SLAUGHTER AND MAY

BRIEFING
MARCH 2015

Are essential suppliers still holding insolvent companies to ransom?

PROTECTING ESSENTIAL SUPPLIES

The law has for some time prevented certain providers of essential supplies (gas, water, electricity) from holding insolvent companies to ransom by demanding payment of outstanding charges as a condition of continued supply. Legislation extending these measures is due to come into force on 1 October this year. IT services have been added to the list of 'essential' supplies, to reflect modern commercial reality. Clauses in essential supply contracts entered into on or after 1 October that provide for termination or more onerous payment terms on account of a business entering certain rescue procedures are also rendered ineffective. Suppliers are well protected, as they can insist on a personal guarantee from the office holder as a condition of supply. In addition, in the case of administration, payments incurred after the process commences should rank as expenses of the administration. This means they will be paid in priority to most other claims, including the administrator's own claim for remuneration. But do these measures go far enough? The list of suppliers the law deems 'essential' is still short, and others not on the list may still be able to hold viable businesses to ransom.

HOW ROBUST ARE OUR RESCUE PROCEDURES?

Things are looking up for the UK economy. The recovery seems to be entrenched, and business confidence is growing. But that doesn't mean that all is rosy; outside times of financial crisis, good businesses can still fail, and the tools a country has for rescuing viable businesses have a vital role to play in a well-functioning economy. This is a sensible time to focus on our corporate rescue procedures, both to see how well they withstood the crisis and to ensure that they will meet their objectives in more stable times. Despite legislative efforts, the rescue culture is not as ingrained here as some would like: champions of the US model, for instance, would love to see a US Chapter 11 style process introduced in the UK – that is, a debtor-in-possession rescue process with plenty of protections for the failing company. Others advocate more piecemeal reforms of our existing procedures, perhaps by incorporating certain cherry-picked aspects of Chapter 11.

One such candidate is the Chapter 11 stay. A moratorium or 'stay' is a legal shield that protects a company in distress by preventing creditors and other interested parties from asserting the full range of their rights against the company. In a restructuring, this gives the company breathing space to turn around its fortunes. Some English rescue procedures already incorporate a stay, but the Chapter 11 stay is considerably wider in scope. Protecting a wider range of essential supplies brings us one small step closer to a Chapter 11 style stay, but should we go further?

THE ENGLISH STAY

Not all insolvency processes benefit from a stay – for instance administration does, but schemes of arrangement do not. It varies a bit depending on the process, but in broad terms the stay prevents creditors and other parties from taking legal action against the company – such as seeking to recover debts, enforce security or repossess goods (unless the court orders otherwise). But even where a stay does apply, contractual provisions that provide for a contract to terminate if the counterparty becomes insolvent or enters a rescue procedure are, subject to the exceptions for essential supplies discussed above, perfectly acceptable. This is, theoretically at least, an important contractual freedom. In an ideal world, it allows businesses to manage the risk of counterparty insolvency, not something that should be interfered with lightly. For instance, it allows a business to be confident that, so long as it has a properly drafted contract, it will not have to continue supplying goods and services to a counterparty that becomes insolvent.

However, in reality, parties often do not often think in much detail about what will happen if their counterparty encounters difficulties at the time they are negotiating contracts, and it's not uncommon to find that the event that actually occurs was not contemplated by the insolvency provisions that are included. Furthermore, parties may have little choice but to accept standard terms and conditions with little modification to the insolvency provisions, whether because of insufficient bargaining power or because it simply would not be practical or cost-efficient to negotiate the details of every contract.

THE US STAY

In the US, a Chapter 11 insolvency procedure is also accompanied by an automatic stay, but it is significantly wider in scope. In addition to the protections afforded by the English stay, counterparties are largely prevented from terminating contracts with the company that has sought Chapter 11 protection on grounds of insolvency alone, whether or not they are 'essential' suppliers. The benefit to the company is clear: if counterparties who would otherwise jump ship stay on board, its chances of turning around its fortunes are significantly improved. The downside is a significant erosion of freedom of contract for the counterparties.

GETTING THE BALANCE RIGHT

In any business rescue, ensuring continuity of essential supplies is crucial. If the utilities and the internet are cut off, the turnaround prospects are clearly bleak. However, most operating companies will have other supplies which are essential for their business. Milk is arguably as crucial to an ice cream manufacturer as electricity. So should the protection of the stay be extended to prevent termination on grounds of insolvency for a far wider category of contracts, as it is in the US?

This would clearly benefit the struggling company, ensuring that it had a genuine breathing space to work through its difficulties. It might help increase the number of businesses that emerge from administration as a going concern. But it would be a significant erosion of the position for suppliers, and inevitably, not all of the businesses that benefited from the stay would turn out to be viable.

However, it would be possible to extend the scope of the stay so that it rendered void termination clauses in a far wider class of contracts while ensuring that suppliers are adequately protected. As with essential supply contracts, debts incurred to the suppliers after the administration started could be classed as expenses of the administration. This means that, if the administrator decided to continue with a contract, he would be obliged to pay the suppliers ahead of all other creditors, with the exception of fixed charge holders. The suppliers' claims would also rank ahead of the administrator's own claims for remuneration – which should make the suppliers feel pretty comfortable that funds would be available! Administrators would have greater scope to rescue the business, as crucial contracts could remain in place, and the only thing suppliers would lose is the opportunity to try to hold the company to ransom by refusing to continue to supply unless they receive better terms – and that to us seems to be a fair trade-off for a more effective rescue culture.

The new legislation referred to is the Insolvency (Protection of Essential Supplies) Order 2015, which was laid before Parliament on 9 February 2015 under sections 92(5) and 95(4) of the Enterprise and Regulatory Reform Act 2013, and, subject to Parliamentary approval, is due to come into force on 1 October 2015.

If you would like further information on any of the issues raised in this briefing please contact Ian Johnson, Tom Vickers, Richard de Carle, Nicky Ellis or your usual contact at Slaughter and May.

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