will play an important role in any Corporate Recovery Plan, as much will depend on whether a class of creditors would be "in the money" or "out of the money". We do not, however, believe that legislating for the use of a "*minimum liquidation valuation*" would necessarily be a helpful measure, even if it was possible to come to a generally accepted definition of exactly what this meant. There are clearly cases where liquidation would be the correct comparator (one obvious example being *MyTravel*, whose business was dependent on the continuing availability of a CAA licence which would be lost if the proposed restructuring was not approved), but there is a risk that the liquidation comparator would rapidly become the default valuation option. The fairness of any plan should be judged by reference to the most likely alternative outcome, which may not necessarily be the immediate liquidation of the debtor company.[12]

35. We would therefore suggest that, as each case turns to some extent on its own facts, the court should continue its current practice of considering valuation issues on a case by case basis, having regard to independent valuation evidence.

THE INTRODUCTION OF A NEW PRE- INSOLVENCY MORATORIUM

36. Members of our committee were, when this issue was raised in 2010, divided in relation to whether a strong case could be made out for a temporary restructuring stay of this nature.

[10] Paragraphs 9.12 and 9.19 of the Consultation

[11] As set out in Paragraph 9.29 of the Consultation

[12] This being the test suggested in Paragraph 9.10 of the Consultation

Some members gave examples of restructurings where it was necessary to use the stay inherent in a formal insolvency process in order to bind dissenting creditors or where a restructuring almost failed as a result of last-minute creditor action. Others questioned whether the moratorium was the right focus for any legislative change, suggesting that the greater risk was not so much that individual creditors might threaten to destabilise a restructuring at the negotiating stage but that such creditors could derail a restructuring altogether by refusing to consent to it.

37. When the issue was raised again in 2015, it was felt that there was a stronger argument for having a short pre-insolvency moratorium available as part of the restructuring tool kit, given the increasing diversification of the creditor base in many restructurings, and the resulting increased challenges faced by the company or representative creditor groups in communicating directly with the wider creditor constituency.

38. We believe that the fundamental point, when considering any such proposal, is to be clear exactly what any such moratorium is expected to achieve. We note, in this respect, the proposals for a short, pre-insolvency, moratorium made by R3 in April 2016[13] which highlighted the problems caused by anxious creditors disrupting business rescue plans by petitioning to have a struggling company wound up. We agree that such behaviour can prove an unhelpful distraction and that it would be useful to have the threat of a statutory moratorium available, in order to deter hostile creditor action of this nature.

39. A measure such as this should be relatively uncontroversial as it would simply formalise the approach already adopted in cases such as *BlueCrest Mercantile BV v Vietnam Shipbuilding Industry Group,*[14] with courts using their case management powers to impose a short de facto standstill on hostile creditor action while a restructuring plan is finalised.

40. Having a short moratorium in place could also have the benefit of creating "deal tension", imposing a timetable within which interested parties should agree the terms of a restructuring. This might make discussions more focussed, to the benefit of all stakeholders.

41. What is proposed in the Consultation would, however, go considerably beyond this identified issue. It would limit significantly the rights of secured creditors (and in particular the rights of the holder of a Qualifying Floating Charge) while allowing a potentially incompetent management team to carry on running a business for an initial period of three months under the (limited) supervision of an individual who would have "*relevant expertise in restructuring*" but who might not be an insolvency practitioner.[15]

42. The risk is that an extensive three month moratorium of this nature may, rather than creating an environment in which plans could be put in place for the rescue of a potentially viable business, simply encourage directors to put off dealing with a company's financial difficulties. This could, in turn, lead to creditor anger and frustration, should the company's financial position deteriorate during the moratorium period.

Concerns with the current moratorium proposals

43. We have two fundamental concerns with the proposals made in the Consultation. The first is that there appears to be a suggestion that a company would have to enter into the

[13] In "*A Moratorium for Business: Improving Business & Job Rescue in the UK*"

[14] [2013] EWHC 1146 (Ch)

[15] Paragraph 7.41 of the Consultation

moratorium process before it could utilise any statutory cram-down procedure. The second is that what is currently proposed does not strike a fair balance between the interests of the debtor company and the legitimate expectations of that company's creditors (and, in particular, its secured creditors).

The first concern - The moratorium should be optional

44. Paragraph 7.7 of the Consultation states that the moratorium would "*precede and act as a single gateway to different forms of restructuring including a compromise with creditors, a contractual/consensual workout, a CVA, administration or a scheme of arrangement*". This suggests that it might be mandatory for a company to propose a statutory moratorium before it could utilise any of these procedures.

45. It is assumed from statements made elsewhere in the Consultation that this is not the intention,[16] but if this is what is being proposed, we believe that this approach would be a significant mistake. In many cases, a company facing financial difficulties which is renegotiating the terms of its financial indebtedness would not want to publicise this fact to its operational creditors, given the reputational damage which would arise from such disclosure.

46. In particular, experience suggests that a notification that a company is seeking protection from its creditors would be likely to concern trade creditors, suppliers, employees, credit insurers and other stakeholders (whose claims might be totally unaffected by any proposed restructuring). It might cause them to change the terms on which they do business with the debtor company, to the detriment of both that company and its creditors. Competitors could also take advantage of concerns surrounding the debtor company's financial standing. Why risk these consequences, unless the debtor company actually needs the protection of a statutory moratorium?

47. As an optional tool, a <u>limited</u> moratorium could have some value. As an obligatory step in the restructuring process, any such value would be very clearly outweighed by the negative impact that seeking an (otherwise unnecessary) moratorium could have on the business being restructured.

The second concern – Striking the correct balance between the interests of the debtor and creditor protection

48. The proposals set out in the Consultation seem to assume an administration style moratorium which would extend to both secured and unsecured creditors. The position here is, however, very different to that which arises in an administration, as (i) the existing management team would continue to run the business, even where they were responsible for the problems which it had encountered, (ii) there is a very limited element of court supervision and (iii) the holder of a Qualifying Floating Charge ("**QFC**") would have no control over the process.

49. **Creditor protection**: It is important that the legitimate expectations of creditors are addressed in relation to any proposed moratorium, particularly if it is to last for three months. Appropriate checks and balances should be put in place to ensure that, as far as realistically possible, the creditors' position does not deteriorate during the moratorium period. We would, in particular, expect to see firmer restrictions on (i) creating new

[16] For example in Paragraph 7.33 which limits the availability of the moratorium – it would be surprising if, as a matter of policy, a company could not be put into administration because it had been subject to an unsuccessful moratorium

security, (ii) disposing of material assets outside the ordinary course of business, (iii) repaying pre-moratorium liabilities and (iv) making payments to connected parties during the moratorium period (together the "**Relevant Transactions**").

50. The Consultation states that the supervisor would need to sanction any disposals made by the company outside of the ordinary course of its business.[17] Given that the supervisor is a company appointee whose appointment is not ratified or approved by the court, and that (unlike under the Schedule A1 moratorium regime) there is no concept of a representative creditor body, there would appear to be a strong argument that, in order to maintain creditor confidence, the company should not be able to enter into any Relevant Transaction without the prior consent of the court.

51. We do not believe that introducing such a requirement would result in a substantial level of court involvement during the moratorium process, as companies should not, other than in exceptional circumstances, be creating security or making significant disposals outside the ordinary course of business during the moratorium period.

52. **The supervisor**: We understand that there may be policy and cost issues underpinning the suggestion that the supervisor should not have to be a licenced insolvency practitioner, as long as they are a solicitor or accountant "*with relevant expertise in restructuring*"[18] Measures should, however, be put in place to ensure that the supervisor's expertise extends to (for example) being able to analyse properly any cash flow/liquidity forecast prepared by the company's directors and to decide whether there are any CoMI issues. The success of any moratorium procedure will depend on creditors having confidence in both the procedure itself and in the supervisor who is effectively protecting their interests.

53. Given (i) the practical difficulties involved in establishing whether a solicitor or accountant has the necessary skill set and experience to take on the role as supervisor and (ii) the possibility that this limitation could be challenged by restructuring specialists who may well have the necessary experience, but who would not necessarily be solicitors or accountants, the simplest option might be, as with other insolvency procedures, to limit the role of the supervisor to licenced insolvency practitioners, given that the latter should, by reason of their qualification, have the necessary skill set to take on this role.

54. **Challenges.** It is proposed that "*creditors would…have a general right to apply to court during the first 28 days of the moratorium*",[19] It is unclear why the right to challenge the moratorium should be limited to this period. Circumstances change, including in relation to the prospects of agreeing a successful restructuring, with the result that creditors may well have valid grounds to argue after (say) two months that the company's financial position and prospects no longer merit the continuation of the moratorium.

55. **Should the moratorium extend to secured claims?** The proposal that the moratorium should extend to the enforcement of security gives rise to two key issues, namely (i) would imposing a three month moratorium on the holder of a QFC be likely to serve any useful purpose, if the latter was determined to enforce their security directly they were permitted to do so? and (ii) even if such a moratorium were to be imposed, would any necessary carve-outs limit its effectiveness?

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[17] Paragraph 7.43

[18] Paragraph 7.41 of the Consultation

[19] Paragraph 7.25

56. Looking first at the position of a QFC holder, it is acknowledged in the Consultation that "*as a matter of practice it would be unusual for a company not to consult, as a minimum, its largest secured creditors before making an application for a moratorium, to ensure that there was support for the principle of restructuring. If that support was not forthcoming it would be questionable whether there was a realistic prospect of rescue, as required by the qualifying conditions*."[20]

57. We agree that a moratorium should not be allowed to proceed where the management of the debtor company lacks the support of the company's key secured creditors, particularly where it is clear that (for example) the holder of a QFC intends to enforce its security at the end of any moratorium period. There may therefore be a case for making the moratorium conditional on first obtaining the consent of any QFC holder (in which case, it should not be necessary for them to be bound by any moratorium).

58. Turning to the question of carve-outs, the Consultation states that the moratorium would cease if a secured creditor could demonstrate to the satisfaction of the court that their "*collateral or interests are not sufficiently protected*"[21] There would, presumably, be further carve-outs from the moratorium on enforcing security as:-

(i) it is assumed that the moratorium would not extend to arrangements falling within the scope of the Financial Collateral Arrangements (No. 2) Regulations 2003 or to security falling within the scope of Article 5(1) of the EC Regulation on Insolvency Proceedings 2000; and

(ii) it is also assumed that those creditors who retain the power to appoint an administrative receiver (such as those granted security as part of a "*capital market arrangement*") and who are currently excluded from the small company CVA moratorium, would also be excluded from this moratorium.

59. We would question, looking at the cumulative effect of these provisions, how valuable a moratorium on enforcing security would be if (i) any QFC holder was effectively excluded, (ii) the various carve-outs set out in the previous paragraph were to apply and (iii) any other secured creditor would, unless the company went into administration, be able to enforce their security after three months.[22]

60. **Eligibility**: There are five specific points in relation to a company's eligibility for the moratorium process which may require further consideration. These are as follows:-

(i) The test for establishing whether the company's financial position makes it eligible for the moratorium needs to be clarified. The Consultation states[23] that "*the company must demonstrate that it is already or imminently will be in financial difficulty, <u>or is insolvent</u>*" [our emphasis] whereas the impact assessment[24] states that in order to be eligible the company must "satisfy the court that it is already or imminently will be in financial difficulty, <u>but is not yet insolvent</u>".

(ii) Experience derived from advising directors of companies facing financial difficulties highlights the amount of work that needs to be carried out, in all but the simplest of

[20] Paragraph 7.27

[21] Paragraph 7.12 of the Consultation

[22] As they would, under the current proposals (Paragraph 7.36) be able to veto any extension beyond this

[23] Paragraph 7.18

[24] Paragraph 1.26 (a)

businesses, in order to establish and maintain a proper cash flow forecast which can give comfort that the company should have sufficient funds to meet its obligations as and when they fall due.

It follows that the requirement that "*the company must be able to show that it is likely to have sufficient funds to carry on its business during the moratorium, meeting current obligations as and when they fall due as well as any new obligations that are incurred"*[25] could*,* assuming that it is taken seriously, limit the availability of the moratorium to companies which have the expertise and/or resources necessary to create a proper liquidity forecast.

(iii) Linked to this point are the questions of (i) whether a lender would be able to accelerate a facility during the moratorium and to demand repayment following such acceleration and (ii) if so, whether the amount demanded would, having fallen due, have to be repaid if the moratorium were to continue. If the intention is that amounts can be accelerated but that they do not have to be repaid as a quid pro quo for the continuation of the moratorium, this should be made clear.

(iv) Conversely, what would the position be if an amount fell due during the moratorium period, but the relevant creditor was prepared to defer payment? Would the continuation of the moratorium be dependent on the company having sufficient funds to pay that amount, notwithstanding the deferral?

(v) Finally, although not strictly an eligibility point, it is stated at Paragraph 7.22 of the Consultation that the requirement that the company must be able to show that it is likely to have sufficient funds to carry on its business during the moratorium *"is to ensure that existing creditors are no worse off*." It is unclear why the availability of such funding would necessarily mean that existing creditors were no worse off.

If such funding is provided by a third party it would, even if not secured, have priority as an expense of the process,[26] and would be repaid out of the company's available assets before the claims of existing unsecured and floating charge creditors. Even if new liabilities were satisfied using the company's assets, such payments could still reduce the amount available for repayment of the company's existing creditors. In either case, particularly where the funding was used to cover ongoing operational losses, existing creditors could be significantly worse off.

We think that it is important that the possibility that the creditors' position could deteriorate during the moratorium process should not be forgotten when considering the length of the moratorium and the balance to be struck between the interests of the company and those of its creditors.

61. **The option of going to court to obtain a moratorium**: It is suggested in paragraph 7.20 of the Consultation that "*if a company …is subject to a winding-up order or petition, it will not be able to qualify for a moratorium.*" This may have the unintended, and unwelcome, consequence that a hostile creditor could circumvent the moratorium by presenting a winding-up petition directly they suspected that the company might seek a moratorium. In order to address this, it may be worth considering giving the court discretion in such circumstances to allow an otherwise ineligible debtor company to use the moratorium.

[25] Paragraph 7.22

[26] Paragraph 7.46

62. **Accruing interest**: Paragraph 7.11 of the Consultation suggests that "*When a company enters the moratorium, the arrears owed to creditors will be frozen*". This would seem to suggest that creditors would be unable to charge either normal or default interest on outstanding amounts during that period. If correct, it is unclear why this significant interference with contractual rights is required as part of a moratorium. The fact that interest is technically accruing on outstanding debts would not interfere with the company's ability to put a restructuring proposal in place. Indeed, allowing interest to keep running, would be more consistent with the concept of the moratorium being a temporary process linked to the company's rehabilitation. The proper place to deal with any such accrued interest is in any restructuring plan.

63. **The position of directors**: The proposed treatment of directors' liabilities may require clarification, as it is proposed that the directors would remain in control of the company during the moratorium period, but with "*no exposure, subject to safeguards, for personal liability*"[27] Normal wrongful trading provisions would not apply during the moratorium,[28] but directors could face personal liability if the moratorium were to continue at a time when there was no longer a reasonable prospect of agreeing a restructuring solution.

64. In practice, the two personal liability tests seem very similar. A simpler, and more straight-forward, solution (which would also avoid confusion) would be to leave the existing wrongful trading regime in place. If a company's directors are satisfied that there is a reasonable prospect of achieving a restructuring, they should also be able to get comfortable that there is a reasonable prospect of avoiding insolvent liquidation/administration.

65. Any other option could be interpreted as a suggestion that there might be a lower bar during the moratorium period than that imposed by the wrongful trading test, a conclusion which could lead to inappropriate risk taking, particularly if directors believed that they could entirely rely on the views of the supervisor, rather than making their own assessment of the company's prospects.

66. **Extending the moratorium**: In larger or more complex restructurings, a three month period may be too short to be useful, unless extended. Under the current proposals, obtaining such an extension may prove problematic as it would require the consent of every secured creditor.[29]

67. Given that the process of seeking an extension would normally be time consuming and potentially disruptive, it may be worth considering building some flexibility into any moratorium legislation, in order to avoid the company's management being distracted during the moratorium period by efforts to obtain the consent of every secured creditor to an extension.

68. One option might be to allow a short further extension in the circumstances envisaged in Paragraph 7.35 of the Consultation with the consent of (say) 75% of each class of secured creditor, conditional on the supervisor confirming that he or she is satisfied that significant progress is being made towards implementing a restructuring solution.

69. **Effect of the termination of the moratorium**: It is unclear from the Consultation whether defaults that occur as a result of the moratorium process are immediately actionable once

[27] Key Points box in Section 7 of the Consultation

[28] Paragraph 7.34

[29] Paragraph 7.36

the moratorium falls away. This may not, in most cases, be a significant issue, assuming that the company either executes a successful restructuring plan which addresses those defaults or goes into a formal insolvency process (in which case the point becomes academic), but there will be cases where neither scenario applies.

EXTENDING EXISTING RESTRICTIONS ON CONTRACTUAL TERMINATION

70. We have previously highlighted the fact that one of the greatest challenges to the successful operation of the existing administration moratorium is that counterparties are able to terminate key contracts simply because a company has gone into administration.

71. This point was reflected in the Insolvency Service's summary of responses to its 2014 consultation on the continuity of supply of essential services to insolvent businesses, which noted that

> "*When a company or individual running a business enters an insolvency procedure, some suppliers may have contractual rights entitling them to terminate the supply contract on account of the insolvency. Where those supplies are essential to the continuation of the business, termination may have an adverse impact on the prospects of a successful rescue of the business and thereby on the amount of money available for creditors*."

72. The proposal contained in the Consultation that existing statutory restrictions on the exercise of contractual termination rights should be extended to "*essential*" contracts therefore addresses an issue raised by various stakeholders. We would, however, suggest that a number of additional checks and balances would need to be considered, should this proposal be progressed, in order to protect the position of the relevant supplier.

73. **Payment terms**: The Consultation focusses on the need for the debtor company to continue making payments under the relevant contract "*on time and in full*",[30] but the supplier is required to continue providing the relevant goods or services *"to the business during the moratorium <u>in accordance with the original terms of supply</u>"*.[31][our emphasis].

74. Where the goods in question were supplied on 90 or 120 day payment terms, a supplier denied the right to terminate the contract could be exposed to a significant credit risk as the debtor company might, contrary to its expectations, be unable to make payment in 3 or 4 months' time. The company could even be in insolvent liquidation at that stage, should its attempts to secure a restructuring have failed before the contractual payment date.

75. The supplier's concerns might be exacerbated by the fact that credit insurers may withdraw cover if a supplier is not able to terminate a contract on the occurrence of a payment default or other insolvency event.

76. While it may be argued that the supplier's claim would have priority as an expense of the process, the benefit of such priority would depend on there being sufficient floating charge or unsecured assets to satisfy that claim. There would also be timing issues, as a supplier (which might be facing pressures on its own liquidity) might have to wait for a considerable time before its claim was paid by the debtor company's administrator or liquidator.

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30 Paragraph 7.29 of the Consultation

31 Paragraph 7.30

77. We therefore believe that any supplier should be able to insist, whatever the original contractual payment terms, on being paid in full, in cash, <u>on delivery</u> of the relevant goods or services, should the contract in question be designated an essential contract.

78. If this were not the case, we believe that there would be a strong argument that the debtor company should have to apply to court to have a contract designated as being "*essential*", thereby giving a judge the opportunity to balance the benefit to the debtor company against the risks faced by the relevant supplier.

79. **Termination of status as an "essential" contract**. Any such designation, whether effected with or without a court order, should lapse if the company fails to pay any amount due to the supplier during the period of the moratorium.

80. **Limitations on the nature of "essential" contracts**: The question of whether a counterparty should be prevented from terminating a contract would depend on both (i) whether the continued provision of a supply was "*essential*" to the successful rescue of the business and its ongoing viability and (ii) whether "*alternative arrangements can be made at a reasonable cost within a reasonable time*".[32] As the term "*essential*" is not defined, it might be read as extending to financial products, such as hedging arrangements, overdrafts and/or the provision of ancillary banking facilities (such as BACs payment arrangements).

81. If it is intended that banks could be prevented from terminating such arrangements if (as is likely) no other bank was willing to provide such facilities on the same terms now that the company was facing financial difficulties, further detailed consideration would need to be given to the question of how best to protect the position of such counterparties. It should be noted in this respect that exposures under such contracts could increase significantly (and, in the case of currency and interest rate hedges, relatively unpredictably) during the moratorium period, and that the possibility of a continuing or increased exposure could have a significant impact on a bank's capital adequacy requirements.

82. In practice, as indicated in the Summary of our response, it may prove impractical to put satisfactory protections in place for certain financial contracts, and it may therefore be necessary to specify that some types of contract (for example interest rate and currency hedging agreements and undrawn overdraft facilities) cannot be designated as "*essential*" contracts.

83. **Treatment of the essential contract in any restructuring plan**: If a supply of particular goods or services is deemed "*essential*", it would logically follow, as noted in Para 8.17 the Consultation,[33] that any proposed restructuring plan would require the support of the relevant supplier. We would therefore suggest, as a further check to ensure that this power was not used inappropriately, that the Court approval of any restructuring plan should specifically take into account the position of any supplier that the company had designated as being "*essential*", focussing on whether that supplier was likely to terminate its relationship with the company and, if so, how the company was planning to deal with the absence of an "*essential*" supply.

[32] Paragraph 8.12 of the Consultation

[33] "*We believe that if a business requires the continued supply of an essential good or service in order to be viable, the supplier of that good or service would need to be in agreement with a proposed restructuring plan or contractual workout in order for the plan to be successful*"

84. **Preservation of rights of set-off**: It is not expressly stated in the Consultation whether any contract could still be designated as being "essential" and therefore not terminable, if the counterparty was relying on a right of set-off which required such termination and, if so, how the relevant counterparty's position would be protected, if its position deteriorated as a result of not being able to exercise such set-off right. In order to avoid an inequitable outcome, one option might be to allow a supplier to terminate the relevant contract, and to exercise any resulting rights of set-off, provided that they confirmed that they were willing to continue making supplies on the same terms under a new contract.

EXPLORING OPTIONS FOR RESCUE FINANCING

85. We think that it is right that this area should be kept under review, as new money has historically been provided by banks who were already creditors of the company in question. Today, those banks are increasingly selling their debt at an early stage in the restructuring process, with the result that a company's creditors, once a restructuring is under way, increasingly comprise CLOs, hedge funds and bondholders who may be unwilling or unable to provide additional liquidity.

86. We do not believe that the reason why competitive DIP finance and exit finance markets have failed to develop to date in the United Kingdom is the absence of mechanisms for giving such claims priority, as:-

(i) any such funding can already be given statutory priority as an administration expense;

(ii) new funding can, as part of a consensual restructuring plan or under a Scheme of Arrangement, be given priority over all other secured claims;[34] and

(iii) it appears that any such funding made available as part of the moratorium process would also be given statutory priority.[35]

In short, procedures are already in place to give priority to new funding, albeit subject, in some cases, to the claims of existing fixed charges.

87. When looking at this issue, the Commission Recommendation of 12th March 2014 focussed on two specific risks which might be deterring new lenders, namely that:-

(i) new financing agreed upon in the restructuring plan and confirmed by a court might be declared void, voidable or unenforceable as an act detrimental to the general body of creditors; and

(ii) providers of new financing as part of a restructuring plan which is confirmed by a court could potentially face civil and criminal liability relating to the restructuring process.

Neither of these risks is considered to be particularly relevant in a UK context.

88. As noted in our March 2015 response, it is possible that one of the main bars to third party funding in a restructuring or insolvency context may be a lack of transparency, which

[34] Should interim liquidity be required, a DIP facility could even be proposed as part of a "*Moratorium Scheme of Arrangement*"

[35] Paragraph 7.46 of the Consultation

makes it difficult for a prospective lender to identify or price potential opportunities.[36] By way of example, in the US, it is possible to search the court docket for all the documents filed with the court in the context of US Chapter 11 proceedings, including any debtor-in-possession financing agreement, whereas, in the UK, it can often be difficult to get hold of a copy of the order placing the company into administration, let alone any of the agreements entered into by the administrator.

89. This is, however, a topic best explored directly with potential providers of third party funding, as they will be best placed to explain whether lack of transparency is indeed an issue (and, if so, whether any practical steps could be taken to address it), or whether there are other potential bars to third party lenders providing additional liquidity during the restructuring process.

90. Once there is a clearer understanding of what is preventing the growth of a competitive third party funding market, and of what steps would need to be taken to remove any identified obstacles, careful consideration would have to be given to the question of whether such obstacles could be removed without causing significant uncertainty and possible disruption to existing financial markets and products and without making new lending more expensive.

91. The concerns voiced in 2009 in response to an earlier consultation would, however, strongly suggest that this "*complicated issue*" is not one which can be satisfactorily explored in the context of a six week consultation.

[36] We note in this context that Para 22(d) of the Commission Recommendation anticipates that any restructuring plan should set out "*the conditions for new financing*", which, if the plan is a public document, may result in a greater degree of transparency than may currently be found in the United Kingdom

APPENDIX 1 – SPECIFIC QUESTIONS

The Introduction of a Moratorium

1. Do you agree with the proposal to introduce a preliminary moratorium as a standalone gateway for all businesses?

We would support the introduction of a short, pre-insolvency, moratorium which put onto a statutory basis the approach already adopted by the courts in cases such as *BlueCrest Mercantile BV v Vietnam Shipbuilding Industry Group,*[37] where case management powers have been used to impose a short de facto standstill on hostile creditor action while a restructuring plan is finalised. Dealing with such actions can prove an unhelpful distraction during the restructuring process and it would be useful to have the threat of a statutory moratorium available, in order to prevent anxious or disruptive creditors from attempting to derail business rescue plans by petitioning to have a struggling company wound up.

What is proposed in the Consultation, namely a wide administration-type moratorium, would, however, go considerably beyond this identified issue, and would make fundamental changes to the existing restructuring landscape. The existing rights of secured creditors (in particular the rights of the holder of a Qualifying Floating Charge) unsecured creditors and suppliers would be significantly restricted, while the directors of a business would potentially be allowed to carry on incurring losses during the moratorium period or to continue trading such that free assets were progressively converted into charged assets during that period.

There is a clear risk that what is proposed may, rather than creating an environment in which plans could be put in place for the rescue of a potentially viable business, simply encourage directors to put off dealing with a company's financial difficulties. This could, in turn, lead to creditor anger and frustration, should the company's financial position deteriorate during the moratorium period.

The question is therefore one of whether the significant restrictions on creditor rights, and the risk of the moratorium being abused, could be justified by reference to the number of viable and well managed businesses which would, under the current legislative framework, fail, but which would be likely to survive, should a moratorium of the type proposed in the Consultation be available.

We have, in practice, experienced very few cases in which a viable and well managed business has failed as a result of the absence of a moratorium of the type proposed in the Consultation. We would therefore not support the wider moratorium proposals contained in the Consultation, as any potential practical benefit is outweighed by the potential prejudice to creditors.

While we do not believe this to be the intention, we would also emphasise our view that the preliminary moratorium should be an optional process and that a company should not have to enter into the moratorium before it can go into administration or utilise any statutory cram-down procedure.

2. Does the process of filing to court represent the most efficient means for gaining relief for a business and for creditors to seek to dissolve the moratorium if their interests aren't protected?

[37] [2013] EWHC 1146 (Ch)

The process of filing at court, combined with filing with the Registrar of Companies and sending a copy of the application to all known creditors, would make the moratorium a matter of public record and should ensure that creditors are made aware that a moratorium is in place.

There may be merit in requiring the company to notify any other parties with which it does business during the moratorium period that it is subject to a moratorium. As with other insolvency procedures, notice to this effect could appear in correspondence from the company and on any website, thereby ensuring that those dealing with the company were aware of its financial position (particularly if they were a potential new supplier who was at risk of having their contract designated as an "essential" contract).

We would also suggest that the court could potentially play a greater role, in certain limited circumstances, in order to avoid the risk of hostile creditors presenting a tactical winding-up petition directly they suspected that the debtor company might seek a moratorium. In order to address this, it might be worth considering giving the court discretion in such circumstances to allow a company to use the moratorium where it would, but for such winding-up petition, be eligible to do so.

Turning to the dissolution of the moratorium, it appears, given the subjective nature of the proposed qualifying conditions, that only the court would be in a position to decide whether or not the moratorium should be ended in the face of creditor objections.

3. Do the proposed eligibility tests and qualifying criteria provide the right level of protection for suppliers and creditors?

Overall, there is a concern that the proposed tests are very subjective and that, as drafted, they lack detail.

The requirement that "*the company must also be able to show that it is likely to have sufficient funds to carry on its business during the moratorium, meeting current obligations as and when they fall due as well as any new obligations that are incurred*" raises the following questions:-

(i) How will compliance with this test be demonstrated? Experience derived from advising directors of companies facing financial difficulties highlights the amount of work that needs to be carried out, in all but the simplest of businesses, in order to establish and maintain a proper cash flow forecast which can give comfort that the company should have sufficient funds to meet its obligations as and when they fall due. This requirement could limit the availability of the moratorium to companies which have the expertise and/or resources necessary to create a proper liquidity forecast.

(ii) How would compliance with this test be policed on an on-going business? It appears that only the supervisor will be in a position to provide independent oversight of the company's liquidity position, but taking on this role would seem to be inconsistent with the "light touch" approach generally contemplated by the Consultation.

(iii) Could this requirement be satisfied by having new third party funding made available? If so, the objective of ensuring that "*existing creditors are no worse off*." may not be satisfied, as even if such funding was not secured, it would still have priority as an expense of the process, and would be repaid out of the company's available assets before the claims of existing unsecured and floating charge creditors, whose position could be prejudiced, particularly if the new funding had been used to cover on-going operational losses.

(iv) If a lender was be able to accelerate a facility during the moratorium and to demand repayment following such acceleration, would the amount demanded, having fallen due, have to be repaid if the moratorium were to continue?

Turning to the requirement that the "*company must be able to demonstrate that there is a reasonable prospect that a compromise or arrangement can be agreed with its creditors*", the following questions arise:-

(i) What does the "*reasonable prospect*" test actually involve? Would the supervisor be looking for evidence of a certain level of creditor support (and if so, what percentage?) or would it be sufficient for the debtor to assert that any plan which improved the position of creditors should, as a general proposition, have a reasonable prospect of obtaining creditor support?

(ii) Would the consent of any qualifying floating charge holder or any essential supplier be required? We would, as noted in the main body of our response, question whether the moratorium should extend to secured claims, but if it did, the moratorium should not be allowed to proceed where the management of the debtor company lacked the support of the company's key secured creditors, particularly where it was clear that (for example) the holder of a QFC intended to enforce its security at the end of any moratorium period.

Finally, we would point out, as stated in the main body of our response, that there should be exclusions from the moratorium for arrangements falling within the scope of the Financial Collateral Arrangements (No. 2) Regulations 2003, security falling within the scope of Article 5(1) of the EC Regulation on Insolvency Proceedings 2000 and security in respect of which creditors retain the power to appoint an administrative receiver (such security being currently excluded from the small company CVA moratorium).

4. Do you consider the proposed rights and responsibilities for creditors and directors to strike the right balance between safeguarding creditors and deterring abuse while increasing the chance of business rescue?

No. As noted in the main body of our response, it is important that the legitimate expectations of creditors are addressed in relation to any proposed moratorium, particularly if it is to last for three months. Appropriate checks and balances should be put in place to ensure that, as far as realistically possible, the creditors' position does not deteriorate during the moratorium period. We would, in particular, expect to see firmer restrictions on (i) creating new security, (ii) disposing of material assets outside the ordinary course of business, (iii) repaying pre-moratorium liabilities and (iv) making payments to connected parties during the moratorium period (together the "**Relevant Transactions**").

There would appear to be a strong argument that, in order to maintain creditor confidence, the company should not be able to enter into any Relevant Transaction without the prior consent of the court. We do not believe that introducing such a requirement would result in a substantial level of court involvement during the moratorium process, as companies should not, other than in exceptional circumstances, be creating security or making significant disposals outside the ordinary course of business during this period.

5. Do you agree with the proposals regarding the duration, extension and cessation of the moratorium?

Duration and Extension: In larger or more complex restructurings, a three month period may be too short to be useful, unless extended. Under the current proposals, obtaining such an extension may prove problematic and time consuming, particularly as it would require the consent of every secured creditor. It may therefore, as noted in the main body of our response, be worth considering building some flexibility into any moratorium legislation, in order to avoid the company's management being distracted during the moratorium period by efforts to obtain the consent of every secured creditor to an extension.

Cessation: It is proposed that "*creditors would…have a general right to apply to court during the first 28 days of the moratorium*". It is unclear why the right to challenge the moratorium should be limited to this period. Circumstances change, including in relation to the prospects of agreeing a successful restructuring, with the result that creditors may well have valid grounds to argue after (say) two months that the company's financial position and prospects no longer merit the continuation of the moratorium. The creditors' right to challenge should therefore last as long as the moratorium lasts.

6. Do you agree with the proposals for the powers of and qualification requirements for a supervisor?

As discussed in the main body of our response, measures should be put in place to ensure that the supervisor has sufficient expertise to (for example) analyse properly any cash flow/liquidity forecast prepared by the company's directors or to decide whether there are any CoMI issues. The success of any moratorium procedure will depend on creditors having confidence in both the procedure itself and in the supervisor who is effectively protecting their interests.

Given the practical difficulties involved in establishing whether a solicitor or accountant has the necessary skill set and experience to take on the role as supervisor, the simplest option might be, as with other insolvency procedures, to limit the role of the supervisor to licenced insolvency practitioners, given that the latter should, by reason of their qualification, have the necessary skill set to take on this role.

Additionally, the idea that the supervisor could be a solicitor sits uncomfortably with the SRA's refusal to regulate insolvency practice.

7. Do you agree with the proposals for how to treat the costs of the moratorium?

While it is reasonable that debts properly incurred running the business and the reasonable costs of the supervisor during the moratorium should be treated in the same way as costs in administration, being repaid first by the company as an expense of the process, there need to be checks and balances on incurring such debts and costs, given that they may reduce the recoveries of the company's floating charge and unsecured creditors. In particular, it is unclear from the Consultation:-

(i) Who would approve such costs? Under the current proposals, there does not seem to be any mechanism for such costs to be approved by either the company's creditors or the court.

(ii) Who would resolve any dispute as to whether such costs were reasonable?

(iii) Should there be a cap on such costs (or at least on the supervisors' remuneration)? and

(iv) Would such costs include liabilities incurred during the moratorium under continuing contracts or would priority only extend to those contracts which were designated as essential?

8. Is there a benefit in allowing creditors to request information and should the provision of that information be subject to any exemptions?

Creditors should be provided with sufficient information to allow them both to (i) assess whether the eligibility criteria are satisfied and (ii) consider the viability of any proposed restructuring plan. They should also be entitled to request such information, if it is not provided. This should increase both transparency and creditor confidence in the process.

There must, however, be limitations on what can be requested, as a flow of requests for information could become so onerous that it began to interfere with the restructuring process. There is a clear risk that those who should be focussing on developing the restructuring plan and negotiating with key stakeholders could be distracted (particularly in a company with limited resources) by requests for additional information.

There should, for example, be a clear carve-out, allowing the company and/or the supervisor to ignore unreasonable requests or requests (such as those for the provision of confidential trading information), the disclosure of which might damage the company's business.

Finally, we believe that it is important that there should, as between creditors, be a level playing field in relation to the provision of information, particularly in the case of larger companies whose debt is being traded. There may therefore be merit is requiring the debtor company to place any material information supplied at the request of one creditor onto its website, so that such information can be accessed by its other creditors.

Helping Businesses Keep Trading through the Restructuring Process

9. Do you agree with the criteria under consideration for an essential contract, or is there a better way to define essential contracts? Would the continuation of essential supplies result in a higher number of business rescues?

The proposed extension of existing statutory restrictions, in order to prevent the use of ipso facto clauses to terminate "essential" contracts, may prove a useful tool in dealing with "ransom" creditors, as long as the interests of the relevant supplier are properly protected. There would, however, appear to be some inconsistency between the Consultation and the Impact Assessment as the Consultation suggests that the number of essential contracts would be very low, while Paragraph 1.74 of the Impact Assessment suggests that "*the average company may ask for 5 – 10 suppliers to be assigned as essential*".

If the figures contained in the Impact Assessment are correct, it might be argued that we are edging towards a general prohibition on ipso facto clauses, given that such prohibition already extends to supplies of gas, water, electricity and IT. While this may, in some respects, be a simpler solution than that proposed in the Consultation, careful consideration would need to be given to the question of whether it was also a desirable solution.

Further measures would, however, need to be put in place to ensure that the position of the relevant supplier was properly protected. There should, in particular, as noted in the main body of our response, be limitations on the nature of "essential" contracts. It is likely, for example, to prove impractical to put satisfactory protections in place for certain financial contracts, with the result that it may be necessary to specify that some types of contract (for example interest rate and currency hedging agreements and undrawn overdraft facilities) cannot be designated as "*essential*" contracts.

10. Do you consider that the Court's role in the process and a supplier's ability to challenge the decision, provide suppliers with sufficient safeguards to ensure that they are paid when they are required to continue essential supplies?

No. The supplier is, for the reasons set out in the main body of our response, potentially incurring a significant credit risk if the goods or services in question were supplied on 90 or 120 day payment terms. The supplier's concerns might be exacerbated by the fact that credit insurers may withdraw cover if a supplier was not able to terminate a contract on the occurrence of a payment default or other insolvency event.

The ability to go to court in order to challenge the decision to designate a key contract as being "*essential*" does not provide a supplier facing this risk with sufficient safeguards. Even assuming that the supplier could afford to go to court (which may not be the case for smaller suppliers) and that it had access to the sophisticated legal advice needed to mount a credible court challenge, it would, as noted in the Impact Assessment, still not make commercial sense for a supplier to do so unless the amount which they expected to lose as a result of continuing supply was greater than the expected litigation costs.

Even if the supplier did go to court, it is unclear from the Consultation whether they could only challenge the decision to categorise a contract as "*essential*" or whether they could also challenge the assessment that the business would be able to meet its payments as they fall due.

Given that the supplier's main concern, in most cases, would be that might not be paid, they should have the right not to supply where they have reasonable grounds for doubting that they would be paid in full. The alternative approach, as noted in our response, would be to allow any supplier to insist, whatever the original contractual payment terms, on being paid in full, in cash, <u>on delivery</u> of the relevant goods or services, should the contract in question be designated an essential contract.

Developing a Flexible Restructuring Plan

11. Would a restructuring plan including these provisions work better as a standalone procedure or as an extension of an existing procedure, such as a CVA?

We would support the suggestion that the Corporate Recovery Plan should be a stand-alone restructuring procedure which would sit alongside the existing rescue options and which could be used by the directors of a company which was, or was likely to become, insolvent or by an administrator or liquidator of that company.

We would not, for the reasons set out in the main body of our response, support the alternative suggestions that the new procedure could be incorporated into the existing CVA voting procedure, or that it should replace the existing, and successful, Scheme of Arrangement procedure.

12. Do you agree with the proposed requirements for making a restructuring plan universally binding in the face of dissention from some creditors?

Yes. We agree, in principle, that the existing corporate rescue regime could potentially be improved by the introduction of a new statutory procedure which permitted the cramming-down of out of the money creditors, whether secured or unsecured, without their consent. The new procedure should not, however, allow interference with the rights of <u>in the money</u> fixed charge security holders without their individual consents.

The proposals set out in the Consultation relating to the new cram-down procedure are, however, relatively high level, and will require further detailed consideration if they are to proceed. In particular, the position of shareholders needs to be clarified, as it would clearly be inequitable if a Corporate Recovery Plan could leave shareholders with their existing equity, at a time when some or all creditor claims had to be compromised or written off.

Turning to the specific proposals, we agree that that (i) voting should be by class, (ii) the class test should be the same as that used in relation to Schemes and (iii) the approval threshold should be 75% by value of each class. We would, however, question whether the numerosity test applicable to Schemes should be incorporated into the Corporate Recovery Plan. Our experience is that this test offers no significant creditor protection. It does, however, give dissenting creditors the ability to sabotage (and potentially kill off) a widely accepted and viable restructuring proposal though the simple expedient of splitting out their votes.

As noted in the main body of our response, there may also be a case for giving the court the discretion, in exceptional cases, to sanction a Corporate Recovery Plan where a creditor whose ongoing support is vital to the debtor's business would receive a larger repayment than more senior creditors, as long as the payment, and the rationale for making it, were fully disclosed and the relevant senior creditors were still better off than would otherwise have been the case

13. Do you consider the proposed safeguards, including the role of the court, to be sufficient protection for creditors?

The existing safeguards relating to Schemes of Arrangement work effectively, both protecting creditors' interests and giving them confidence in the process. We therefore believe that existing case law and best practice established in relation to Schemes of Arrangement should also apply to the new Corporate Recovery Plan.

Similarly, we believe that the role of the court in considering whether to approve a Corporate Recovery Plan should be the same as the role of the court when sanctioning Schemes of Arrangement. The test currently applied by the court when deciding whether or not to sanction a Scheme works well and is widely understood. The same test should therefore apply to a Corporate Recovery Plan, thereby avoiding uncertainty and possible attempts to "play the system".

14. Do you agree that there should be a minimum liquidation valuation basis included in the test for determining the fairness of a plan which is being crammed down onto dissenting classes?

We do not, as noted in the main body of our response, believe that legislating for the use of a "*minimum liquidation valuation*" would necessarily be a helpful measure, even if it was possible to come to a generally accepted definition of exactly what this meant, as there is a danger that this would rapidly become the default valuation option. The fairness of any plan should be judged by reference to the most likely alternative outcome, which may not necessarily be the immediate liquidation of the debtor company.

As each case turns to some extent on its own facts, the court should continue its current practice of considering valuation issues on a case by case basis, having regard to independent valuation evidence.

On this basis, we would not agree that "*potential future earnings*" should be excluded for valuation purposes in every case, as a business may depend on a key contract (such as a patent) which would reasonably be expected to provide a future income stream. This could have a significant impact on the company's value. While it could be argued that this income stream was "expected" rather than "potential", attempting to draw a firm line between expected and potential earnings is likely to prove both problematic and a likely cause for dispute.

Rescue Finance

15. Do you think in principle that rescue finance providers should, in certain circumstances, be granted security in priority to existing charge holders, including those with the benefit of negative pledge clauses? Would this encourage business rescue?

Rescue finance can already be given statutory priority as an administration expense. New funding can also, as part of a consensual restructuring plan or under a Scheme of Arrangement, be given priority over all other secured claims. Mechanisms therefore already exist for rescue finance providers to be given priority over existing floating charge holders, including those with the benefit of negative pledge clauses.

Extending such priority arrangements to the holders of fixed charge security would, however, be a major step. As explained in the main body of our response, doing so would create significant problems that would in turn have a significant impact on new money lending.

Turning first to potential problems, giving new lenders priority over existing fixed security is likely to generate significant disputes as to, for example, (i) whether new fixed charge security is actually required, (ii) the value of the assets over which security has been created and (iii) whether the existing charge holder would be adequately protected. It is not clear that the UK courts have the experience or capacity to deal with such disputes.

These issues are likely to create uncertainty. Even if some safeguards are put in place, who would take the risk of the valuation being incorrect or the value of the secured asset deteriorating after new prior ranking security has been created? Lenders facing the possibility that the benefit of taking fixed charge security might be eroded would inevitably try to pass that risk onto new borrowers, resulting in increased costs for those borrowers

16. How should charged property be valued to ensure protection for existing charge holders?

Please see above. As with the question of how to value assets for the purposes of the proposed Corporate Recovery Plan, we believe that the court should consider valuation issues on a case by case basis, having regard to independent valuation evidence. We do not consider that it would be realistic, or helpful, to set out rigid guidelines for valuing assets as diverse as ships, commercial property, intellectual property rights and book debts, particularly where those fixed charge assets may be located in different jurisdictions and subject to local factors which impact on their value.

17. Which categories of payments should qualify for super-priority as ‘rescue finance’?

If by “super priority” this question refers to giving rescue financing priority over existing fixed charge security, we refer to our previous answers. If it refers to giving rescue financing priority over floating charge security that would suggest that the existing administration/liquidation expense regime should apply.

5 July, 2016

APPENDIX 2

THE CITY OF LONDON LAW SOCIETY INSOLVENCY LAW COMMITTEE

Individuals and firms represented on this Committee are as follows:

Jennifer Marshall (Allen & Overy LLP) (Chair)

Ms C. Balmond (Freshfields Bruckhaus Deringer LLP) (Deputy Chair)

H. Anderson (Norton Rose Fulbright LLP)

J. Bannister (Hogan Lovells International LLP)

G. Boothman (Ashurst LLP)

A. Cohen (Clifford Chance LLP)

L. Elliott (Herbert Smith Freehills LLP)

S. Frith (Stephenson Harwood LLP)

I. Johnson (Slaughter and May)

B. Klinger (Sidley Austin LLP)

B. Larkin (Jones Day LLP)

D. McCahill (Skadden Arps Slate Meagher & Flom (UK) LLP)

B. Nurse (Dentons UKMEA LLP)

J.H.D. Roome (Akin Gump Strauss Hauer & Feld LLP)

P. Wiltshire (CMS Cameron McKenna LLP)

J. Windsor (Linklaters LLP)

M. Woollard (King & Wood Mallesons SJ Berwin LLP)