OPINION

CORPORATE INSOLVENCY REFORM

Moratorium-blockers and super-priority debt

Bruce Johnston of Morgan, Lewis & Bockius UK LLP discusses how the recent corporate insolvency reforms will affect UK corporate financings.

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The Corporate Insolvency and Governance Act 2020 (2020 Act) came into effect in the UK on 26 June 2020, bringing major changes to UK insolvency law (*see News brief "Corporate Insolvency and Governance Bill: reforms to weather the storm", www.practicallaw.com/w-026-1272*). The full extent of the reforms will only become apparent in the coming months, as the courts and insolvency practitioners grapple with its 254 pages.

Moratorium on enforcement

A key feature of the 2020 Act is a moratorium on enforcement in the new Part A1 of the Insolvency Act 1986 (1986 Act). The moratorium lasts for 20 business days and can be extended for up to one year, subject to certain criteria. One criterion for the extension is that specified debts incurred before the moratorium must have been repaid (*sections A10, A18 and A53, Part A1, 1986 Act; and Schedule ZA2, 1986 Act*) (Schedule ZA2).

One of the consequences of the new moratorium is the creation of super-priority debt in a later insolvency. If the borrower goes into liquidation, administration or other restructuring within 12 weeks after the end of the moratorium, the specified debt that fell due before or during the moratorium (and that has not been accelerated) will get super-priority over all other creditors, excluding creditors holding fixed charges (*section 174A, 1986 Act*) (section 174A). Any later restructuring of the borrower will need to recognise this super-priority (*section 901G(3), Companies Act 2006*).

Financiers will need to look for ways to get super-priority or prevent other creditors from getting super-priority. This can be done by structuring the financing either:

- With a moratorium-blocker; that is, a feature that prevents the borrower from starting a moratorium and therefore prevents the creation of super-priority debt.
- So that it is eligible to be a super-priority debt.

Moratorium-blockers

A financier can ensure that there is no super-priority debt by making sure that the borrower cannot start a moratorium.

Some companies are not eligible for a moratorium (*see box "Ineligible companies"*). The tests for non-eligibility are complex, but careful structuring of the financing can sometimes mean that the borrower or guarantor is not eligible for a moratorium. For example, with careful structuring, many special purpose vehicle (SPV) borrowers can fall within the definition of a "securitisation company", even if the financing is not a securitisation.

Section A6(1)(e) of the 1986 Act requires that, as a precondition to the start of a moratorium, the proposed monitor (that is, an insolvency practitioner) makes a statement that "it is likely that a moratorium for the company would result in the rescue of the company as a going concern". To make it more difficult for the proposed monitor to make that statement, and therefore prevent the moratorium and the creation of super-priority debt, the financier could add a statement in the loan agreement that the financier will not consent to any "rescue of the company" where that company has super-priority debt.

Super-priority

If there is no moratorium-blocker, a financier should consider structuring the financing so that it is eligible for super-priority. The following are three examples of debt that can be structured to be eligible for super-priority.

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Ineligible companies

Schedule ZA1 to the Insolvency Act 1986 lists the companies that are ineligible for a moratorium, including:

- Insurance companies (*paragraph 3*).
- Banks (*paragraph 4*).
- Investment banks and investment firms (*paragraph 5*).
- Securitisation companies (*paragraph 12*).
- Parties to capital market arrangements (*paragraph 13*).
- Private-public partnership project companies (*paragraph 15*).

Revolving loans. A moratorium can confer super-priority on a revolving loan, but not a term loan. In order for a loan that falls due before or during the moratorium to get super-priority, it must not have been accelerated during the moratorium (*sections 174A(3), (4) and (11)*). However, a revolving loan with an interest payment date during the moratorium will become due during the moratorium without acceleration if the lenders cease to make new replacement loans. Most revolving loan agreements will have a clause that allows lenders to stop making replacement loans if the borrower or guarantor starts a moratorium. If a revolving loan is not rolled over during a moratorium, and the borrower does not repay the revolving loan, the borrower will not be able to extend the moratorium. It is therefore likely to go into administration or liquidation, with the revolving lender then having super-priority.

The 2020 Act gives preferential treatment to revolving loans over term loans in most circumstances. It will encourage revolving lenders to not make replacement loans during the moratorium in order to get super-priority in the resulting administration or liquidation and ensure that they are not subordinated to other creditors that can get super-priority. New lenders to UK borrowers should try to restructure their loans as revolving loans with one-month interest periods, instead of term loans. Those new revolving loans should have clauses that do not oblige lenders to make replacement loans when a borrower or guarantor is in a moratorium.

Borrowers and guarantors. The new insolvency law treats borrowers and guarantors differently. If there is a moratorium for a borrower and a guarantor, and the guaranteed loan fell due before or during the moratorium (other than by being accelerated during the moratorium), the lender cannot get super-priority in the subsequent administration or liquidation of the guarantor, but it can get super-priority in the subsequent administration or liquidation of the borrower. The reason for this is that the liability of the guarantor, which arises when the guaranteed loan becomes due, will be "relevant accelerated debt" because that liability of the guarantor only fell due as a result of the happening of an event; that is, a failure to pay the guaranteed loan or a demand under the guarantee (*sections 174A(4) and (11)*).

The 2020 Act should encourage loans to be made to the most creditworthy entities in a group of companies, rather than being made to finance companies or SPVs, with guarantees.

Bonds and loans. The 2020 Act treats some bonds differently than loans. For a debt that fell due before or during the moratorium to get super-priority, that debt must arise under a contract or other instrument involving financial services (*section 174A(3)*). That includes, among other things, loans, derivatives, repurchase agreements and capital market investments (*Schedule ZA1, 1986 Act*) (Schedule ZA1). As a result, while all types of loans may get super-priority, some types of bonds that are not capital market investments cannot get super-priority.

For a bond to be able to get super-priority, it must be either:

- A capital market investment that is listed, rated or traded (or designed to be), or issued to specified classes of professional investors (*paragraph 6, Schedule ZA2; paragraph 14, Schedule ZA1*).

- Secured by a financial collateral arrangement (*paragraph 10(c), Schedule ZA2*).

Other bonds will not be able to get super-priority, such as intra-group debt evidenced by loan notes or unlisted notes issued to custodians.

In addition, a UK company cannot start a moratorium if it is a party to a capital market arrangement (*paragraph 13, Schedule ZA1*). In summary, this is a capital market investment in excess of £10 million that is secured or guaranteed. A financier may prefer a secured or guaranteed bond, rather than a secured or guaranteed loan, because that bond is a moratorium-blocker.

The 2020 Act should encourage financings to UK companies to be structured as loans, rather than as bonds.

Changes to the new insolvency law

The 2020 Act was rushed through Parliament with inadequate consultation. The government has indicated that it might later adjust the super-priority and moratorium arrangements if they are not working. It can make those adjustments by secondary legislation, which it has already done for social housing (*Co-operative and Community Benefit Societies and Credit Unions (Arrangements, Reconstructions and Administration) (Amendment) and Consequential Amendments Order 2020 (SI 2020/744)*).

In the meantime, financiers should structure their financings so that they can stop the creation of super-priority debt, or create debt that is eligible for super-priority and cannot be subordinated to other creditors that can get super-priority.

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