Trading through the pandemic: insolvency issues, risk and contractual performance

As England enters its second lockdown, it remains unclear how long we will continue to live under coronavirus restrictions. The economic fallout is staggering and the pressure many businesses are facing is unprecedented. According to Bank of England data, UK Gross Domestic Product ("GDP") fell by 22% over quarters one and two this year, the biggest fall on record. Against this background, job vacancies are down by 55% year-on-year. Last month, Government support was estimated to have cost £192bn (equivalent to 9% of annual GDP) and support is expected to be reduced markedly next year.

In response to the COVID-19 pandemic, the Government passed the Corporate Insolvency and Governance Act 2020 ("CIGA"), which made substantial changes to insolvency and rescue laws. We are also seeing a real desire to tighten up Government subsidies. A reduction in fiscal support alongside a second lock down will undoubtedly have a serious impact on businesses in the coming months as things get a lot tougher.[1]

Exploring these issues, Mark Lim and Fraser McKeating from our commercial dispute resolution team hosted a webinar with Helen Pugh of 3 Hare Court Chambers to discuss a range of practical and legal issues facing businesses operating during the pandemic. This is a summary of some of the key points discussed.

Director risk from over-trading - where are we now?

First, Mark covered some recent developments in director risk:

- **Wrongful trading** – CIGA retrospectively introduced a temporary, non-rebuttable assumption to the effect that directors are not to be considered responsible for any worsening of the financial position of their company from 1 March to 30 September 2020. However, directors' other statutory and common law duties remained in force throughout. Mark has written a note commenting on the decision not to extend the "suspension period" for wrongful trading, which is available here.
- **HMRC claims – Finance Act 2020** – new measures have been brought in, including (from 22 July 2020) new powers for HMRC officers to issue a "joint liability notice" ("JLN") when it "appears" that certain criteria have been met. The aim is to combat tax evasion, avoidance and repeated insolvency (which can potentially kick in when there are multiple insolvencies within a group). Directors, managers or shareholders can now be jointly and severally liable personally for company tax. The potential application of JLNs is wide in theory, even if the intended reach is more limited. Also, (from 1 December 2020) is the promotion of HMRC to preferential status for some taxes above unsecured creditors in insolvencies.

You can read more generally about wrongful trading and other areas of potential liability for directors upon the occurrence of corporate insolvency, plus about some practical steps for minimising exposure to personal liability, in Mark's guide "*Insolvency – issues for directors*".

Restrictions preventing termination for insolvency

Fraser moved on to discuss "ipso facto" clauses. These boilerplate termination clauses are triggered by the occurrence of an insolvency event or the potential insolvency of one party to an agreement and normally either automatically terminate or give one party the option to terminate the agreement.

Section 14 CIGA introduces a new provision which applies to contracts for the supply of goods and services and gives distressed companies "breathing space" when exploring options for recovery. It:

- Contains a blanket prohibition on ipso facto termination clauses (either automatic or elective) having an effect; and
- Prohibits the supplier from doing "*any other thing*" which it is entitled to do under such clauses as a result of the counterparty entering into the insolvency procedure.

Subject to certain exclusions and carve-outs, the provision applies to any contract for the supply of goods and services and the prohibition kicks in from the moment the distressed company enters into the relevant insolvency procedure. Fraser emphasised the retrospective nature of the prohibition.

As **practical steps** to consider, suppliers should review all existing supply contracts to check if they include any ipso facto clauses and, depending on the terms and the commercial position, potentially re-negotiate to include additional earlier triggers. Suppliers should also carefully monitor the financial position of counterparties to supply contracts. Businesses making substantial supplies to a single company or group and likely to face significant exposure could consider taking out trade credit insurance.

1 Ahead of our talk the BOE reported that the UK Government's (then) plans indicated an intention to reduce public spending over Q4 2020 and Q1 2021 by some £15bn. In recent weeks the (less generous) Job Support Scheme has been shelved at short notice and the Job Retention (or "furlough") Scheme has been extended. It was due to finish on 2 December 2020 at the time of our talk but shortly after our presentation, the Chancellor announced an extension through to March 2021.

Limitation on debt recovery tools

Fraser then discussed the temporary restrictions on statutory demands and the presentation of winding-up petitions brought in by Schedule 10 of CIGA. The restrictions are currently in place until the end of December but may be extended into 2021.

The restrictions relate to:

- **Statutory demands** – winding-up petitions cannot be presented against a company based on a statutory demand served between 1 March and 31 December 2020.
- **Winding-up petitions** – creditors are now prevented from presenting a petition against a company unless the petitioner has reasonable grounds for believing that either: (1) coronavirus has not had a financial effect on the company; or (2) the facts by which the relevant ground applies or the relevant ground itself would have arisen even if coronavirus had not had a financial effect on the company. The burden is on the petitioner to show that one of these two conditions is met.

Fraser explained that it is now much more difficult to get a winding-up petition off the ground. Instead, unpaid creditors may need to consider other angles such as standard Part 7 court claims, bringing legitimate pressure to bear on the individual directors of the debtor company; and/or alternative insolvency processes.

Rescue through administrations

Shortly after the webinar concluded, the Chancellor announced a further extension of the furlough scheme until March 2021. That notwithstanding, as Helen explained, the practical impact of the significant drop in GDP, together with the withdrawal of fiscal subsidies, will inevitably lead to more companies in financial distress. Hence, we are expecting increased number of administrations.

Helen reminded us that to go into administration, a company must be unable to, or likely to be unable to, pay its debts as they fall due. The three statutory objectives of an administration are (in descending priority order):

- To rescue the company.
- To achieve a better result for the creditors as a whole.
- Realisation of some or all the company's property to make a distribution to secured or preferential creditors.

A moratorium kicks in when the administrator is appointed, although an interim moratorium often precedes this. The moratorium is an important aspect of administration because it restricts the commencement of insolvency proceedings, the enforcement of security over company assets, the forfeiture of a lease by a landlord and the commencement of other legal processes against the company or its assets.

Whilst a creditor can apply to court to lift the moratorium, Helen discussed the fact that (in very general terms) money claims, proprietary claims which will add substantially to the costs of the administration and landlords' actions for repossession are not likely to be permitted.

Helen then ran through some key potential advantages and disadvantages of administration for directors and creditors. A summary of these is set out in the table below. She emphasised that, generally, directors and creditors will fare better from an administration than a liquidation.

	Advantages	Disadvantages
Directors	• May ensure survival of the company as a going concern • Often ensures continuity of the business • Strategic use of the moratorium • May continue to have a role in management • Pre-pack administration to minimise erosion of goodwill and value of the company	• In most cases, administrator will take over the management of the company • Can be an expensive prelude to insolvent liquidation • Erosion of goodwill and value of the business • Administrator gains powers to investigate the conduct of directors and, if necessary, taking actions
Creditors	• Obtain a better result than with liquidation • Prevent unilateral creditor action • Pre-pack administration to minimise erosion of goodwill and value of the business • Administrator management might be preferable • Administrator can investigate conduct of directors and bring actions	• Achieve a better result for creditors as a whole but at the expense of individual creditors • Erosion of goodwill and value of the business • Pre-pack usually lacks transparency • Limited means of challenging administrator's actions

Practical changes at the court – what is happening in practice?

Helen shared some of her anecdotal experiences of the courts during the pandemic. She noted that whilst the Insolvency & Companies List "*very much hasn't been business as usual*", the courts have tried very hard to keep matters running after an initial hiatus and, generally, to support the Government in its aims with insolvency and rescue reforms.

The Temporary Insolvency Practice Direction ("TIPD") currently in force is designed to assist with the practical problems posed by COVID. TIPD applies to all insolvency proceedings in the Business and Property Courts (wherever they might physically take place). The assumption is that all winding up and bankruptcy petitions will be held as remote hearings conducted by video or telephone conferencing. Other hearings may be conducted by one of three methods: in-person, remote or hybrid hearing.

Predictions for 2021

Once Government funding comes to an end, the team predicts a significant increase in the number of insolvencies. Now is the time for distressed businesses and their creditors alike to start thinking about restructuring options.

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