COVID-19, football & the threat of insolvency

The spread of COVID-19 across the world has led to the cancellation or postponement of some of the largest sporting events worldwide; Euro 2020 and the Tokyo Olympics have both been pushed back to next summer, Wimbledon was cancelled for the first time since the Second World War, and the Ryder Cup will now take place in September 2021. Closer to home, the disruption has been just as severe, with the temporary hiatus of supporters attending events in the domestic sporting calendar. It is the lasting financial damage caused by the pandemic, however, which is most concerning to many sporting bodies.

Various reports have identified underlying structural financial weakness within the English Football League (EFL). When this is combined with the overwhelming negative financial impact of COVID-19 it is likely that, even with clubs making full use of the available Government support packages, a large number of clubs will be driven towards and into insolvency.

This note looks at the current position facing the football industry and the possible restructuring tools available to assist those clubs in peril.

Football finances: The current situation

The financial outlook for football clubs within the EFL was, even before the onset of COVID-19, increasingly unstable and fragile. Available financial results for the 2018/19 season show that:

- Matchday income for Championship and League 1 clubs made up around 15% and 30% respectively of total revenues.
- Championship and League 1 clubs spent approximately 90% of all income on player/staff salaries. This figure was 60% for League 2 clubs.
- At an aggregated level, the Championship, League 1 and League 2 clubs had total liabilities which exceeded their assets. This means that on an aggregate basis the clubs in the EFL leagues are insolvent on a balance sheet basis.
- EBITDA (the standard metric for assessing cash flow) was negative in aggregate for all leagues below the Premier League.

As previous crises have shown, it is the clubs further down the footballing pyramid which are most at risk of insolvency. This is due to their reliance on gate receipts and merchandise, rather than broadcast income and sponsorship deals on which the larger clubs can continue to rely.

The Government's reversal of plans for a staged reintroduction of supporters into stadiums, originally planned for October 2020, will be severely felt amongst the lower tier of the EFL. With no proposed date of return, clubs also lack any degree of certainty as to when this income might start to recover. The call by the Football Supporters Association for a rethink of the ban on supporter attendance is of fundamental importance in securing the short-term viability of football clubs which rely upon these income streams. This will in turn impact investment in facilities and staff, including players, which increases the likelihood of deteriorating on-field performance and in the worst case could lead to relegation and further income reduction.

This state of affairs should be particularly alarming to all those boards of directors of clubs that are currently technically insolvent, as it raises the spectre of personal liability for those directors, should the clubs fail.

Once a director concludes that there is no reasonable prospect of the company avoiding an insolvent liquidation or an insolvent administration, then that director has a duty to take every step, which a reasonably diligent person would take, to minimise the potential loss to the company's creditors. If a director fails in that duty, the court can order the director to make such personal contribution to the company's assets as it thinks proper. That "contribution" could be a frightening number, depending on the level of loss suffered; this presents directors with the alarming, but realistic possibility of losing their current lifestyles, or even seeing their homes at risk.

Whilst the risk of personal liability for wrongful trading was temporarily suspended back in March of this year, as part of the Government's emergency measures, that suspension has now come to an end (as of 30 September 2020) and the risk of directors being personally liable for wrongful trading is once again a very real and live risk for all directors.

Working out the point at which there is no reasonable prospect of avoiding insolvency is a tricky balancing act and directors need to be constantly aware that there are two different tests of insolvency which apply: the "balance sheet test" - does the Company's liabilities exceed its assets, taking into account all its contingent liabilities, and the "cash flow test" – can the Company meet its liabilities as they fall due?

Based on the above, there will be a significant number of EFL clubs that are currently trading whilst technically insolvent, whose boards of directors are at risk of incurring personal liability for the losses those clubs are suffering.

Impact of insolvency within football – the need for restructuring

Insolvency law in England and Wales exists to protect creditors where a business continues to trade whilst there is no plausible prospect of repayment. Where a company is deemed to be insolvent (i.e. usually, that it cannot pay its debts as they fall due) certain creditors can seek to have the business wound up, with its assets being sold to repay these liabilities. Currently, there are restrictions on winding-up companies until the end of the year, so there is some degree of protection, albeit temporary.

In order to avoid liquidation, and in the absence of any viable financial route forward, a club must assess a range of insolvency and restructuring procedures to establish whether the club can rescued as a going concern. Typically, this will involve placing the club into administration or entering into a company voluntary arrangement (CVA) with its creditors, or a combination of both.

Whilst the EFL has rules (EFL Rules) to protect the competitions it governs, these now appear to be unlikely to deal with the shadow hanging over the future of English football. In its current form, the EFL Rules prescribe a 12-point penalty deduction for any club which enters into an "Insolvency Event" – the definition of which includes administration and a CVA, as well as other restructuring procedures, such as a scheme of arrangement (Scheme) with the club's creditors. In consequence, EFL clubs are unable to seek a compromise with their creditors to reschedule their debt repayments without incurring the points penalty, which in all likelihood is likely to result in the the club's relegation.

Moving forward: New tools for a new era

An inherent weakness of the use of a CVA in football insolvencies is that this mechanism cannot bind any creditor which holds security over the club's assets. Under a Scheme, a statutory procedure which allows a company to seek a compromise with its creditors, a class of creditor cannot be bound by the Scheme if less than 75% of that class does not vote in favour. In practice, this means that a football club is unlikely to be able to proceed with wholesale structural changes which do not satisfy the interests of each class of creditor.

Since the onset of COVID-19, the Government has passed the Corporate Governance and Insolvency Act 2020 (CIGA), which represents the most significant upheaval to the insolvency legal landscape in the last twenty years. It introduced two significant, permanent restructuring mechanisms under English law aimed at saving businesses and avoiding insolvencies.

1) The Restructuring Plan

This is a statutory procedure which allows a company to seek a compromise with its creditors. All parties are free to agree to any terms they wish, such as rescheduling and/or a reduction of debt repayments, group reorganisations and internal restructuring.

Whilst similar to a Scheme, the "cram-down" feature to a Restructuring Plan is a crucial distinction. This allows a struggling EFL club to come to a binding compromise with its creditors, even where some classes of creditor have voted against the proposals of the Restructuring Plan.

In consequence, a class of creditor can be bound to a Restructuring Plan even where it has voted against it, as long as certain other conditions are fulfilled. The crucial test is that they are no worse off under the proposed Restructuring Plan than they would be in the most likely alternative outcome (e.g. administration or liquidation). This significantly alters the restructuring landscape, and provides a new way for companies in distress to enter turnaround negotiations with their creditors. This means that unsupportive creditors could be forced to accept restructuring proposals that would otherwise fail, which represents a possible game-changer for clubs in distress.

We would note however that the current EFL Rules have not been amended to reflect the changes made by CIGA, and so it remains unclear whether use of a Restructuring Plan would trigger the points penalty without obtaining the prior support of the EFL Board.

2) The Standalone Moratorium (the Moratorium).

This provides eligible companies an initial 20 business day grace period (extendable to 40 business days by the directors) whereby the company enjoys protection from creditor enforcement action, as well as a payment holiday for certain pre-Moratorium debts (i.e. those which fell due before the club entered the Moratorium, or became due during the Moratorium under an obligation incurred beforehand). Previously, a club would have had to file for administration in order to make use of a similar moratorium period, which would have triggered the points deduction under the EFL Rules.

The Moratorium might provide the breathing space football clubs require to reorganise their finances without the overhanging threat of creditor enforcement action or having legal proceedings taken against them, whilst also, we hope, avoiding the points deduction in the process. However the Moratorium only provides temporary respite and so we see it as of limited assistance for football clubs.

A call for change

Given the unprecedented circumstances all EFL clubs now find themselves in, the FA and EFL are no doubt considering adopting practices which acknowledge the unique situation facing the football leagues. Whilst the EFL Rules help foster appropriate and sound economic practices and attempt to punish those clubs which act beyond their financial means, it would be reasonable to argue that the gravity of the current situation merits a relaxation of the existing penalties for clubs entering into an Insolvency Event caused by COVID-19.

The EFL Rules already provide that a club may appeal the points deduction on the grounds that the Insolvency Event arose as a result of "Force Majeure" (i.e. an unforeseeable and unavoidable event). There is also the carve-out to the definition of Insolvency Event (which therefore avoids the points penalty), where the club submits a scheme of proposals approved in advance by the EFL Board.

The EFL Rules therefore do include exceptions to the imposition of penalties on clubs employing restructuring mechanisms but we believe more can be done and we think it is the appropriate time for the EFL to act and remove any ambiguity.

The FA and the EFL could provide the foundations necessary to allow all clubs the breathing space to reorganise their finances free from the threat of being heavily penalised by a points deduction. An important step would be confirming that the use of the Restructuring Plan or Moratorium will fall outside of the definition of Insolvency Event within the EFL Rules. This would allow football clubs, which are facing unprecedented circumstances and the most challenging financial outlook, to utilise these new statutory restructuring tools to put into effect viable turnaround solutions, thus relying less on support from the Premier League and avoiding insolvencies in the EFL.

In the absence of such support from the FA and the EFL to help clubs in financial distress through this incredibly difficult time, multiple failures across all leagues is a very real prospect. Clear and decisive guidance is needed now, to give clubs the confidence they need that they can access the new restructuring tools that are available, without suffering the double injury of a severe points penalty.

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