UK GOVERNMENT LAUNCHES REVIEW OF CORPORATE INSOLVENCY REGIME; PROPOSALS INCLUDE NEW MORATORIUM AND 'CRAM DOWN' MECHANISM

OVERVIEW

During the final week of May the UK Insolvency Service launched its consultation '<u>A review of the corporate insolvency framework: A consultation on options for reform</u>'. The consultation, which runs until 6 July, seeks opinions on whether the UK's corporate insolvency framework requires modernising and improving. This is in light of international principles promoted by the World Bank and the United Nations Commission on International Trade Law (UNCITRAL), large-scale corporate failures over recent years as well as the enhanced focus on business rescue at a European level. The intention of the consultation is to "enable more corporate rescues of viable businesses and ensure that the insolvency regime delivers the best outcomes".

In this Special Report, the *Debtwire* legal analyst team looks at some of the key aspects of the four proposals subject to the consultation.

NEW MORATORIUM

The first proposal is a new restructuring moratorium to give companies breathing space, ie by staying certain creditor actions while stakeholders assess the options and devise a rescue plan. The idea is that the moratorium "precedes and acts as a single gateway to" various types of workout, including consensual agreements, schemes of arrangement, company voluntary arrangements (CVAs) and administrations. An eligible company's directors could opt to enter a moratorium if the business is suffering from, or anticipates, imminent financial difficulties or insolvency. The moratorium would be kick-started by filing papers at court (without a hearing).

Only 'eligible' companies could utilise the moratorium: a company would need to show that it is, or will imminently be, in financial difficulty or is insolvent. While the intention is not to limit eligibility by reference to size, certain types of company (including banks and insurance companies) would be excluded, as would those that have been in a moratorium, administration or CVA in the previous

NEW MORATORIUM (CONTINUED)

year or are subject to a winding-up order or petition. The company must also meet certain 'qualifying conditions', including being able to show that it is likely to have enough money to continue its business during the moratorium and that there is a reasonable chance that a compromise or arrangement can be reached with creditors. Should circumstances change during the moratorium, and the company no longer meets the conditions, the supervisor will end the moratorium.

The suggested duration of the moratorium is up to three months, with extensions available in certain circumstances. It would end if the company reaches an agreement with creditors (ie an informal workout), enters a formal insolvency process or if no solution has been proposed within the three months and the creditors do not agree to an extension.

The moratorium would be overseen by a supervisor, proposed by the directors, with the latter retaining control of the company. However, as well as the supervisor needing to be satisfied that the company is eligible at the start of the moratorium, the supervisor will have the ability to attend board meetings, request information and would approve any transactions outside the ordinary course of the company's business, as well as monitoring compliance with the qualifying conditions. To ensure independence, the supervisor would be prohibited from taking the appointment of insolvency office-holder, should the company subsequently enter a formal insolvency process.

In addition to the eligibility criteria, qualifying conditions and role of the supervisor, the review suggests certain additional protections for creditors. It proposes that extending a moratorium beyond the three-month period would require creditor support – the suggested threshold is 100% of secured creditors plus over 50% of unsecured creditors (in value) who respond to the extension request.

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NEW MORATORIUM (CONTINUED)

Additionally, creditors would have various rights including to apply to court within the first 28 days of the moratorium to challenge it, the ability to challenge actions of the company's officers if they unfairly prejudice creditor interests and the right to request information from the supervisor.

To encourage directors to use the moratorium, the review proposes giving them protection from liability for trading the company during the moratorium (as long as they comply with their legal duties, conditions for the moratorium etc). It is proposed that directors' duties remain unchanged during the moratorium, although the Government may introduce new sanctions for certain actions (eg not providing creditors with a copy of the moratorium application). A breach of a director's duties will trigger liability for potential disqualification.

Regarding costs, the review proposes that debts incurred in running the business during the moratorium, as well as the supervisor's costs, would be paid in priority as an expense of the process (akin to costs in an administration) and would be categorised as a first charge were the company to go into a formal insolvency process following the moratorium, offering some protection to those who deal with the business throughout the moratorium.

FLEXIBLE RESTRUCTURING PLAN

The review also proposes a "statutory, time-limited to 12 months, multi-class restructuring procedure to aid company rescue". This would include a 'cram' mechanism and it would be possible to bind secured creditors on the grounds that creditors would not be worse off than in a liquidation. The review envisages that such tools could either form a new type of plan within the existing CVA regime or a separate process. As with the moratorium, certain entities (including banks and insurance companies) would be excluded.

Under the proposed process, which bears various similarities to schemes of arrangement, creditors would be divided into classes, based on having similar rights or treatment. The company would propose the classes and the court would approve them, with creditors having the chance to challenge their class before the plan is put to the court for approval. The plan would require both creditor and court approval, with the court having discretion whether to sanction it. The review also sets out certain information that the plan must contain/criteria it must meet (including that the plan must be fair and equitable, which is described as meaning all creditors would be no worse off than in liquidation, secured creditors will be granted absolute priority on repayment of debts and junior creditors should not receive more on repayment than creditors more senior than them). An approved plan would be binding for all creditors. The court could reject a plan if the rights of opposing creditors would be slashed to less than in liquidation.

FLEXIBLE RESTRUCTURING PLAN (CONTINUED)

The court would also be able to overrule the class or classes that voted against the proposal and declare it binding if it considers the plan fair and equitable.

The Government proposes using the voting thresholds applicable to schemes (a majority in number representing 75% in value of the creditors or class of creditors). It would be possible to cram down dissenting junior classes. The two tests to ascertain whether a class could be crammed down would be: at least 75% (measured by value of gross debt) and more than 50% of each remaining class of creditors approved the plan; the plan is in the best interests of creditors as a whole – ie it recognises the economic rights of 'in the money' creditors and others are not worse off than in a liquidation scenario.

RESCUE FINANCING

The review sets out some possible options for rescue financing:

- Rescue finance in administration having super-priority status (ie ranking ahead of other administration expenses) – a proposition that has been considered previously. The Government seeks views on if the current regime and order of priority encourage rescue finance and if not what changes could be made.
- The ability to override 'negative pledge clauses' (broadly, where a borrower agrees with the lender not to grant further security over its assets without the lender's consent) if a secured lender unreasonably refuses to consent to new security which would not adversely impact it. This would apply in both debtor in possession rescues and administrations.
- Granting security to new lenders over charged property, with the new security ranking as either a subordinate charge, or where the existing charge holder does not object or the court permits, a first or equal first charge. Where the secured assets are insufficient to discharge the debts the shortfall would rank above preferential creditors and floating charge holders.

The review proposes that during the moratorium, administration, CVA or an alternative insolvency restructuring plan a proposal seeking rescue financing, with the new money lender(s) taking super-priority security, could be put forward. The granting of such security would need to be necessary to secure the new money, existing security holders would need to be adequately protected and the rescue financing would have to be in the best interests of creditors as a whole. Where the new money is not being provided by the existing charge holder, they would be asked to consent to the new security. If they did not consent, the office-holder or nominee would need to show that they are not being disadvantaged. The existing charge holder would have a right of challenge, to the extent the new security affected their priority.

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RESCUE FINANCING (CONTINUED)

The options put forward in this area are quite radical, and the Government is interested to hear any alternative options for encouraging rescue financing.

ESSENTIAL CONTRACTS

The review makes certain proposals aimed at helping businesses continue trading through the restructuring process. Certain insolvency events (such as a company entering administration) often enable a contractual party (eg a supplier) to terminate contracts. At times, suppliers may seek to adjust supply terms or demand 'ransom payments'. This can clearly hinder a company's chance of recovery. While existing legislation provides for continued supply of utilities as well as IT goods and services to insolvent businesses, the Government proposes to expand the ambit of contracts that may be categorised as 'essential'.

Under the proposal, companies entering certain processes (including the moratorium and the alternative restructuring plan in insolvency discussed above as well as administration and CVA) would be able to categorise certain supplies as 'essential', preventing those contracts from being terminated. This would be done by application to court. Responsibility for deciding which contracts are essential would lie with the office-holder (or the company when in conjunction with a moratorium). The decision would involve considering whether the continued supply would contribute to the success of the rescue plan, and the possibility of making reasonably priced alternative arrangements within a reasonable timeframe. A contractual counterparty would be able to challenge the application, requiring the court to sanction the application. The designation of contracts would be reviewed if the company enters administration after a moratorium and again if the administrators decide to liquidate all or part of the company.

COMMENT

The UK is a popular jurisdiction for debt restructuring; indeed over recent years foreign companies have increasingly resorted to UK procedures, in particular schemes of arrangement and administration. Persuasive factors include familiarity with UK restructuring processes, the sophistication of the English legal system and the (relative) certainty of outcome. Schemes can also be comparatively cost effective and the timeframe for completion may be shorter than other processes, such as the US Chapter 11 procedure. Additionally, schemes avoid the stigma of insolvency, given that they are not insolvency proceedings. The UK's regime is popular and seems to be working well, so is it a case of '*if it ain't broke, don't fix it*'? The changes proposed could affect certainty of outcome, speed and costs .

On the other side of the coin, as noted in the review, many of the UK's basic insolvency procedures have been largely unchanged since 2004, and a lot has happened since then. Harmonised insolvency standards

COMMENT (CONTINUED)

is on the European agenda and the Government's proposals are in line with the European Commission's current consultation, and bear similarities to the US regime. Further, many other European jurisdictions (including Spain, France, the Netherlands, Germany and Italy) have recently updated, or are in the process of reforming, their insolvency laws and the UK will be keen to ensure it does not lose its foothold as other jurisdictions play catch up.

More specifically, the moratorium could certainly prove to be a positive development, encouraging directors to take stock at an early stage. Although administrations and CVAs do already provide for moratoriums, the effects of the administration moratorium are limited, eg suppliers may still be able to terminate contracts, and the CVA moratorium is only available to certain small companies and is rarely used. Additionally, both are categorised as 'insolvency procedures' (in contrast to schemes of arrangement) and thus can have undesirable consequences, not to mention the stigma. While they can be combined with administrations, or the court can order a stay on particular actions while they are prepared, schemes alone do not provide for an automatic moratorium, or stay of proceedings (although we have seen schemes used to effect standstills in themselves see Metinvest and DTEK). In practice, many companies hoping to restructure will negotiate a consensual 'standstill' agreement with creditors and if the proposals came into effect it is likely that companies would continue to consult significant creditors prior to applying for the moratorium to get them on board with the restructuring plan.

The review recognises that capital structures have become more complex, and acknowledges the value of cram down procedures. Although the UK has two such procedures (CVAs and schemes of arrangement) the situations in which CVAs are useful restructuring tools are somewhat limited, given that they do not bind secured creditors (unless they agree to be bound, which is unusual) and provide no automatic moratorium (the optional moratorium is limited to small companies). Indeed, the review notes that in 2014 there were 563 CVAs with a 60% failure rate. Despite the flexibility of schemes, it is not possible to cram down entire classes, although there are structures that can be used to leave behind 'out of the money' creditors. The new procedure proposed would enable classes to be crammed. Combined with a moratorium, this could certainly be a valuable tool.

Rescue financing is an area where it could be argued that the UK regime lags behind. In contrast to other jurisdictions (notably the US) the UK does not have an established market for rescue financing, with new monies often being provided by existing lenders and security arrangements make granting security in favour of new lenders problematic.

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COMMENT (CONTINUED)

The Government's proposals to enhance access to rescue financing will clearly be beneficial to companies needing to restructure, with a more competitive rescue financing marketplace potentially driving down the costs of such new funds. However, initial borrowing costs may increase if lenders' security is compromised and many will no doubt consider the options which the Government is considering in this area fairly radical.

Although the proposals are clearly very debtor-friendly, they do provide various safeguards for creditors, eg the proposed eligibility requirements and ongoing qualifying conditions aim to prevent abuse of the moratorium. In particular, the consultation paper makes it clear that the moratorium is not intended to allow failing businesses to buy more time if there is no realistic chance of a rescue or compromise being reached. The proposed reform package may change creditor tactics, driving them into agreeing to a consensual deal and it is possible that creditors may feel that the protections do not go far enough and that the moratorium period is too long.

The review does not propose amending the UK pre-pack regime as it has recently been reviewed, as reported.

The consultation closes on 6 July and the Government will publish its response within three months of that date.

Source: A review of the corporate insolvency framework: A consultation on options for reform