

# PROPOSALS FOR MITIGATING THE SHORT TERM EFFECTS ON VIABLE BUSINESSES OF COVID-19

## 1 INTRODUCTION

- 1.1 Many will have concerns about the short term impact that Covid-19 may have on businesses that would otherwise be viable (for example as a result of short term disruptions to supply chains or temporary reduced customer demand). We have therefore set out below a number of proposals, for discussion with the Insolvency Service, as to how some of the immediate effects of Covid-19 may be mitigated.
- 1.2 If the short-term impact of Covid-19 is not satisfactorily countered, and viable businesses are not preserved, there will be lasting damage to the wider economy.
- 1.3 Given our focus as City of London lawyers, we put forward our ideas by reference to the impact on the corporate sector but we are conscious of the importance of taking complementary measures to achieve stability amongst partnerships and other unincorporated businesses if the objectives articulated below are to be achieved.
- 1.4 We would be happy to discuss or expand on any of the comments made in this paper, if requested.

## 2 PROPOSALS

- 2.1 The objectives behind these proposals are:
  - (a) to give businesses a short breathing space, to address a temporary disruption in revenue and to free them from the risk of a creditor presenting a winding up petition and all the consequences that flow from that, in which to deal with any short term liquidity or trading issues that they may suffer as a result of the Covid-19 situation;
  - (b) to provide an additional mitigating factor in relation to wrongful trading, in order to give directors the opportunity to assess fully the impact of Covid-19 on their business; to enable directors to accept emergency government-backed loans to aid survival; and to limit the risk of such directors prematurely putting their company into an insolvency procedure: all without the unwarranted risk of incurring personal liability; and
  - (c) to mitigate the risks of a “domino effect” whereby the failure of one business triggers to failure of other businesses where there are trading relationships between businesses or where a concentration of failures in a sector or locality causes a downward spiral.
- 2.2 The proposed changes focus on assisting businesses that are viable, but which may suffer short term disruption to cash flow as a consequence of Covid-19. They are not intended to provide a solution to the problem of businesses which cease to be viable as a consequence of Covid-19.
- 2.3 These objectives could be achieved by taking some or a combination of the following steps.

### **Moratorium measures – limiting winding up petitions**

- (a) Introducing an optional form of declaration that could be made by a director of affected companies, particularly in circumstances where a winding up petition is presented or threatened, stating that the company is facing liquidity or operational challenges as a result of circumstances related to Covid-19 (a “Covid-19 Declaration”). The effect of filing would be to trigger a 90 day

grace period<sup>1</sup>. The Covid-19 Declaration could be signed electronically and filed at court using the e-filing process (assuming this is still operational in the current climate)<sup>2</sup>. We suggest that:

- directors are only able to make one Covid-19 Declaration, with the result that their maximum grace period would be 90 days unless the Government exercised a reserved power to amend the legislation by statutory instrument so as to enable the directors to make successive declarations;
  - directors making a declaration without reasonable grounds be subject to sanctions<sup>3</sup>; and
  - there be a long-stop date (to be determined by the Government after the Covid-19 crisis has reduced) after which it is no longer possible to swear a Covid-19 Declaration.
- (b) Amending the circumstances in which a company is deemed to be unable to pay its debts under section 123(1) Insolvency Act 1986, so that for the purposes of a hostile winding-up petition a company cannot be deemed to be unable to pay its debts for a period of three months<sup>4</sup> from the date of a Covid-19 Declaration. This would give temporary relief from applications for a winding-up order under section 122(1)(f) Insolvency Act 1986.
- (c) The “balance sheet insolvency test” contained in section 123(2) Insolvency Act 1986 would not be amended, as this new legislation is intended to protect companies with short term liquidity issues, rather than those with longer term problems. As protection against abuse, where the onset of insolvency for transaction avoidance purposes occurs less than 2 years/6 months after the end of the period(s) covered by a Covid-19 Declaration, those look-back period(s) should be extended to include the period(s) covered by the Covid-19 Declaration(s).
- (d) Providing that any winding-up petition would, unless its filing had been pre-approved by the court, be invalid if filed by a creditor within three months of the date on which the company’s directors filed a Covid-19 Declaration at court. This would both protect the company, limit the application of section 127 Insolvency Act 1986 and ensure that creditors could still commence an insolvency process with court approval in appropriate cases, on the basis of section 122(1) (f) Insolvency Act 1986.
- (e) Providing that any winding up petition would also be invalid if the company’s directors filed a Covid-19 Declaration at court within 2 Business Days of being served with that creditor petition. This should ensure that any bank accounts frozen as a consequence of section 127 Insolvency Act 1986 should be unfrozen once the directors file the Covid-19 Declaration. In such circumstances, the creditor would, if it wanted to cut short the three month period, have to apply to court for permission to present a new winding up petition.

#### **Moratorium measures – administration style moratorium<sup>5</sup>**

- (f) In addition to the measures discussed above, companies could be given the ability to obtain the benefit of a moratorium identical to that currently available under paragraph 44 of Schedule B1 to the Insolvency Act 1986 but on different grounds. Currently, to obtain the benefit of this interim moratorium, directors must have a settled intention to appoint administrators. We consider that the grounds for seeking the interim moratorium could be expanded to include a situation where directors have an intention to put in place measures to overcome a temporary Covid-19 related liquidity crisis in order to avoid insolvency, or, if that is not possible, appoint an administrator. The current interim moratorium applies only for ten business days – in the context of Covid-19 we consider that such a moratorium would need to be longer to be of benefit to companies. It could operate for the same period as the protection from winding up petitions under the proposals made

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<sup>1</sup> This could be extended to 180 days to align with the period for an automatic stay under US Chapter 11.

<sup>2</sup> An alternative to a court filing would be a board resolution whereby the board of directors makes a resolution to the effect outlined above. Although this would be easier for the board to do, there is a risk of fraud (i.e. by companies who do not make the resolution at the time but attempt to make a retrospective resolution later).

<sup>3</sup> cf s89(4).

<sup>4</sup> This could be extended to 6 months.

<sup>5</sup> This measure has the potential to provide more comprehensive protection for companies, it could use the existing court e-filing system, and without the additional costs of a formal appointment of administrators. It would however be dependent on other government measures to assist with liquidity, employment obligations, and essential supply arrangements.

above and certainly should be no longer than that period. A reasonable period within which to put measures in place to overcome the temporary liquidity problem which be less than the 90 day period of protection under the proposals made above in respect of winding up petitions because companies who could not put such measures in place expeditiously would retain the ability to go into administration with a view to their rescue as a going concern. As with the moratorium measure described in the paragraphs above, this would give companies protection from winding up petitions but would go wider by provided extended protection against other hostile action without approval including: the enforcement of any security against the relevant company; the re-possession of hire purchase goods; forfeiture by landlords and the commencement of any legal proceedings against the company. This is particularly valuable for companies whose revenue has been disrupted and could otherwise be at risk of litigation for failure to make payments.

- (g) Just as the protection from hostile winding up petitions afforded by a Covid-19 Declaration could be overridden by court permission, so too the para 44 moratorium should be capable of being set aside by the court upon proof that there was no realistic prospect of creditors being paid in full after the crisis has passed.
- (h) The hardening periods applicable to transaction avoidance should be extended to cover this new version of a para 44 moratorium in line with the proposals advanced above in respect of Covid-19 declarations.
- (i) Liabilities incurred by a company during the period in which it has the benefit of the new style para 44 moratorium and which would have constituted an expense of the administration had the company been in administration during this period should enjoy priority over pre-moratorium unsecured liabilities in any subsequent insolvency proceedings. This would include liabilities in relation to new supplies of goods and services or for new borrowings during this period other than through Government facilities.

#### **Amending the "wrongful trading" and directors' duties provisions**

- (j) The "wrongful trading" provisions in section 214 Insolvency Act 1986 could be amended, so as to make it clear that, when assessing whether a company still had a reasonable prospect of avoiding insolvent liquidation or administration, a director should not be made liable if, acting reasonably, they misjudged the potential negative impact of Covid-19 on their business in particular they should not be exposed to personal liability for incurring any indebtedness under the emergency borrowing arrangements provided by or supported by the government to assist in this crisis<sup>6</sup>. An easier alternative would be to suspend these provisions altogether for a limited period, relying instead on the fraudulent trading and common law duties to keep directors honest.
- (k) One of the challenges when advising directors of companies in financial distress is that, following the decision of Snowden J in *Ralls Builders*<sup>7</sup>, directors are required to consider not just the position of the creditors generally, but to consider the position of each and every creditor individually in circumstances where they are continuing to trade beyond the point that it is reasonable to conclude that an insolvent administration or liquidation can be avoided. This is extremely difficult to manage in practice and may lead directors and their advisers to conclude that the better course of action is to put the company into administration or liquidation and thus perhaps bring an end to any hope of rescuing that company or its business. If section 214 is to continue to operate and apply to decisions taken throughout the Covid-19 crisis then it may be helpful to directors to clarify that the reference in section 214(3) to minimising losses to "creditors" means the general body of unsecured creditors – i.e. reducing or minimising the net deficit<sup>8</sup> – rather than minimising the loss to each and every unsecured creditor.

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<sup>6</sup> We do not advocate any relaxation of the fraudulent trading rules but there are circumstances where the application of the full rigour of those rules, for example in relation to unauthorised credit periods (*R v Grantham* [1984] QB 675) and the sort of trading activity considered in *Re Ralls Builders Ltd* [2016] Bus LR 555 (where fraudulent trading was not pleaded) would be a practical constraint on what a board could legitimately do unless it was confident of the priority of liabilities being incurred.

<sup>7</sup> *Re Ralls Builders* [2016] EWHC 243 (Ch); see also *Re Ralls Builders No 2* [2016] EWHC 1812 (Ch).

<sup>8</sup> By "net deficit", we mean the amount by which sums owed to unsecured creditors at the time of administration/liquidation exceeds the amounts that were owed at the point when the directors ought to have concluded that the company had no reasonable prospect of avoiding insolvent administration/liquidation.

- (l) If there is not time for legislative amendments (or while such amendments are considered), some softer comfort from Government in relation to its approach to calling in emergency support loans or its approach to director disqualification cases might help in calming down nervous directors.

### **Effect on administration**

- 2.4 We do not think it is necessary to restrict a creditor's right to make an application for administration. In such circumstances, the company would have the benefit of the moratorium that arises in an administration and the court could always exercise its discretion not to make the order if the issues were short term and Covid-19 related. We consider that it would be necessary to make it clear that Covid-19 reasons were to be sufficient grounds for the court to exercise its discretion to refuse relief in circumstances where an order would otherwise have been made. Furthermore, we do not consider that the holders of qualifying floating charges should be prevented from making out of court appointments of administrators, as interfering with such rights could have a negative impact on the prospects of a successful business rescue, particularly if the charge holder was unwilling to provide additional funding until an administrator was appointed.
- 2.5 More generally, the issues surrounding e-filing and the commencement of administration should be resolved by enabling directors to trigger the procedure by e-filing outside court hours.

### **Further considerations**

- 2.6 We have also given thought to whether to include *ipso facto* provisions in the proposed legislation but we are concerned that this might over-complicate matters, given that it may be necessary to provide for safe harbours and exceptions to provide market transactions. We do note, however, that contractual counterparties may use a Covid-19 Declaration or the interim moratorium as grounds for contractual termination and one solution may be to include similar provisions to section 48Z(6) of the Banking Act 2009 in relation to "crisis prevention measures" or "crisis management measures" so that use of a Covid-19 Declaration or the interim moratorium cannot be used as grounds for termination where the substantive obligations provided for in the relevant contract continue to be performed. Consideration could be given to whether an extension of the essential supplies regime under sections 233 and 233A Insolvency Act 1986 would be appropriate. Consideration could also be given to giving the court power to grant relief from contractual sanctions in cases not covered by those sections.<sup>9</sup>
- 2.7 These measures would be publicised by easy to access links from Insolvency Service webpages publicising these temporary solutions, providing a template for the Covid-19 Declaration and setting out the procedure for its filing.
- 2.8 In addition, we would strongly encourage the Government to consider advancing the corporate insolvency law reforms that were consulted on in 2016.
- 2.9 As a separate issue, HMRC, which will often be a significant creditor, should be encouraged to adopt a supportive role during the three month period. We also question whether the proposal to re-introduce Crown preference in relation to certain taxes (albeit postponed until December 2020) is a sensible one in the current climate. It is notable that that proposal is in direct conflict with the recent increase of the maximum prescribed part (which, in itself, fits well with other emergency measures to preserve businesses and prevent a domino effect).
- 2.10 We are also concerned about the new criminal sanctions in the Pension Schemes Bill which might discourage companies drawing down on secured facilities if that could have the effect of having a material detrimental effect on the defined pension scheme if the company does not ultimately survive as a result of Covid-19. While it may be that the directors and the lenders will have a "reasonable excuse" in pursuing the secured lending, we wonder if this is the right time to be introducing such criminal sanctions. More generally, we wonder if The Pensions Regulator needs to introduce a different approach to clearance applications in the current climate as companies may not have the time to produce gold-plated EPMS or recovery analysis with everything else that

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<sup>9</sup> Which could be modelled on relief from forfeiture.

is going on. This may require discussions with The Pensions Regulator as to its approach rather than legislation.