SQUIRE PATTON BOGGS

Lenders, Did Someone Move the Goalposts?

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Monitoring Winding up Petitions

While not an everyday occurrence, a company being issued with a winding up petition is an eventuality that all providers of finance, whether on a secured or unsecured basis, will prepare for.

From a contractual perspective, facility agreements will include specific monitoring information covenants as part of the core relationship housekeeping, supported by a hard backstop of event of default triggers, with rights for debt acceleration, and (if applicable) security enforcement operating in tandem from that point.

Lenders, account banks and UK clearing banks have well-established and rigorous systems in place to monitor the advertising of winding up petitions in the London Gazette, that will also flag winding up orders being granted. Those monitoring systems are utilised not least to avoid the disposition of assets between the petition being issued and winding up order being granted, but also as an early warning system to consider whether to take enforcement or protective action.

But, with developments in how insolvency searches are undertaken, is the frivolous or vexatious caveat to the winding up petition event of default redundant and a hinderance to lenders, and are the monitoring systems still enough?

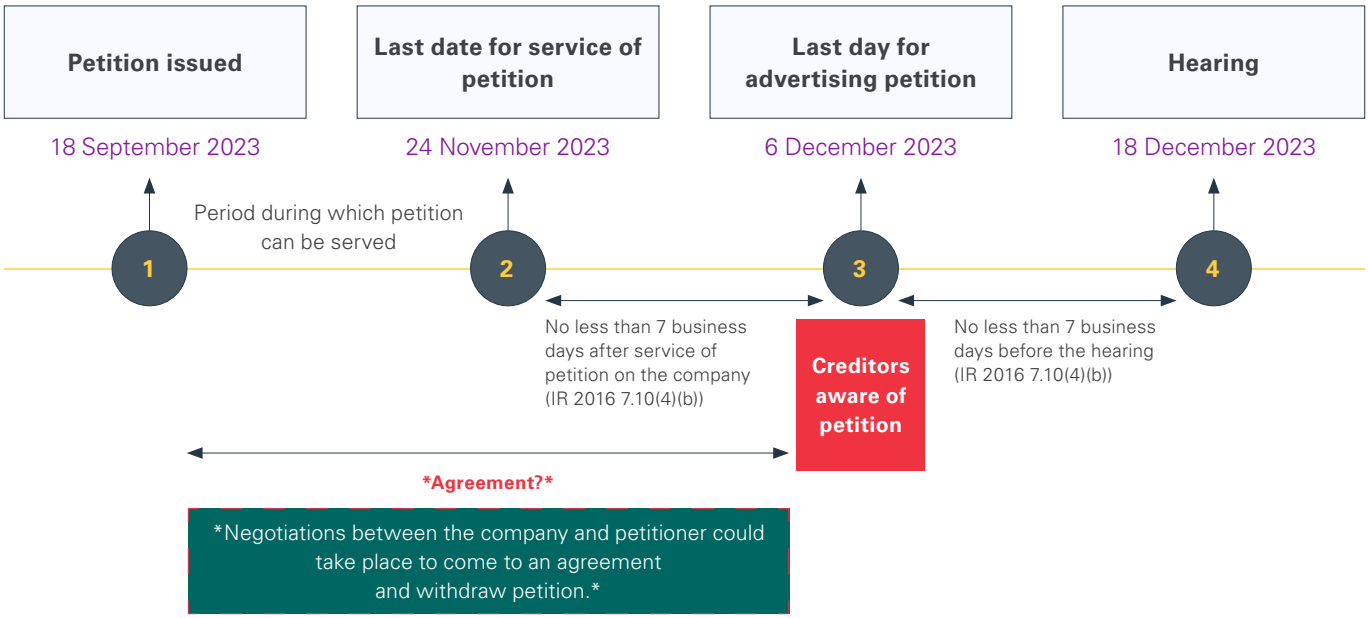
Awareness of a Winding Up Petition

Historically, a winding up petition would only become public knowledge when the petition was advertised in the London Gazette. Even a prudent lender with rigorous monitoring systems might not have become aware of a winding up petition until several weeks, or even months, after the issuance of the petition unless notified by the borrower because of the limitations in the way that insolvency searches could be conducted.

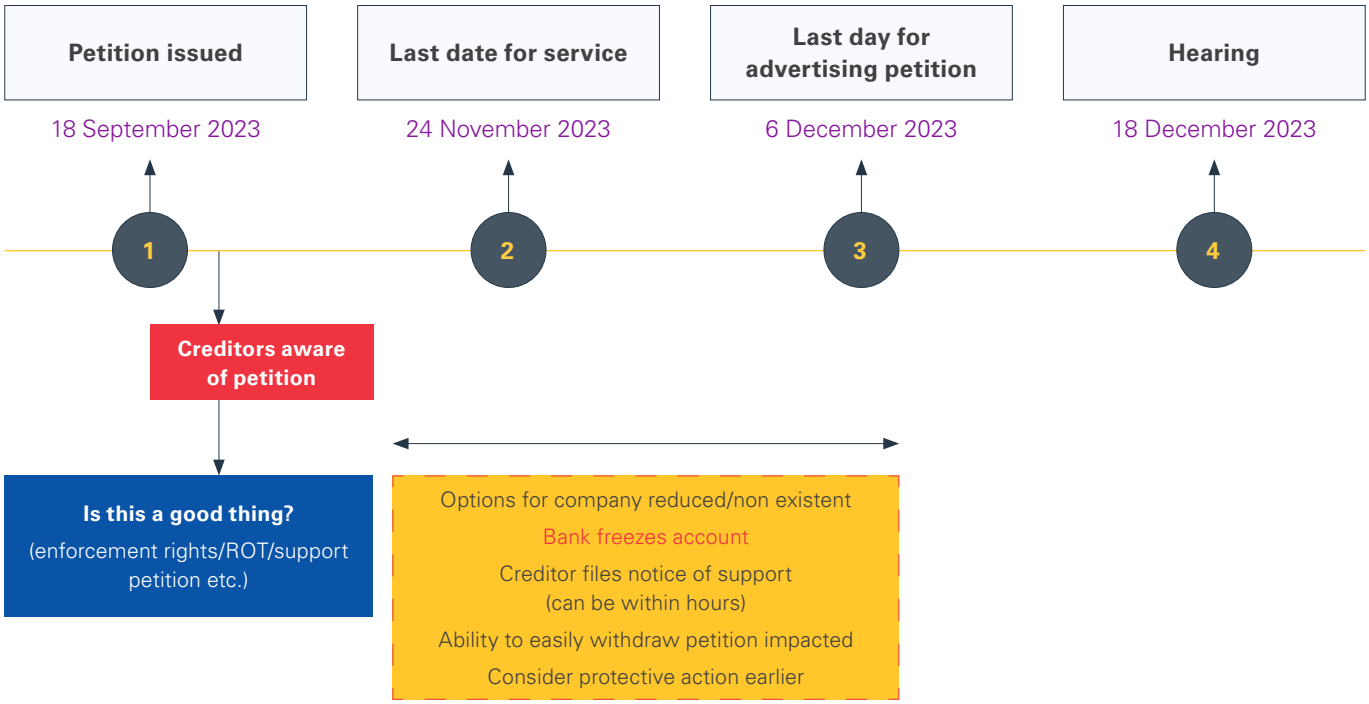
However, it has now become largely academic when a winding up petition is advertised because online resources that are freely available to the public mean that the fact that a winding up petition has been filed is in the public domain almost immediately after filing with the court (potentially even before it has been formally served on the company, and certainly before it has been advertised).

As is shown below, a lender (and a borrower's other creditors) may now be aware of a winding up petition significantly sooner than was previously possible. This has both advantages and disadvantages to lenders and borrowers.

Historical Timeline



Current Timeline



Most standard finance documents include a caveat to the winding up petition event of default, which prevents, or cures, the event of default where such petition is frivolous or vexatious and is discharged, stayed or dismissed within, for example, 14 days of issuance. What this effectively means is that a lender cannot call in a debt or enforce security during this period where a borrower has challenged the petition or notifies the lender that it intends to challenge the petition. Previously, this would have been less of an issue, as a borrower's other creditors or credit insurers for such creditors may never become aware of a frivolous or vexatious petition – the borrower having dealt with the petition, and it being dismissed before advertisement.

However, with the immediate publicity of winding up petitions, a lender may now take the view that it needs to take protective action much earlier than it might have previously done, given that other creditors may support the petition (whether vexatious or not) as soon as it is presented. However, early action is likely to be hampered by the standard restrictions in finance documents.

Immediate protective action has both pros and cons:

Pros	• Accessible information gives creditors early warning signs of financial distress, which can bring parties to the table to resolve sooner. • Account banks can freeze accounts earlier, preventing disposition of assets that might otherwise be clawed back by an insolvency practitioner if the borrower is wound up. • Where available, lenders can exercise set-off. • Lenders are less liable to losing out on assets to other creditors or negotiation opportunity to refinance and/or restructure – time is precious.
Cons	• Other creditors and suppliers can easily find out about the petition and support it. This is likely to hinder efforts by a lender to resolve financial distress and prevent the business collapsing because a petition cannot be withdrawn where there are supporting creditors. This will extend the life of the petition and the existence of other supporting creditors will need to be factored into negotiations with borrowers. • It is arguable that the delay in enforcement for frivolous or vexatious petitions no longer exists. However the provisions remain prohibitive on a lender taking action during this period, potentially putting the lender's position, and likely return, at risk. • While a frozen account cannot make payments, it also cannot receive payments. Further, while early freezing may prevent dissipation of assets, there is a risk of insolvency becoming a self-fulfilling prophecy, as frozen accounts will put the trading capabilities of the business at risk, where it may otherwise be avoided.

The above analysis is subject to any specific additional rights which may exist in a loan document, which allows a lender to take certain action where a "Default" exists, which has not yet become a full "Event of Default".

Questions a Lender Should Be Considering

Ultimately, in practice, it no longer matters when a winding up petition is advertised, as petitions are in the public domain from day one. Lenders should, therefore, consider:

- **Are there early signs of distress? Monitoring and knowledge of a borrower's ongoing financial health is key** – Lenders should ensure that the monitoring requirements in finance documents are robust and sufficient, although relying solely upon rights in the finance documents to receive financial information relies on the borrower adhering to those terms. Lenders should think about proactively engaging with their advisors and borrowers at the earliest sign of distress to have the best possible chance of retaining control of the situation and avoiding liquidation.
- **What is the risk to an account bank?** – Are internal procedures sufficient when a winding up petition becomes known? The payment and receipt of money between the issuance of a petition and a winding up order being made may be deemed void, with a liquidator seeking to recoup proceeds directly from the bank, where the account bank knew of the petition's existence. Further, the payment into a company's overdrawn bank account, or the repayment of loans or other funding arrangements after the commencement of winding-up will be a disposition within the meaning of section 127(1) of the Insolvency Act 1986 because the payment reduces the company's indebtedness to the bank – these payments will also be susceptible to challenge.
- **Who are the other known creditors?** – It is worth considering whether there are other creditors, such as HMRC, which are not constrained by contractual protections preventing immediate action. Are there other third-party threats to the stability of the financial circumstance of the borrower?
- **How are borrowers monitoring their payment systems and cash flows?** – Does the borrower have sufficient monitoring systems to ensure creditors are paid on time, in particular smaller creditors or creditors that may be more likely to issue a winding up petition without notice to the borrower or in respect of which such early notice might simply be overlooked? Is a borrower on top of cash in and out in a manner that allows it to notice early signs of distress? The threat of a demand letter should be taken seriously (no matter what the size of the debt), as the consequences can be immediate and adverse; failure to respond to a demand letter can be used as evidence that a company is unable to pay its debts and be used as evidence to support the presentation of a winding up petition, which may subsequently be issued on very little notice
- **Does a borrower have robust payment systems?** – It will be more important for lenders to have confidence that borrowers have efficient and robust payment systems in place to avoid unnecessary issues of non-payment arising and that any disputes or issues around payments can be quickly escalated to the right level internally to avoid frivolous or vexatious situations wherever possible.

Key Contacts

John Alderton
Partner
M +44 788 505 8896
E john.alderton@squirepb.com

Roy Grist
Partner
M +44 792 160 0017
E roy.grist@squirepb.com

Matthew Ingram
Partner
M +44 782 520 4519
E matthew.ingram@squirepb.com

Paula Laird
Partner
M +44 797 694 0288
E paula.laird@squirepb.com

Jon Lent
Partner
M +44 771 492 2722
E jonathan.lent@squirepb.com

Monika Lorenzo-Perez
Partner
M +44 778 572 0439
E monika.lorenzo-perez@squirepb.com

Charlotte Møller
Partner
M +44 788 180 4970
E charlotte.moller@squirepb.com

Chris Roberts
Partner, Manchester
T+44 773 647 9569
E chris.roberts@squirepb.com

Devinder Singh
Partner
M +44 772 139 9625
E devinder.singh@squirepb.com

Tom Telford
Partner
M +44 792 160 0176
E tom.telford@squirepb.com

Rachael Markham
Professional Support Lawyer, Leeds
M +44 754 511 0781
E rachael.markham@squirepb.com

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