

A Moratorium for Businesses:

Improving Business & Job Rescue in the UK

Part of the Insolvency Landscape Series

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Summary

- While the UK's corporate insolvency regime is flexible and effective (and ranked by the World Bank as one of the best in the world), directors of struggling companies sometimes lack the time to make considered decisions about their company's future when facing insolvency.
- A key reason for this is that anxious creditors can disrupt business rescue plans by petitioning to have a struggling company wound up. This is understandable given creditors want to protect their own financial interests, but it can put directors under pressure.
- To avoid this, business rescue deals tend to be quick and confidential. This can leave unsecured creditors in particular feeling out of the loop.
- Additionally, faced with the risk of losing control of their company upon entering an insolvency procedure, directors may put off seeking advice or taking action until it is too late, reducing the chances of a full business rescue.
- To counter these problems, **R3 recommends the introduction of a 21-day moratorium for struggling businesses**. During the moratorium, creditors will be prevented from taking any action to recover their debts.
- Under the proposals...
 - The moratorium period will last 21 days. It can be extended either with the issue of a CVA proposal or by applying to court for a 21 day extension.
 - The directors will remain in control of the company during the moratorium.
 - A licensed insolvency practitioner will act as a Moratorium Supervisor over the length of the moratorium.
 - Companies in a moratorium must meet debts created during the moratorium and directors must confirm that funding is in place when filing the notice of moratorium in court. Subsequently if a company cannot pay the debts created in the moratorium, it must enter an insolvency procedure.
 - Suppliers may not withdraw supply or change the terms of supply during the moratorium – although suppliers may request to be paid pro forma or require a guarantee from directors.
 - Creditors may challenge the moratorium in court.
 - There should be a publically accessible register of moratoriums. This could be funded by a small filing fee for each application.
- Moratoriums are already part of the UK insolvency regime but are only available in limited circumstances. Introducing a broader moratorium would be in tune with proposals made by the European Commission and would introduce to the UK a positive aspect of the US insolvency regime without importing the downsides.

Introduction

The UK's insolvency regime is effective but has an important capability gap: there is no breathing space from creditor pressure that allows directors of struggling companies the opportunity to consider their options and take difficult decisions without risking a calamitous collapse of the company's supply chain and increased pressure on cash flow, both of which could hasten the onset of formal insolvency. Filling this gap could help save more businesses and consequently return more money to creditors.

The regime currently contains two tools that attempt to bridge this gap: a Schedule A1 moratorium, preventing creditor enforcement action ahead of Company Voluntary Arrangements and the interim moratorium that arises upon the filing of a Notice of Intention to Appoint an Administrator. However, the A1 moratorium is impractical and is little used, while Notices of Intention have limited outcomes. Under the A1 moratorium, directors effectively lose control over their company and an insolvency practitioner is expected to comply with a disproportionate reporting burden for the moratorium's duration.

R3 proposes overhauling the existing Schedule A1 moratorium to make it available to more companies, more flexible and to ensure that directors remain in control of their company.

The concept of a moratorium has already attracted attention at Westminster and in the EU, and is already used in the US. This short paper sets out how a moratorium would work in ideal circumstances.

Background

The existing insolvency regime has a good track record with business rescue and returning money to creditors. R3 members said that in 2013-14, two out of every five businesses they worked with were able to continue in some way (equivalent to almost 7,000 business rescues and 230,000 saved jobs¹). However, there is a common complaint that when the threat of formal insolvency looms, decision-making time is too limited. This can have consequences for business rescue, creditor returns and creditor engagement.

Concerns about a lack of time are not surprising: as it is currently configured, the insolvency regime places a premium on speed and discretion. In terms of achieving the regime's originally stated goal of maximising returns to creditors, this makes sense. The quicker and quieter a sale or restructuring can be arranged, the more likely it is to go off without a hitch; creditor returns are often better when businesses can continue seamlessly as going concerns.

The need for speed and discretion in the face of insolvency is partly down to the fact that business rescues and a business' value are somewhat fragile. This puts directors and their advisors in a difficult position.

On the one hand, discussing a company's problems with its creditors could lead to a restructuring of its debts, limit creditor losses and could help head off formal insolvency; on the other, informing creditors about the company's problems could make them worse.

¹ R3 Why Insolvency Matters, May 2015

Once the details of a struggling company's difficulties are exposed, creditors may take unilateral action to protect their own position: contracts may be cancelled, credit insurance may be suspended and debts may be called in or credit terms shortened or removed; any of these could tip a company into a formal insolvency process. Wider knowledge of the extent of problems hurts a business' goodwill value as well, potentially dissuading customers from placing new orders, further reducing creditors' potential returns.

Of course, there are some companies that may be seen by their creditors as 'too big to fail' and they would be willing to help once they know how bad things are, but these cases are relatively few and far between.

Even during an insolvency procedure (and despite recent reforms), rescue can be stymied by suppliers withdrawing supply or increasing prices as they attempt to minimise the risk of trading with a struggling company.

As a result of these concerns, rescue deals are generally kept under-wraps, with a restructuring or sale completed either without the company entering a formal insolvency procedure or through a 'pre-pack' administration, where the business sale is completed immediately or very shortly after the insolvent company has entered administration.

Pre-packs are an effective business rescue tool but should only be used when they can get the best return for creditors in the circumstances. Some creditor groups and others have expressed dissatisfaction with the lack of transparency around the deals that result in pre-packs, even though they are only a small proportion of insolvencies. This has led to a clouding of the perception of the insolvency regime as a whole.

There are insolvency procedures that allow for greater creditor engagement, but they are not suitable in all circumstances. Company Voluntary Arrangements (CVAs) are often complex to negotiate and sustain, while trading administrations – where a business continues to trade until new investment is found – are suitable only in limited circumstances and can, as above, be disrupted by non-cooperative suppliers.

Concerns about creditors enforcing debts (or customers, staff, or potential new lenders losing confidence) when a company struggles are not the only factor that puts pressure on directors: the company will be losing money, possibly at a rapid rate. Either way, the lack of time causes several problems.

One issue is a simple one: directors do not have much time to come up with a plan on how to turn things around. Nor, given the typical limitations on speaking to creditors when insolvency looms, can such rescue plans be put together with much buy-in from important stakeholders. The more creditors directors speak to, the greater the risk that one of them might take action that defeats the rescue.

Directors will also be focused on saving the business in the short-term: in practice there may be little time to consider all of the company's options, including whether to bring in external advice or whether entering an insolvency procedure might be necessary.

There is a further problem in that directors face a binary choice when approaching insolvency: they can try and turn their company around outside of a formal insolvency procedure, or they can do it through an insolvency procedure. The problem here is that while both paths have downsides, only the consequences of entering a formal insolvency procedure might be more apparent from the directors' perspective.

Avoiding entering an insolvency procedure when the company is insolvent could leave the directors open to a later wrongful trading action, but directors may carry on trading all the same, hopeful they can turn things around. Selling assets to realise much needed cash at this point may also expose the directors and buyers to subsequent scrutiny or challenge if the company does fail. On the other hand, entering insolvency comes with the very immediate risk of losing control of the company (unless a CVA is possible), which could put some directors off from taking a step that might be in their own best interests or the best interests of their creditors.

It is also worth noting that it is not just directors who may be keen to avoid or delay an insolvency procedure. Some creditors, worried about their return in an insolvency procedure, may also put pressure on directors to persevere with non-insolvency options – even if the directors are concerned about the risk of wrongful trading.

What is missing is a halfway house, between formal insolvency procedures and 'normal' trading. Such an option would give directors of struggling businesses relief from creditor action or pressure and time to consider their options and to put together a rescue plan – while they remain in charge of the business.

A moratorium for companies – why it would work

R3 believes that the business rescue regime could be improved with the introduction of a moratorium for companies that would prohibit creditors from enforcing their debts for a short period of time. During this time, the company may formulate a comprehensive rescue plan and discuss their situation with creditors. At the end of the moratorium, the company may enter a formal insolvency procedure, continue trading in its existing form, or restructure, depending on whichever course of action has been decided upon during the moratorium.

The introduction of the moratorium would help provide the time needed by directors that is missing from the current regime. It would allow for more considered decision-making and greater creditor involvement in the business rescue process – without risking creditors taking unilateral action to protect their own position once a company announces it is struggling.

By allowing companies to benefit temporarily from the protections offered by the insolvency regime and withholding some restrictions, directors may be encouraged to take action about debt problems sooner. As the insolvency profession often argues, the sooner a company takes action on problem debts, the easier it is to achieve a positive outcome and rescue businesses.

The principle of a moratorium already exists in the insolvency regime: small companies considering a CVA may apply for a Schedule A1 moratorium. However, the rules on using Schedule A1 moratoriums are very demanding and the option is rarely used. Compliance requirements mean there are more costs than benefits of the moratorium in most cases.

The government has previously considered expanding the existing moratorium beyond CVAs and consulted on proposals in 2010. R3 supported these proposals although expressed concern that they replicated some of the flaws of Schedule A1: the proposed expanded moratorium would have again placed an excessive burden on an insolvency practitioner to monitor the company's activities during the moratorium. The proposals did not make it past the consultation stage, but not because they were unpopular or unworkable: reports suggest that key staff in charge of developing the policy at the Insolvency Service moved on and the idea was mothballed.

Elsewhere in the regime, a moratorium can be initiated by filing a Notice of Intention to Appoint an Administrator. As the name suggests, this is available to those companies considering entering administration and confers a 10-day moratorium from creditor action. Unlike the moratorium proposed by R3, this moratorium period is designed specifically to precede administration.

R3's new proposals envisage a practical role for an insolvency practitioner, which is less demanding than the A1 moratorium, as well as a structured flexibility that is missing from Notices of Intention to Appoint. The proposals would mean moratoriums are less cumbersome to use, directors would be less worried about losing control of their company and safeguards for creditors should be clearer. Expanding the 'exits' from a moratorium beyond CVAs and administration would also create a larger pool of companies eligible for moratoriums.

Notably, R3's proposal introduces another element of 'debtor in possession' to the UK insolvency regime. This concept – a key part of the US bankruptcy system – has gained traction in the UK over the past few years as a way of introducing greater flexibility to our insolvency regime. R3's proposals represent a way to bring the concept of 'debtor in possession' into the UK by adapting an existing part of the UK regime and avoiding a complete overhaul – and the high costs associated with the US regime.

A proposal for a moratorium or 'stay' is also a concept included in a 2014 European Commission Recommendation on business failure and insolvency. The proposed 'stay' would last for a maximum of 12 months (and a minimum of four months) and would prevent creditors from taking enforcement action against companies putting together a business rescue plan. The Commission proposal would also remove the obligation of companies using the 'stay' to enter an insolvency procedure if they are insolvent.

This latter point is something with which R3 agrees. A non-statutory insolvency solution may be the best way of rescuing an insolvent company (and getting better returns to creditors) and the moratorium gives companies and their advisors a limited time to explore all their options free from creditor pressure. An obligation to enter a statutory insolvency procedure would narrow the purpose of the moratorium in the first place and would severely limit the number of companies that could benefit from the existence of the moratorium. During the moratorium, should the company and its advisors decide that a statutory insolvency procedure is in creditors' best interests, the company should be allowed to enter a voluntary insolvency procedure.

Finally, it is also worth noting that the government is already exploring the concept of a 'breathing space' for individuals from their debts. R3 has argued that a formal breathing space should be made available to struggling debtors to give them time to consider their options and put together a plan without the pressure of creditor action. This would ensure that individuals can choose a way of dealing with their debts in an orderly and informed fashion. This concept and the principles behind it could translate to corporate insolvency.

How the moratorium would work

R3's moratorium would include the following provisions:

Companies eligible to enter a moratorium/requirements for entry

- Any company can enter a moratorium if it is insolvent or if insolvency is in prospect.
- Company directors must make a statutory declaration confirming that the company is insolvent or is likely to become insolvent (absent a restructuring), setting out the objectives of the proposed moratorium and identifying the Moratorium Supervisor.
- Should an extension be required, directors must make an application to the court explaining why the extension is necessary. Applications for extension must be supported by a statement from the Moratorium Supervisor.

Process for entering a moratorium

- Companies applying for a moratorium should file a notice in court.
- There is no requirement to notify creditors that the filing is being made, unless there is an outstanding winding-up petition. In that case, the petitioner must be given 3 days' notice of the filing.
- Once the filing has been made, creditors should be notified (by email or post where possible or by gazetting).

Restrictions on creditors/suppliers imposed by the moratorium

- During the period of the moratorium, no creditor can take action to recover their debts. This does not include any new debts created during the moratorium.
- Charge holders will not be able to exercise their security during the period of the moratorium.
- Suppliers may not withdraw supply or change the terms of supply during the moratorium – although suppliers may request to be paid pro forma or require a guarantee from directors.
- Creditors may challenge the moratorium in court.

Restrictions on companies in a moratorium

- During the moratorium, there will be a freeze on disposing of assets other than in the normal course of business.
- During the moratorium, connected party payments (unless made in the ordinary course of business) are prohibited.
- Companies in a moratorium must meet debts created during the moratorium and directors must confirm that funding is in place when filing the notice of moratorium in court. Subsequently if a company cannot pay the debts created in the moratorium, it must enter an insolvency procedure.

Wrongful trading and preferences

- Any trading during a moratorium would not qualify as wrongful trading, unless the company fails to meet any new debts created in the moratorium.
- The payment of moratorium debts would not constitute a preference.

The role of the Moratorium Supervisor

- The directors will remain in control of the company during the moratorium.
- A licensed insolvency practitioner must be named in the filing who will act as a Moratorium Supervisor over the length of the moratorium.
- Directors must make a weekly report to the Moratorium Supervisor on progress made in the moratorium.
- The Moratorium Supervisor will act as a mediator between the company and its creditors.
- The Moratorium Supervisor must resign – bringing an end to the moratorium – if they determine that creditors' interests are being damaged by continuation of the moratorium.

Other

- The moratorium period shall last 21 days once the filing has been made. It can be extended either with the issue of a CVA proposal or by applying to court for a 21 day extension. The application would be made by the directors and would set out the reasons for seeking the extension.
- There should be a publically accessible register of moratoriums. This could be funded by a small filing fee for each application.
- Companies may only enter one moratorium per year unless the court agrees to grant another moratorium in that timeframe.
- A company can exit a moratorium at any time by notifying the court and creditors.
- A Moratorium Supervisor will become the Office Holder of that company in any subsequent insolvency procedure either where their appointment is approved by a simple majority by value of those creditors voting (and any floating charge holder has not exercised their statutory right to appoint another IP) or where the court makes the appointment.

Potential drawbacks

While the proposals envisage an extension of the circumstances where creditor rights are circumscribed, these new limits, as argued above, could actually lead to a better deal for creditors in the longer-term: with more time to put together a business rescue proposal, chances of rescue could increase. This, in turn, would lead to creditors seeing more of their debts repaid.

Protections for creditors are built in to the proposals. Companies would not be able to enter moratoriums frequently, while creditors would always have the ability to challenge the moratorium in court once it is underway. An insolvency practitioner would always be present to look out for creditors' interests.

The main drawback for a company opting for a moratorium would be a reputational one: although a moratorium would not mean the debtor company is in a formal insolvency process, entering a moratorium would be enough to cause concern about the company's financial health. Creditors may not be able to act on the concern during the moratorium, but they may well do so once the moratorium period is over. Similarly, the decision to enter a moratorium could have a negative impact on the relationship between a debtor and a creditor.

As such, the onus is on the struggling company to make the most of the moratorium period. This includes being proactive in talking to creditors during the moratorium to keep them informed of progress and plans. The moratorium should be used by companies as an opportunity to put together a business rescue plan to be presented to creditors before the end of the 21 days. Ongoing creditor support will be crucial to the survival of any company in a moratorium.

The major 'unknown' with any moratorium proposal is how companies will be funded during the moratorium. Lending to a company in a moratorium could be risky and lenders will be understandably cautious when it comes to extending credit to such companies. Some companies considering a moratorium will have sufficient cash to get them through the moratorium; others closer to insolvency may not. Whichever is the case, a company will not be able to last long in a moratorium unless it can fund its business.

However, the funding question is not something that would rule out the introduction of a moratorium. At least some companies are likely to benefit from its introduction even without reforms to rules on lending, whether because they have cash available or because they can attract new funds. Indeed, funding options for distressed companies have increased markedly since the financial crisis and it might be expected that the introduction of a moratorium will lead to further innovation in the funding market.

The introduction of a moratorium should act as a prompt to consider whether other changes need to be made, including whether 'Super Priority' funding – where those lending to insolvent companies take a higher position in the statutory hierarchy of creditors than existing secured lenders – should be brought to the UK.

Alternative moratorium proposals – would they work?

There are two key points of difference between the main moratorium proposals that have so far been put forward by interested parties: the length of the moratorium and the role of an insolvency practitioner or third party oversight.

How long should a moratorium be?

The length of a moratorium is one half of a trade-off between creditor rights and supervisory or reporting requirements. Given that the moratorium would involve some suspension of creditor rights, the moratorium needs to offer something to creditors in return (aside from an increased chance of business rescue and potentially greater returns). This could include more information for creditors during the moratorium or restrictions on what creditor rights are limited. The longer a moratorium goes on, the greater the concessions creditors will need to be offered.

From R3's perspective, a shorter moratorium period is considered more practical and likely to meet its objectives: this requires little to be offered to creditors in return for having their rights suspended, as they would only be suspended briefly. This allows flexibility, which could lead to a greater chance of business rescue. A longer moratorium, on the other hand, could require more to be done to keep creditors and other stakeholders on board, or trading performance could deteriorate further, exacerbating the company's problems. This quid pro quo could take the form of oversight from an independent third party (see below) or greater reporting requirements, but would create extra costs and replicate the burdens that prevent the existing moratorium system from working effectively.

On top of this, while time is a valuable commodity in business rescue, 'too much' time could also be a problem. The longer the moratorium process, the more likely creditors will become frustrated with restrictions placed on them, regardless of concessions that have been made. A shorter moratorium, however, creates a sense of urgency and forces a company to confront its problems; a longer moratorium would allow a company to 'drift' and put off dealing with its financial difficulties, drawing things out for creditors. One of the concerns about Chapter 11 in the US is the length of time that companies spend in the process. Besides, were a company to use the short moratorium properly, a longer period of protection from creditors would be unnecessary: a company exiting a short moratorium should already have some sort of plan in place that keeps creditors onside for the foreseeable future.

As such, the moratorium length envisaged by the European Commission – of between four and twelve months – is, in all but the most complex cases, far too long. Ideally, a moratorium should be very short with limited accompanying reporting requirements to ensure that the moratorium is flexible and that disruption for creditors is brief. The R3 proposal for a 21 day moratorium, extendable to 42 days with directors remaining in control and limited reporting to creditors required, achieves these goals.

A case could be made for a slightly longer moratorium than 42 days, but it would have to be carefully designed to ensure that added creditor concessions (such as oversight requirements) did not outweigh the advantages of using the moratorium in the first place. There is no point expanding the existing moratorium if the reporting burdens, which render the existing option pointless, remain as they are.

Importantly, the issue of time also affects the viability of a moratorium: it would be much easier to fund a company for three weeks during a moratorium than it would be to fund one for three months. Once a company runs out of cash, a company will need to enter an insolvency procedure, regardless of how much time they theoretically have.

Should there be third party oversight of moratoriums?

Tied into the time issue is the possible requirement for an individual or the court to provide oversight of the moratorium on behalf of creditors. As above, the longer the moratorium, the greater justification there is for extra creditor protection; in this case, in the form of third party oversight. To repeat the earlier point, it is the over-burdensome requirements on this third party monitor (an insolvency practitioner) that mean the existing Schedule A1 moratorium is little used.

R3's proposals include a role for an insolvency practitioner acting as a Moratorium Supervisor, although it is relatively limited – and much more practical – than the moratorium proposals from 2010.

The European Commission prefers that supervision should be exercised by the courts, but this approach tends not to be favoured by the UK.

Unlike most other countries, court involvement in the UK insolvency regime is limited. Court involvement and sometimes court approval is needed to begin processes, but after that things are generally left in the hands of insolvency practitioners or the Official Receiver (all of whom are officers of the court). Indeed, the general trend in the UK is for less court involvement: from April 2016, debtor petition bankruptcies joined Debt Relief Orders and Individual Voluntary Arrangements in becoming an administrative rather than court-driven process. This trend is happening with good reason with court time and budgets increasingly limited. Requiring major court involvement for the moratorium process would put significant additional burden on the already resource-constrained court system.

It's also worth noting that court involvement is a key feature of the US bankruptcy code – and a key reason for the great expense and delays associated with that regime. While importing some aspects of the US bankruptcy regime might be a good idea, importing the expense of that regime should be avoided.

Without substantial court involvement, the logical candidate to fill the role of third party oversight is a licensed insolvency practitioner. Insolvency practitioners are highly regulated, familiar with insolvency issues, are officers of the court, already have a duty to act in creditors' interests and are already expected to fulfil this function under existing legislation. It cannot be emphasised enough, however, that the obligations required of any individual providing a supervision role should be significantly less stringent than they are under the existing moratorium statute. Any attempt to replicate the Schedule A1 oversight requirements in an expanded moratorium would be likely to see this new moratorium little used.

Conclusion

Early action is the best way for a company to avoid formal insolvency. This means more businesses rescued, more jobs saved and, very importantly as far as insolvency practitioners are concerned, more money back to creditors.

The proposals for an expanded, but time-limited, moratorium would make it much easier for companies to take early action to set their finances straight.

The proposals give directors time to make considered decisions about how they can rescue their company's business without having to worry about unexpected creditor actions or pressure. With temporary limits on creditor rights, creditors can be better informed about the process too, helping maintain their confidence in what is being done by the directors.

The proposed moratorium would create what is currently a missing stepping stone to formal insolvency procedures and would allow companies to take decisive action earlier rather than putting off an insolvency appointment and the downsides that can come with it. Even though an early entry into an insolvency procedure could help a company and its creditors, it is easy to understand why directors will try for as long as possible to avoid it. A moratorium could act as an important gateway into the insolvency regime for those companies (and creditors) whose interests would be best served by entering it, and entering it early.

The reporting requirements and insolvency practitioner involvement will be limited, ensuring the moratorium process is not cumbersome. The onerous requirements for insolvency practitioners are the dominant reason why the existing Schedule A1 moratorium is little used.

The moratorium will be open to any company, rather than just the limited few for whom a CVA might be appropriate (as per the existing Schedule A1 moratorium). Such a moratorium would introduce a high degree of flexibility to the insolvency regime and help ensure that the advantages of a moratorium are not unnecessarily restricted.

All in all, a new moratorium represents the best way to encourage companies to take the early action that saves businesses, jobs and creditors' money.

About R3:

R3, the insolvency trade body, represents the UK's insolvency practitioners. R3's full members are all regulated by their recognised professional bodies, they can be licensed insolvency practitioners, solicitors, chartered accountants or certified accountants. They have extensive experience of helping businesses and individuals in financial distress.