Restructuring the R&I Regime

September 2018

It never rains but it pours

The August bank holiday weekend was shaping up to be something of a disappointment, the heatwave long gone and unseasonal black clouds overhead. The Government, presumably realising we all needed a little distraction from the miserable weather, chose the Sunday, August 26, to release its response to two consultations: its 2016 'Review of the Corporate Insolvency Framework', and the more recent proposals on Insolvency and Corporate Governance issued in March this year. The detailed document reveals that the Government intends to push ahead with some significant changes to our restructuring and insolvency regime.

2016 'Review of the Corporate Insolvency Framework' consultation

This consultation proposed the introduction of a stand-alone restructuring moratorium, further limitations of the use of 'ipso facto' clauses to protect supplies deemed essential to businesses in distress, the introduction of a flexible restructuring procedure, with provision for cross-class cram-down, and measures to incentivise rescue finance.

The Government intends to push ahead with the first three proposals, with some modifications. The rescue finance proposals received a luke-warm response and have been dropped.

The consultation was driven by a desire to promote business rescue and ensure the UK remained a restructuring jurisdiction of choice, with one eye on the World Bank rankings and the other on reform initiatives across Europe. However, it predated the Brexit vote, and was conceived in an era in which there was little serious contemplation of the idea that we might lose access to the EU framework for mutual recognition and enforcement of insolvency proceedings. The clock is ticking more urgently now and ultimately the UK's status as a restructuring jurisdiction of choice may depend as much on the realities of cross border implementation as on the contents of the toolkit.

2018 'Insolvency and Corporate Governance' consultation

This consultation put forward a number of proposals intended to reduce the risk of major company failures and toughen up the responsibilities of directors of companies in financial difficulties.

For instance, the Government suggested that when a holding company sells a financially distressed subsidiary, some degree of responsibility for the ultimate fate of that subsidiary should sit with the directors of the holding company. It also proposed introducing new measures to unwind transactions that 'unfairly' remove value from insolvent companies.

As we wrote in our briefing in March, the consultation gave rise to a number of concerns, including that some of the proposals could contribute to an environment of fear and drive value-destructive decision making, rather than encourage business rescue and bolster the protections available for vulnerable creditors.

The response indicates that the Government has adapted its position to take into account a

number, though not all, of the concerns raised by industry bodies and professional groups.

Corporate Insolvency Framework: key outcomes

Standalone moratorium

The Government intends to introduce a new moratorium. It will be a standalone procedure, similar in scope to the administration moratorium, and accessed by filing papers at court. In order to qualify, an eligible company must demonstrate that (1) it is at risk of insolvency, but not actually insolvent, (2) rescue is more likely than not, and (3) it has sufficient funds to carry on business during the moratorium, meeting current obligations as well as any new obligations it takes on while it is in the moratorium. A 'monitor', who must be an Insolvency Practitioner, will assess whether these criteria are met, but his/her role will otherwise be limited in scope.

The moratorium will last for 28 days initially, but can be extended. Extensions beyond 56 days would require the support of a certain proportion of secured and unsecured creditors (or court sanction if this is impracticable). Before then, creditor support will not be required, but may be a factor that the monitor takes into account when considering whether rescue is more likely than not. Creditors will be able to challenge the moratorium in court on the ground that the qualifying conditions are not met or of unfair prejudice.

We believe that the new moratorium could be a useful addition to the toolkit. However, the qualifying conditions will require further thought in order to avoid the risk of the procedure not being used in practice and it seems likely that a number of restructurings could still be implemented (e.g. in a scheme) without the need for a standalone moratorium. The procedure will also need to ensure it can compete with established alternatives such as the chapter 11 stay and European alternatives.

New restructuring procedure

The Government intends to introduce a new procedure, closely modelled on the scheme of arrangement. There will be no financial conditions set, and, as with schemes, creditors will vote in court-approved classes on a restructuring plan, which may be used for a wide variety of purposes. Within each class, support will be required from creditors representing 75 per cent in value, and from more than half of the total value of 'unconnected' creditors. The court must also sanction the plan.

The plan may allow for cross-class cram-down in certain circumstances. It is this feature which may make the procedure a distinct and valuable addition to the tool kit. It is also likely to cause the most teething difficulties. While in other areas, such as class composition, the plan will benefit from a detailed body of case law, in this one the court is likely to have a number of issues to consider. In particular, in determining fairness, the Government has decided to adopt a 'next best case for creditors' alternative valuation model. While this potentially allows an important degree of flexibility, it may well give rise to complicated valuation disputes. However, the English court has a strong track record of developing case law responsive to evolving market practice, so we would hope that these issues are surmountable.

It is not yet clear what the jurisdictional criteria for entry into a plan will be, and whether it will be accessible to companies that do not have their centre of main interests (COMIs) in the UK, as is the case with schemes, or whether it will adopt a narrower COMI test, as is currently the case for administration. The Government notes that it will continue to consider the issue of jurisdiction in the context of Brexit. If the plan is to bolster this regime's attractiveness from a cross-border perspective, there is likely to be a good argument for mirroring the scheme 'sufficient connection' test. However, while we agree with the Government that this issue needs to be considered in light of Brexit, we are concerned

that the proposed timeframe makes this difficult. The Government has indicated that intends to legislate to introduce the procedure as soon as possible, whereas it may be some time before it becomes clear what, if any, arrangements will be put in place to address mutual recognition and enforcement of insolvency and restructuring proceedings after Brexit.

Unenforceable Ipso-facto clauses

In the consultation, the Government proposed that companies in certain rescue and insolvency procedures could designate key contracts as 'essential', which would prevent counterparties from terminating them for the duration of that procedure. The Government has widened the scope of this proposal, and now intends to prohibit the enforcement of clauses that provide for termination on the grounds of formal insolvency in all contracts for the supply of goods and services (save for some exemptions for financial products and services). Termination on other grounds will still be permitted. The court may, exceptionally, allow termination on the ground of 'undue financial hardship'.

The extent to which this wide prohibition on ipso facto clauses facilitates company rescue, and whether it does so at the expense of others in the supply chain, remains to be seen. In principle, it is a significant erosion of parties' freedom of contract.

Insolvency and Corporate Governance: key outcomes

Sale of distressed subsidiaries

New measures will require that, before selling a financially distressed subsidiary, directors of the holding company should consider whether the *subsidiary*'s stakeholders would be better off if it were placed in an insolvency process. Failure to give due consideration to the interests of the subsidiary's stakeholders will become a ground for disqualification, if the subsidiary enters insolvent administration or liquidation within 12 months of the sale. Disqualified directors may also be required to pay compensation. Only sales of large subsidiaries (those that do not qualify as small or medium sized companies under the Companies Act 2006) will be caught.

The proposed measure is narrower in scope than originally envisaged. The look-back period has been reduced from two years, liquidators and administrators will not be given powers to bring actions, and the rather nebulous idea that the measure might be extended to target any act procured by the holding company that operates to the detriment of the subsidiary's creditors in the event of its insolvency has fallen away.

We remain unconvinced that the case for deviation from the basic principle of limited liability and separate corporate existence has been made out. We also believe that large groups generally do take appropriate legal and financial advice when considering the sale of distressed subsidiaries, and this often extends to detailed scrutiny of the rescue package on offer from the perspective of both the holding company and the subsidiary.

However, now that the policy decision has been taken, from a legal perspective the important thing is to ensure that the measure is framed in clear terms, and very careful thought is given to what directors will need to do to discharge their responsibility. Balancing multiple duties, particularly in times of financial difficulty, is challenging. It will be important that the measures make it as clear as possible what level of consideration the directors must give to the subsidiary's stakeholders and how they can satisfy the requirement in practice.

The Government has indicated that it will provide, through legislation or guidance, a non-exhaustive list of relevant matters, such as whether professional advice on the sale was obtained, and whether creditors of the subsidiary were consulted. Guidance is to be welcomed, but we hope that it will take into account practical

matters, such as avoiding disproportionate cost, the likely willingness of third party buyers to provide potentially sensitive information, such as turnaround plans, to the sellers, and the feasibility of consulting with subsidiary stakeholders if a fast deal is necessary to prevent value draining from the failing business.

If the measures are not clear and the guidance not practical, there is a risk that directors may take the cautious approach and decide that it is safer to allow subsidiaries to enter insolvency rather than risk disqualification and the financial burden of a compensation order.

Value extraction schemes

The consultation sought views on whether a new power should be introduced to allow Insolvency Practitioners to apply to court to reverse transactions which unfairly extract value from a company in the run up to insolvency, benefitting investors but disadvantaging creditors.

We are pleased that the Government has listened to those respondents to the consultation who noted that the proposed new powers would overlap with existing provisions, and risk causing additional complexity and confusion.

The Government instead intends to enhance the existing recovery powers available to Insolvency Practitioners. In particular it will (1) review the operation of section 244 of the Insolvency Act 1986, which targets extortionate credit transactions, and (2) amend the section 239 preference provision, which provides a remedy where a company has acted to prefer a creditor in the run up to insolvency, so that there is a presumption of insolvency where the transaction concerned connected parties. It will also work with stakeholders to clarify whether there are other provisions, such as those concerned with wrongful trading, which may benefit from clarification.

In general, we believe that reviewing these measures to check whether they are operating as intended and responsive to current market practice is a sensible and proportionate response. We hope that the Government will seek comments on any draft legislation it intends to bring forward, so that it can benefit from the experience of practitioners who have first-hand knowledge of these provisions.

Corporate governance and stewardship

The governance of group structures

The consultation sought views on whether stronger governance and transparency measures might improve oversight and control of complex group structures. It is reassuring that the response recognised that complex group structures can serve a number of legitimate purposes. The Government is not currently pursuing any specific measures, but instead intends, amongst other things, to continue working with the Financial Reporting Council to promote good group governance and consider whether any further measures, such as requiring groups of a 'significant' size to produce group organograms, would be proportionate, business friendly and beneficial.

Enhanced stewardship

The consultation asked what more could be done to promote more engaged stewardship and active risk monitoring by investors. In the response, the Government acknowledges that some avenues for reform would be better explored after various other initiatives have been completed, such as the upcoming FRC consultation on the revised Stewardship Code, the ongoing review of the FRC itself, and the implementation of the revised Shareholder Rights Directive. In the meantime, it intends to discuss various opportunities to promote good stewardship with interested parties, but makes no specific proposals for immediate legislative reform.

Review of rules on dividends

The Government intends to work with legal and accountancy bodies and business groups to explore the strength of the case for a comprehensive review of the UK's dividend regime, and has given an indication that it may introduce legislation to address some specific concerns, such as the practice of paying only interim dividends, and disclosure and explanation of capital allocation decisions, if investor pressure (and, in some cases, new reporting requirements) do not deliver sufficient progress.

Conclusion

Overall, there are a number of positive outcomes, in particular the new restructuring tools, which, if properly refined and developed, may well enhance our already well regarded regime. This in turn may help ensure that we stay competitive, and remain a restructuring jurisdiction of choice following Brexit, though as already discussed, issues of recognition and enforcement are crucial in a cross border context and cannot be solved by domestic legislation alone.

The Government has indicated that it intends to legislate on some of the proposals as soon as parliamentary time permits (though, in the context of Brexit, when it might permit remains to be seen). Some of the concepts are quite broad-brush, and will need a lot of work and further debate to translate them into detailed legislation. We hope that, given the significance of the reforms, the Government will release draft legislation, and allow sufficient time for detailed comment and feedback.

While we are not in full agreement with all of the reforms, the response to the consultations shows the importance of active engagement, as several of the more problematic elements of the original proposals have been dropped or adapted in light of respondents' feedback to date.

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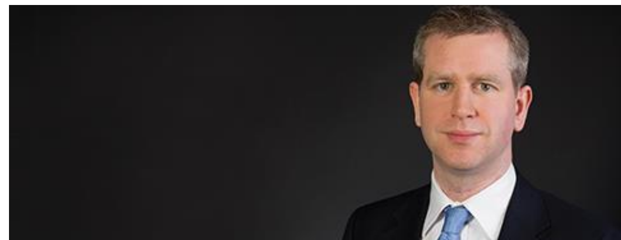

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