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The Insolvency Service

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Dear Sir/Madam

RESPONSE OF CITY OF LONDON LAW SOCIETY – FINANCIAL LAW COMMITTEE

INTRODUCTION

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 is made by the Financial Law Committee of the City of London Law Society (CLLS). Further information about the CLLS and the Committee appears at the end of this submission.

Introduction

The Committee is pleased to have an opportunity to comment on this proposed major reform, the subject of a very short consultation. We are also grateful for your kindness in allowing us to submit this response a little after the official deadline.

General Observations on Approach

Given the scale and complexity of the proposed addition to the UK's already complex insolvency laws, we question the wisdom of seeking to proceed to legislation without a proper White Paper process or any consultation with the Law Commission or consideration of the need for integration with the rules dealing with the legal responsibilities of Directors and quasi-directors of businesses in financial difficulties. For large companies we believe this area and the role of and protections for the insolvency practitioner require much more careful consideration as does the time for which a moratorium should be allowed to continue.

We consider that any moratorium should be linked to the intention to resolve the situation without any insolvency process through a scheme of arrangement, CVA or informal composition with creditors.

We therefore consider that a different approach is needed reflecting the relevant linked process. It is worth remembering that the widely admired scheme of arrangement process leads to the rescue of many large businesses in the UK which have fallen on hard times financially. Although not an insolvency process, it fulfils many of the functions of the proposed new process. While in some cases a moratorium might be a useful adjunct to the process, this does not require a whole new set of rules. For larger companies, on introducing a moratorium process to support a financial restructuring there would be a huge advantage in using the settled approach and judicial authority of the scheme of arrangement e.g. adopting an identical approach to identification of classes of creditors and voting (not a different and untested scheme, as proposed). The Scheme of Arrangement process is much admired internationally and should not be undermined in any way.

For smaller companies many of the complexities proposed are simply beyond their resources. For them building on the existing CVA moratorium would be more useful and some of these measures are suitable in that context. A moratorium linked to a CVA should adopt its simple voting scheme. Rather than adapt the proposed new moratorium scheme before it is fully thought through, we believe it might be better to experiment by introducing some of these measures (e.g. essential contracts) into the current regime for SME moratoriums.

In addition, where points are referred to the court, the questions for decision will be as much of a commercial as a legal nature. Unlike under Chapter 11 in the USA, UK judges have not been required to make day to day judgments of this nature in insolvency processes. Before the proposals could be implemented the resource and training implications for the judiciary would need to be considered. The impact assessment has missed this point.

Need to achieve accessible Point of Record for Insolvency Processes

In addition, we believe that legislative time and public funds would be best spent first on achieving an accessible central point of record for the commencement of all insolvency processes (including any preliminary moratorium), rather than adding another substantive complex process using the courts' antiquated record system which is extremely difficult to access. (See our answer to question 2) This would be a real efficiency gain and underpin of the introduction of any new insolvency process, while allowing time for full consideration of these proposals. We fear that rushing these proposals into legislation will not assist their effectiveness in practice and would not achieve an improvement on the present situation, but would contribute to legal uncertainty.

Consideration of the Existing Administration Process

We also observe that the existing administration process was formed to rescue companies. It has been successful in leading to the rescue of businesses following their transfer to new companies but not in achieving the rescue of the company that goes into the administration process. There may be multiple factors in this being the case, (including the fact that taking a company out of administration may expose it to claims including that the administration process does not provide for a composition with creditors as such.) We believe that it would be worthwhile looking again at the administration process before introducing another process with the same aims. This could be a cheaper and less complicated alternative to these proposals, which are a more complex variant of proposals considered and rejected in 2010.

Risk of Abuse

In addition, the concern remains that this type of reform would open up a gateway for poor or fraudulent management to stay in place causing further damage, which was a factor in rejecting the 2010 proposals. These proposals do not have enough safeguards particularly with regard to smaller companies, where the scrutiny of the markets and of lenders with relatively low exposures would be less intense and the cost of court proceedings prohibitive in relation to the amounts of money involved.

Risk of Increased costs for Companies

Finally, we are concerned that without further considerable work the proposals for rescue finance may raise the costs of raising secured finance for solvent companies, particularly if they have expropriatory effects on the rights of existing secured creditors.

There is also a concern that the increased risks to cash flow for suppliers and lenders would increase costs for companies at a time when other economic shocks are exposing companies to potentially steep rises in costs in any event.

Brexit: Need for Resources on other aspects of Insolvency Law

Since the consultation was launched, the UK has voted to leave the EU. This will place further pressures on our insolvency processes, in particular with the loss of the Insolvency Regulation (the recast Regulation (EU)2015/848 on insolvency proceedings Replacing Council Regulation (EC) No 1346/2000) with effect from mid-2017). We understand that this Regulation does not have an EEA dimension, so it would seem lost to the UK on all the "leave" options that have a precedent. This Regulation has been extremely valuable in increasing the efficiency and returns for creditors in UK insolvencies with a cross-border element within the EU and resources should be devoted as a matter of urgency to considering to what extent its benefits can be replicated, either through negotiations with the EU or domestic legislation. This is, we submit, more important than further complicating the UK insolvency processes at this difficult time, bearing in mind that resources to deal with the huge legislative challenge posed by the UK leaving the EU are limited.

Response to Questions

Despite our strong misgivings outlined above, in our answers below we seek to make constructive suggestions as to how they might be made to work.

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

In a limited number of cases, a moratorium may be a useful introduction to promote rescue. However, we are firmly of the view that the availability of such a moratorium should be limited to cases with a clear exit from the moratorium, i.e. a CVA, a scheme or a restructuring plan. We are also of the view that there ought to be an independent assessment of the viability of the business, so as to prevent abuse. Having said that we believe that to introduce a moratorium for all businesses is disproportionate to the potential benefits and number of rescues it may facilitate. In fact, it ought to be noted that under the current regime creditors who seek to derail a restructuring are either dealt with on a consensual basis, or if the rescue is well advanced, the court can intervene on a case by case basis *(e.g. Re Telewest; Vietnam Shipbuilding).*

The impact that the introduction of a preliminary moratorium may have on the balance between the company and its creditors should not be underestimated, in particular on the provision of credit and the costs associated with such new risks. We note that there is no economic assessment of the potential negative consequences of introducing a moratorium in the context of the Impact Assessment which we consider undermines the economic rationale for the proposal.

In addition, we note that there already is a moratorium provision linked to the CVAs of small companies. Any new process of the complexity described is only suitable for larger companies.

2. *Does the process of filing to court represent the most efficient means for gaining relief for business and for creditors to seek to dissolve the moratorium if their interests are not protected?*

No, the existing consensual approach will in our view remain the most efficient means of gaining relief for cases where there is a real prospect of rescue. We note that the proposal is aimed at companies of a significant size, but it may also be used by smaller companies who are simply seeking to buy more time. Although the proposal states that it would be not an appropriate course to pursue a moratorium in such cases, there would be nothing to prevent the filing and creditors (who may be small and with limited means) would therefore be put to the time and cost of seeking to lift the moratorium which ought never to have been in place.

In addition, the courts have no central and publicly accessible record system for filings related to current insolvency processes and this is a considerable difficulty in relation to finding out about new administrations under the current system. In particular, this because, even in this digital age, the systems used remain local and paper based.

This is bad for creditors in most current circumstances, but in the context of the proposed new process would be bad for both companies and their creditors, causing unnecessary costs for both sides and potentially frustrating the purpose of the process. We would not recommend that any further burdens are placed on the courts or on affected parties by attempting to use the courts as a registry of record.

There is an urgent need for all insolvency processes (but especially those started by private act, rather than a court order) to be recorded primarily in a service that is online and can be filed to and searched remotely and updated in real time as far as practicable. Although not perfect in terms of timing, the Companies' Registry provides a service that is much closer to that needed than the courts' antiquated processes. The Companies' Registry also has the advantage of being the place of record for many other events affecting a company, so that filing and searching against a company is a familiar process - it is reliable and far less time consuming than trying to interrogate multiple courts by telephone, which is the only way of finding out about new administrations currently.

It would be a far better use of public resources to make the Companies' Registry the place of record for this new process and existing processes and work with the Registry to ensure information is available promptly upon filing. This would relieve the courts of a considerable administrative burden which is not central to the administration of justice and enable the courts to concentrate on matters that require judicial decisions. Achieving this would be an excellent use of Parliamentary time.

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

Both the eligibility tests and the qualifying criteria as set out in the consultation are vague. For example in relation to the eligibility tests, it is suggested that the companies and financial transactions to be excluded from the regime would follow the exclusions in schedule A1 of the Insolvency Act 1986 for the most part. Does this mean for example, that capital market transactions, project finance transactions, or transactions that benefit from a disapplication of the impact of insolvency as a financial collateral arrangement are outside the scope of the moratorium? We would consider that they ought to be as they are essential to the efficient operation of the financial markets and key from a capital adequacy perspective.

Also, in relation to the qualifying criteria, these are entirely reliant on the company's own assessment as to whether it is reasonable to conclude that a compromise may be reached and it has sufficient funds to carry on its business. Experience suggests that debtors in distress may not always be in a position to provide an objective view. We think an independent assessment should be a requirement.

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?*

This mechanism lacks any real safeguards for creditors, or at least the safeguards that are suggested are limited to action that either creditors, in the form of a challenge, or the supervisor can take after the moratorium has been in operation, when at least some damage will already have been done. Even the reference to a potential disqualification mechanism being introduced will be cold comfort for creditors and not necessarily compensate them for the loss of an ill-fated rescue.

Better safeguards would be ensuring that there is some independent assessment as to the directors' views on rescue and ability to pay their debts.

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

We can see that in certain cases a moratorium may be of assistance. However, we have reservations in relation to the length of the moratorium and potential extensions, especially given that it may be triggered without any court or creditor involvement at all. We query whether it is right that the company should be able to initiate the process unchecked when there is to be no independent assessment that this is in fact the case. Even in cases where the company has an honest and genuine hope that rescue is an option this should be subject to a professional sense check. Given the consequences of getting this wrong (without any fear of personal liability attaching to the directors under these proposals), the cost to the stakeholders of the business, who may already be significantly out of pocket, and exposed to further losses during the moratorium, simply having the ability of the creditor to challenge the moratorium within the first 28 days (at further cost to them) does not offer much comfort.

In terms of the extension, we consider that the maximum period for which any moratorium is permitted should be no longer than 6 months (certainly no more than a year including extensions). We also consider that the proposals to have the extension agreed by all secured creditors may be favoured from the secured creditors' perspective, but in practice, difficult to achieve and so it may be sensible to have a majority consent.

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

The consultation provides very little detail in relation to the role and powers of the supervisor. From a stakeholder's perspective given the light touch approach to the Court's involvement in relation to the imposition of the moratorium, it would be essential, were the proposal to be pursued, that the supervisor represents those stakeholders interests during the period for which any moratorium is in operation and the debtor remains in possession. Under the proposals, however, it appears that it is the debtor who selects the identity of the supervisor, and there is no reference in the consultation to the supervisor being independent, we would be concerned that such choices would give rise to potential abuse.

The powers of the supervisor also appear to be limited, essentially to a monitoring role, and it is unclear as to whether there is any duty to the stakeholders or liability attached to the role of the supervisor in exercising or failing to exercise even these limited powers. There also does not appear to be any information about how the supervisor is to be remunerated for his/her role and how this is to be assessed or agreed.

In terms of qualifications, we have reservations about extending who can be a supervisor beyond insolvency practitioners, to other regulated professionals such as solicitors and accountants. In addition, there does not appear to be any clear guidance in the proposals as to what level of expertise in restructuring would be required to fulfil the role.

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

These arrangements address the situation if the purpose of the moratorium fails and the company goes into administration (or more likely after a prolonged moratorium, particularly if saleable businesses have passed to new owners during the moratorium straight into liquidation.)

They do nothing to ensure timely payment of debts incurred during the moratorium or if the company emerges into normal operations. We consider that creditors for debts created during the moratorium require some safeguards for their cash-flow, particularly in the case of any contracts designated as essential: it is not their role to fund the business through a moratorium and leaving them exposed to this risk could lead to contagion from the company in difficulties to its suppliers.

They should be able to seek redress, including asking the court to place the company into administration or liquidation, if their debts are not paid at due date. This would also reduce the risk of reckless or fraudulent trading during a moratorium and the risk that suppliers have to increase charges to solvent companies to reflect this extra risk.

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

This proposal would be open to abuse running counter to government policy in a number of other areas. In particular:

Creditors who are competitors would be able to obtain confidential commercial information through this process and use it to damage an already struggling business. We note that if a competitor then acquires the business, the "hold separate" order which the CMA routinely issues in this process and which forbids the transmission of this type of information to the acquirer (in some cases also before purchase), could have already been rendered valueless.

Suppliers and customers could have their dealings with the company exposed to a wide body of creditors contrary to their wishes and without any regard to their rights, either to commercial confidentiality in the general sense or to their proprietary rights in e.g. know-how, copyright or other intellectual property. This could discourage dealings with a company in the process and to unnecessary litigation, as well as possibly causing collateral damage to third parties and their businesses.

Laws relating to the privacy of personal data could be breached.

At best, even a limited regime would be time-consuming to administer, while a complex scheme of exceptions to address points such as those made above could lead to an expensive distraction from the efforts to manage the company safely through a very difficult time. It could be used by an unscrupulous creditor as a destabilising tactic.

Rather than allow a regime which could involve a running battle with creditors, it would be better to require frequent (say monthly) reports to creditors on a carefully defined list of topics laid down by statutory instrument, making it clear that detail of dealings with third parties and related documents should not be disclosed in these reports and commercial confidentiality of parties dealing with the company respected. We would suggest only dealings with Directors of the Company, their families and the Supervisor should be fully open to disclosure.

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?*

We understand the concern to prevent core supplies being cut off; the introduction of rules on essential contracts may be helpful to achieving the rescue of some businesses. This has, however, to be balanced with the interests of suppliers in keeping their own businesses sound. We believe it will need more than admonitions about minimal use to restrain abuse of the proposed process with its wide definition and unfettered court discretion. We suggest additional provisions are needed:

(1) suppliers under essential contracts should have special payment terms, e.g. the earlier of pre-existing terms and 7 days from invoice or with disputes to be settled after payment. This would mean that the company must take financial responsibility and risk in a real sense where it seeks designation of a contract as essential and therefore encourage the company to limit claims to contracts which are genuinely essential;

(2) financing contracts should not be capable of designation as essential contracts for the purpose of obtaining further advances. If a company needs further funding this should be obtained as rescue finance, unless a particular financier chooses to operate an existing loan facility. Any other approach would increase the costs of lending to solvent companies over and above the costs inherent in the introduction of a moratorium affecting out-standing principal repayments and interest payments on existing loans.

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 intone essential supplies?*

No. See answer to question 9 above.

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 consider that the existing CVA is not in itself an answer for larger companies. It is suitable in some straightforward cases where creditors can vote as a single body and this feature should be maintained for a moratorium linked to a CVA. However, for larger companies restructuring financial obligations (although there are some differing views among our members), we consider that the new moratorium process should adopt the existing scheme of arrangement approach to identification of classes, voting processes and court supervision for the following reasons:

It may be used to support completion of a scheme of arrangement.

We agree that the proposed cross-class cram-down mechanism should require court approval. The CVA has no existing framework for court hearings for convening classes or approval of the arrangement, and would require significant modification in order to introduce an entirely new procedure for court approval. It would be preferable, in our view, to produce a moratorium which is as close as possible in terms of its management processes to the scheme of arrangement procedure which already requires sanction by the court, and has a long procedural history. We stress that the Scheme of Arrangement process itself should remain as currently (it is hugely valued by international businesses and brings work into the UK), but are concerned that the moratorium process would cause huge legal confusion if it uses different rules for identifying classes and voting. This would reflect very badly on the UK's legal system and would not assist it to rise in world bank rankings.

The CVA does not require creditors to be organised into classes for the purpose of consultation and voting on the restructuring, whereas the scheme of arrangement procedure already does. Rather than introducing a new procedure, with all the uncertainty it would bring, it would seem much more straightforward for the moratorium process to adopt the existing scheme procedure, with its tested procedural mechanism, the practice statement letter and convening hearing, and considerable precedent concerning the constitution and approval of classes. These features of the existing scheme of arrangement procedure are similar to those envisaged by paragraphs 9.16-9.18 of the consultation. It would be an unnecessary burden on the courts to use a different approach.

The CVA requires all unsecured creditors to be included in the compromise whereas the scheme approach is significantly more flexible – a company proposing a scheme need not consult creditors whose rights are not affected by the scheme. If one were to start with the CVA legislation as a base, there would need to be additional rules as to which creditors the compromise affects, and voting by impaired/unimpaired classes similar to the US Chapter 11. These matters are already part of scheme of arrangement practice and procedure and would not require extensive changes to work when transferred to the moratorium context.

The CVA does not bind secured creditors, and does not therefore interfere with property rights. There would need to be new legislation to extend the effect of CVAs to property rights, which may come into conflict with human rights legislation. For example, in the existing CVA framework the arrangement is not required to be approved by a court.

The CVA procedure is not well known internationally, and is limited to companies which have their centre of main interests in the UK or which are incorporated in England and Wales or Scotland.

It is important to the UK's international financial markets that the UK has a satisfactory mechanism for restructuring debt that is governed by English law, notwithstanding that the company that has issued the debt may be incorporated outside of the UK or have its centre of main interests situated outside of the UK. This may be particularly important given the uncertainty around recognition of UK insolvency proceedings, including the CVA, in the EU, if the UK leaves the EU, the EU Insolvency Regulation no longer applies. The scheme of arrangement as a non-insolvency procedure provides such a procedure, and avoids recognition issues in most jurisdictions (the private international law of many jurisdictions recognises the principle that a debt may be compromised in accordance with its proper law). Being able to do that outside insolvency is a huge practical asset for UK law. An insolvency process that cut across the use of schemes of arrangement would be a backward step.

The CVA has been used relatively infrequently for large companies (with some notable exceptions). The scheme of arrangement approach is more appropriate for restructuring larger companies with complex capital structures.

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

The existing combination of a scheme of arrangement and administration is in many cases adequate to successfully restructure a company where one or more junior classes of creditors or shareholders have no economic interest in the company. Two examples of situations where this approach is not always adequate are:

(1) where the holders in the junior class of debt are not completely out of the money, i.e. have or arguably have a small economic interest in the company; or

(2) where there is some benefit in rescuing the legal entity, for example because there are licences, permits or contracts which cannot easily be transferred to a purchaser on a sale of the business.

In the first example, a junior-ranking class with a very small economic interest could potentially hold up a restructuring, and force a ransom payment greater than the economic interest held by such creditors. In such a situation, the availability of a cross-class cram-down mechanism would prevent such creditors from extracting more than the value of their holdings.

In the second case, selling the business without the corporate entity might destroy value. If so, creditors or shareholders with no economic interest could potentially hold up the restructuring or demand a payment for their consent in excess of the value (if any) of their holdings. A cross-class cram-down could enable the company to restructure its balance sheet without selling its business.

A well designed cross-class cram-down mechanism should therefore achieve a more equitable outcome for those with true economic interests in the company to be restructured.

It is not entirely clear from paragraphs 9.19 and 9.20 of the consultation paper exactly what voting requirements are being proposed. However, we would suggest that:

(i) absent cram-down, the plan should be approved by a majority in number representing 75 per cent in value of each class;

(ii) in the case of cram down, the plan should be approved by at least a majority in number representing 75 per cent in value of the most senior secured creditors .

If the intention is as stated in paragraph 9.19, to "cram down the proposal on junior classes which disagree", it is important to ensure that the members of the most senior class are able to veto the proposal, provided they vote against the proposal as a class. If not, we would strongly oppose the ability for more junior classes to impose a plan on senior classes.

We assume that the "best interests" test set out in paragraphs 9.20 and 9.21 is a reference to the "fair and equitable" test described in 9.29 and 9.32, and on this basis please see our response to question 13.

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

Absent a good reason for doing so, there should be as little departure as possible from existing scheme procedure. The existing scheme procedure is well regarded internationally for, amongst other reasons, legal certainty.

We would suggest that, in cases where there is no cram-down, the test for sanctioning the arrangement ought to be the same as that which applies to sanction a scheme of arrangement under the existing legislation.

In cases where a cram-down is to be used, it is not clear what benefit a requirement that "secured creditors would be granted absolute priority on repayment of their debts" would add if approval by the senior-most class, voting as a class, is a requirement for court sanction of the plan. If this is not the intention, as mentioned above, we would strongly oppose any procedure which would allow a plan to be approved over the objections of impaired senior secured creditors.

Provided that the plan cannot be crammed down on senior secured creditors, we do not object to the requirement that "junior creditors should not receive more on repayment than creditors more senior than them", although we note that in other jurisdictions (such as the USA) which adopt such a rule, there are exceptions, for example where the junior out of the money creditors are prepared to contribute new money to, in effect, purchase the equity. Provided that the senior creditors must approve such a plan by voting as a class, injection of new funds should not be discouraged by overly-rigid formalities.

Similarly, it is not entirely clear why there should be an absolute requirement for the plan to last no longer than 12 months. The procedure for approval of the plan should be short, but it is not clear why the duration of the plan itself needs to be limited, provided that it is fair and equitable, and that fairness calculations take into account the present value of future payments under the plan.

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*?

No, this is not an acceptable proposal. In order for any cram down procedure to have credibility and robustness, the basis of valuation needs to be fair and reasoned. A liquidation value generally represents the lowest possible valuation. It exposes the greatest number (in value and by class) of stakeholders to the risk of being considered to be ”out of the money” and therefore effectively unprotected. It may well fail to reflect any kind of commercial reality including the valuation which forms the basis of the economic decision of the "in the money" creditors to approve the restructuring. The only advantage of using the liquidation value is that it appears to increase certainty. In reality, as it maximises the loss to creditors, the valuation process (and the entire cram down process itself) will likely give rise to a significant degree of legal challenge and therefore the apparent benefit in terms of legal certainty is at best marginal and adopting such an off-market approach may actually give rise to a fatal flaw in the entire cram down concept.

Value is at the heart of the any restructuring and no adoption of some legal fiction will overcome that. Value needs to be ascertained by a fair and rigorous process which has a high degree of acceptance amongst the affected parties. It is necessary for the courts to accept the degree of vigorous challenge involved in ascertaining value if they are to take jurisdiction over value determined issues such as who may be crammed down. If any valuation process is to be given some kind of judicial preference then it should be limited to a market driven process involving a fair and open auction or sale. But any attempt to legislate for that must acknowledge that not all assets can be readily exposed to the market and that the process may not always be the fairest route to ascertain the true value to a particular buyer. Valuation issues will inevitably require the courts to become embroiled in determining some difficult questions. Value is not a fact which can be objectively tested. But if a cram down process is to be adopted which is capable of being acceptable to the market then the courts must be willing to equip themselves to rise to that challenge and cannot be restricted by a rigid rule such as the proposed minimum liquidation value proposal.

We do not think that the imposition of a minimum liquidation value would be appropriate. The restructuring plan envisages a continuation of the business, so in such cases the liquidation value would not reflect the actual position. We note that the consultation envisages that the liquidation value will be simply be used as the lower threshold, but in our view it is likely to become or argued to be the actual benchmark upon which valuation is measured. In this respect, if such an approach were to be introduced, we anticipate that valuation would become an area of much contention and result in a significant amount of litigation, detracting from the restructuring itself.

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?*

We do not think that reforms are necessary to incentivise rescue financing for administrations, CVAs, or alternative insolvency restructuring plans.

However, we think that the efficacy of the proposed moratorium may be increased if finance providers are incentivised to provide limited rescue bridging finance, as companies seeking the protection of the moratorium may find that their existing funding lines are cut off or made subject to more onerous terms. Our comments below apply only to rescue financing provided within the proposed moratorium process.

It may be that according such rescue financing high priority status as an expense of the moratorium would be sufficient to achieve this objective. This is likely to depend in part on the successful resolution of the issues regarding the status and qualifications of the supervisor highlighted in our response to question [6] above, as these will have a significant impact on market confidence. It may be that it is not desirable to encourage lending in circumstances where the market does not have confidence that the company's prospects are such that the expenses of the moratorium will be paid.

One option is allow the moratorium a 'bedding in' period in which rescue financing can be granted high priority as an expense (equivalent to the administration regime), subject to the existing security regime, and then review whether further reforms are necessary.

If the Government does feel further measures are required, we think that the proposal to introduce provisions permitting companies to override negative pledges and grant fixed security over company property already subject to charges is worth considering further. Any new funds advanced which did not benefit from a fixed charge could rank as an expense, ahead of floating charges.

We have concerns about the possibility of introducing a fair and practical mechanism for valuing the security to determine whether or not the company has surplus equity in the assets. In circumstances where the proposals are not supported by the existing charge holder(s), any such process is likely to be expensive and controversial, requiring court supervision and expert involvement. As such we think that the risk and expense of valuing the existing security and determining whether there is surplus value needs to fall on the proposed rescue financer (supported by the company). On this basis, we do not think that companies should be permitted to grant new security as a first charge or an equal first charge in the absence of consent from the existing beneficiary of the security, but that they should be allowed to grant security which would rank as an additional but subordinate charge where necessary. In this way, rescue financers would be incentivised to lend in circumstances where they believed there was sufficient surplus equity in the company's assets, but not otherwise.

We consider that going further than this would entail significant changes to the current security regime and questions could arise regarding the expropriation of the existing rights of secured creditors. Such revisions may be justified, but we think they would need to be carried out (a) as part of a wider review of the transactional security framework (b) on the basis of a much more detailed review of the impacts on the cost of credit and (c) on the basis of detail exploration with providers and potential providers of rescue financing to ascertain the factors which in fact constrain their lending. Unless this is undertaken, the creation of these rights for rescue financiers would risk increasing the cost of secured borrowing for solvent companies to cover its risks of loss of equity as a result the company raising rescue finance during a moratorium.

We consider that if the proposals for moratorium expenses and/or overreaching existing security interests are implemented, there would be a case for "grandfathering" provisions to protect the priority of security entered into before the legislation is introduced.

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

See our response to question 15 above. Absent a wholesale review of the security framework, we think the risk of the valuation exercise needs to be borne primarily by the provider of the new credit.

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

If rescue financing is to benefit from super priority status, its scope would need to be carefully delimited. It would need to be narrowly construed so as to cover only limited finance packages put in place to allow the company to continue as a going concern while implementing a restructuring plan under the protection of a moratorium. It should not extend to injections of funds required to put the company's finances on a stable footing for the long term. Nor should it extend to funds to meet a company's existing debt obligations during the moratorium period, as if the company has not been able to agree a deferral of these payments it is unlikely to be in a position to reach a long term accommodation with its key creditors.

It would also be necessary to ensure that a company which agreed a rescue finance package would still satisfy the eligibility criteria for the moratorium – we note that the proposed primary qualifying condition requires that the company is able to meet 'any new obligations which are incurred' during the period (paragraph 7.22); the application of this condition to rescue finance needs further thought.

Paragraph 10.27 of the consultation notes that 'rescue finance' is a broad term and that the Government does not intend to restrict the proposals to finance provided by financial institutions. It also notes that other forms of finance, such as trade credit, may be crucial to company rescue.

We agree that it would be unnecessarily restrictive to focus on finance provided by financial institutions, and doing so might risk any new measures becoming unresponsive to a changing market. We suggest focusing on the nature of the finance provided rather than the characteristics of the provider; in general we would expect a rescue finance package to be an injection of liquidity which allowed the business to meet its various outgoings during the rescue period.

We agree that trade credit can be crucial to company rescue, but think that any proposal to treat trade credit as 'rescue finance' for these purposes would require very careful thought. Such a measure would risk (a) a cascade effect in which any supplier supplying on extended credit terms (and such arrangements are common) demanded super priority status (b) cutting across the proposed protections for essential supply contracts (c) widespread interference with the normal *pari passu* distribution principles for unsecured creditors. We suspect that in the majority of cases the 'trade credit' packages which would be extended to companies in rescue proceedings would be too narrow to qualify as rescue finance.

18. *Are there any specific measures for promoting SME recovery that should be considered?*

We note that there is already a moratorium available for SMEs using a CVA. We do not believe it has been very successful. It may be that some of these measures should be introduced into that process first, for example, essential contracts, to see if they make a difference, before committing to any wholesale reform.

Yours sincerely

Dorothy Livingston

Chair, CLLS Financial Law Committee

About the CLLS Financial Law Committee

The Committee submitting this paper is made up of solicitors specialising in UK and international financial law in a number of law firms based in the City of London, who advise and act for UK and international financial institutions and businesses and for regulatory and governmental bodies on financial law matters.

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