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Mr. Stephen Leinster
Insolvency Service
21 Bloomsbury Street
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Dear Steve

Consultation on Encouraging Company Rescue (June 2009)

As you may be aware, the remit of the Financial Markets Law Committee ("FMLC") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

Following the publication by the Insolvency Service of its consultation paper on proposals for the reform of English insolvency law, the FMLC resolved to respond addressing issues that particularly concern its remit. To that end, the FMLC seeks to bring to your attention certain issues of legal uncertainty which it has identified. However, the FMLC has been prevented from commenting from a legal certainty standpoint on some aspects of the proposals because of the lack of detail in the consultation paper, which has made it unclear in places what precisely is being proposed. This letter describes both the legal uncertainties and the lack of proposal clarity under their respective headings below.

Legal uncertainties

The FMLC has identified two issues of legal uncertainty in the proposals. The first of these concerns the requirement that the interests of certain creditors are "adequately protected" where a court sanctions a moratorium (Proposal B) or where new secured charges are created in an administration or CVA (Proposals D and E).¹ This wording appears to derive from the US bankruptcy regime on which these proposals are based; and a test to determine whether the requirement is satisfied in the US has been developed over a number of years in the US courts. It is not clear from the consultation paper whether it is proposed that this same test will be adopted in the UK and this is an area in which further clarity is required. However, the FMLC would note that it might not be possible to transplant a judicial test effectively from one jurisdiction to another without giving rise to significant legal uncertainty. The development of the test in the US will have been influenced, for example, by the particular nuances of US law and the concerns of the US financial markets, which may be very different from those in the UK.

The second issue of legal uncertainty concerns the relationship between the insolvency practitioner and the directors of a company where application is made by the directors for a

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Paragraphs 44, 65 and 73

court sanctioned moratorium, which would be available to all companies under Proposal B. According to the consultation paper, this application should be supported by a statement from an insolvency practitioner that, in his view, the company satisfies the tests which are prescribed for obtaining a moratorium, including, for example, that sanctioning a moratorium would be in the interests of creditors as a whole. In addition, the insolvency practitioner is required to report to the court, as soon as practicable, in the event that circumstances change so that these tests are no longer satisfied.² However, it is not clear what measures will be put in place to enable the insolvency practitioner to comply with this latter requirement. The consultation paper provides no detail, for example, as to the degree of scrutiny which the insolvency practitioner should exercise over the company for this purpose, whether the directors will be under an obligation to provide the practitioner with relevant information or what timescales would apply to such an obligation. Legal uncertainty will undoubtedly arise if the duties of both director and insolvency practitioner are not properly considered in this context and set out in legislation.

Lack of proposal clarity

First, it is not clear what effect the proposals are intended to have on CVAs. As things stand, CVAs are not intended to affect secured creditors and unless a secured creditor specifically agrees to such an arrangement, he is not bound by it. However, under Proposal E (“Greater ability to create new secured charges in a CVA”), any rescue finance provider would have priority over any existing floating charge holder for the repayment of money owed and, in certain prescribed circumstances, the new finance can be secured as a first charge which ranks ahead of other fixed charges.³

The FMLC would also like to be given further clarification of Proposal F, “Cessation of certain asset based lending (ABL) arrangements on administration or CVA”. According to the consultation paper, this proposal would limit a floating charge or an ABL agreement entered into before an insolvency event to assets acquired or “book debts arising” before that insolvency event takes place.⁴ It is unclear however when a book debt “arises” in the case of company receivables. A book debt may arise, for example, when an invoice is issued or when a service is rendered; and the lack of clarity in this respect would cause uncertainty where a company becomes insolvent after it has invoiced a customer for a service which has yet to be performed. The FMLC would expect that future receivables are likely to be particularly problematic in this context. In addition, under Proposal F, the floating charge holder, or the other party to the ABL agreement, would have the right to appeal to the Court if it felt that it was being “unfairly treated”.⁵ However, there is no explanation as to the criteria which would be used to determine unfair treatment in this context.

The consultation paper refers elsewhere to various restrictions as to the type of company that is eligible for a moratorium whilst a CVA is being put in place.⁶ These restrictions are contained in Schedule A1 of the Insolvency Act 1986;⁷ and you may recall that the FMLC was a strong advocate for the introduction of the capital markets exemptions at the time that the Enterprise Act 2002 created a new administrative regime for small companies. The consultation paper states that, under Proposal A, these restrictions would apply also to medium and large-sized companies.⁸ It is self-evident that they should apply also to the proposals to introduce a court-sanctioned moratorium, debtor-in-possession financing and super-priority, but it is unclear whether you intend them to do so.

Another concern, which the FMLC expressed in its letter to the Insolvency Service of 25 July 2008, is the compatibility of the proposals with European law. In order to implement the proposed regime effectively, it would be necessary to avoid any conflict with legislation at the European level and, in particular, the Settlement Finality Directive (Directive 98/26/EC) and

² Paragraph 46-47

³ Paragraphs 73-83

⁴ Paragraph 85

⁵ Paragraph 85

⁶ Paragraph 42

⁷ Insolvency Act 1986, Schedule A, paragraphs 2, 3 and 4

⁸ Paragraph 42

the Financial Collateral Arrangements Directive (“FCAD”) (Directive 2002/47/EC). It is evident that the FCAD, for example, would require an exemption from any administration moratorium in respect of the collateral arrangements to which it applies. However, there is no consideration of this issue in the consultation paper.

It appears likely that the proposed regime will not have retrospective effect. In this case, the existing regime will continue to apply to security arrangements which are entered into before the proposed regime comes into force; and security arrangements entered into after that date will be subject to the new regime. Further clarification will be required as to how these two regimes will interact, particularly where separate security arrangements in place over the same pool of assets are subject to the different regimes. Notwithstanding this, the FMLC would strongly object to any proposal that the regime should be made retrospective in its effect, since it may then affect security arrangements in place before information regarding the new regime was made public.

The proposed legislation may also be in breach of article 1 of Protocol 1 of the European Convention on Human Rights, since it provides retrospectively that a person may, in certain circumstances, be deprived of his interest in property as a secured lender or as the holder of a negative pledge. Under article 1, a person may be deprived of his possessions only where this is in the public interest and subject to the conditions provided for by law and by the general principles of international law. This has been interpreted to mean that any interference in a person’s property rights must satisfy, amongst other things, “the qualitative requirements of accessibility and foreseeability”.⁹ It is clearly difficult for the proposed legislation to satisfy these requirements where it was not discoverable at the time that any affected security interest was granted.

The FMLC would welcome the opportunity to discuss this further if that would be useful.

Yours sincerely

Joanna Perkins

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The UK Parliament Joint Committee on Human Rights, Twelfth Report –
<http://www.publications.parliament.uk/pa/jt200304/jtselect/jtrights/93/9305.htm>