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Contracts and insolvency – a transformational change

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New statutory provisions retrospectively change the way many existing and future contracts work. Businesses urgently need to look afresh not just at supply arrangements but also many other significant transactions of which the supply of goods or services forms part.

Background

The Corporate Insolvency and Governance Act 2020 (the Act), was first published as a Bill on 20 May 2020, fast-tracked though Parliament and came into force on 26 June 2020.

The Act introduces significant permanent and temporary measures which are intended to help companies who may be suffering from temporary difficulties due to the COVID-19 pandemic. According to the Act's explanatory notes "*the overarching objective [...] is to provide businesses with the flexibility and breathing space they need to continue trading during this difficult time.*"

This alert deals with significant changes which the Act introduces to the operation of contracts (including those already in force) under which goods and/or services are supplied (subject to certain limited exemptions).

What contracts are caught?

Any contract which involves the supply of goods or services[1] to a "company". The definition of what type of "company" is covered by the new rules, generally, depends on how "company" is defined for the relevant insolvency process.

The new law is not limited to contracts which only cover goods or services. So, for example, business transfer agreements which include the sale of any assets, stock, consumables or other goods would appear to be caught. Equally IP licences which also involve the provision of some services will be within scope. And in many cases, the supply of goods or services will be an integral part of a wider transaction such as a joint venture or corporate acquisition.

[1] The Act is inconsistent in its application as some of the prohibitions apply to contracts for the supply of goods or services, but others apply to the supply of goods and services.

Is the Act retrospective?

Yes, the Act is not limited to new contracts and so applies to any contract within its scope, even if that contract already existed before 26 June 2020.

Termination for insolvency clauses now largely ineffective

If a company enters into a "*relevant insolvency procedure*" on or after 26 June 2020, a person supplying any goods and/or services to that company will no longer be able to rely on a contract term entitling the supplier to terminate the contract because the company becomes subject to such a procedure. This means the contract will continue and both parties will continue to be bound by it. The Act expressly prohibits making the continued supply of goods and/or services to a company after that company has entered into a "*relevant insolvency procedu*re" subject to the payment of any outstanding charges for supply which accrued before the procedure began.

As above, this will not be limited to traditional supply agreements. So, for many business purchase agreements, the seller will no longer be able to automatically rely on a clause entitling it to terminate the deal if the buyer becomes insolvent between exchange and completion.

Scope of prohibition goes far beyond termination

The rules go much further.

A person supplying goods or services to a company which enters into a "*relevant insolvency procedure*" will no longer be able to rely on a contract term entitling it to do "*any other thing"* because the company becomes subject to such a procedure.

This would include a provision entitling the supplier to withhold deliveries from an insolvent customer if the trigger for that right is the entry into the procedure. It could also extend to, for example, a put or call option existing under a multi-party venture agreement of which the supply of goods or services forms part.

Non-insolvency related termination rights impacted as well

The Act also provides that where a right for a supplier to terminate the supply of goods and/or services to a company arises and then the company becomes subject to a relevant insolvency procedure, that pre-existing and unrelated termination right is suspended.

So, for example, if a company breaches a warranty that it is entitled to licence key IP or provide personal data to a supplier, the supplier will not be able to terminate on the basis of that breach if the company becomes subject to a relevant insolvency procedure before termination has taken place.

By contrast, the supplier would be able to terminate on the basis of an unrelated breach which takes place once the relevant insolvency procedure starts. So the position for continuing or repeated breaches will be particularly complicated.

What is a relevant insolvency procedure?

A "*relevant insolvency procedure*" includes the new moratorium (introduced by the Act), administration, administrative receivership, CVAs, liquidation, provisional liquidation and the new rescue plan proceedings (but not schemes of arrangement).

What isn't caught?

The relevant sections of the Act only apply where the company which is the recipient of the goods and/or services goes into a relevant insolvency procedure. So, for example, it will not prevent the exercise, before a relevant insolvency procedure is initiated, of a provision allowing the supplier to terminate if the customer to is unable to pay its debts when they fall due.

Are there exceptions?

It is still potentially possible to rely on the termination and other rights described above if the supplier can satisfy a court that a prohibition would result in "hardship" for the supplier or with the consent of the relevant office holder or the company (depending on the insolvency proceeding).

Many financial services arrangements are exempted. In addition, the coming into force of provisions relating to certain small suppliers is delayed until 1 October 2020.

The impact of the new rules

The impact of the new rules is likely to be significant, particularly given the retrospective nature of the new rules, their breadth and ambiguity.

Suppliers won't simply not be able to terminate an agreement when their customer enters a relevant insolvency procedure – they will also risk being in breach of contract if they fail to continue to supply.

The approach to the management of existing contracts will need to change significantly. New contracts involving an element of supply of goods and/or services will need to be negotiated and drafted to take account of the new rules. Amongst other things, it is likely we will see a growing trend toward pre-insolvency triggers. And, as stated above, where a supply arrangement forms part of a wider transaction, the change may fundamentally alter the overall status under that wider transaction.

Recommended actions

- Review and redraft all forms of contract typically used in a business, which involve an element of supply of goods and/or services, so they are fit to be used under the new law;
- Review contract management processes and procedures and retrain those responsible for managing contracts to ensure that they understand the implications of the Act;
- Review and assess all existing material contracts to identify changes to the way they will need to be managed going forward;

- Improve, if necessary, financial monitoring of counterparties to get earlier warning of likely difficulties; and
- Assess the impact of the changes on any significant corporate, commercial or finance transaction to which a company is a party and which involves any element of the supply of goods or of services.

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