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Shaking Things Up: U.K. Government's Proposals for New Corporate Insolvency Toolkit

By Graham Lane and Alexander Roy*

The Insolvency Service has published a consultation on options for reform of the U.K. corporate insolvency framework. This article provides a summary of the key features of each of the four main proposals, as well as the responses to them received to date.

In May 2016, the Insolvency Service (a U.K. government agency) published a consultation on options for reform of the U.K. corporate insolvency framework. The four main proposals for reform put forward by the government are to:

(1) create a new, optional moratorium procedure for companies undergoing restructurings;

(2) develop a new cram-down mechanism to force dissenting creditors to accept a restructuring plan as well as the ability to bind secured creditors to a plan approved by a majority of creditors and by the English court;

(3) develop the availability of rescue financing by awarding it super-priority status in a restructuring or insolvency process; and

(4) expand the existing range of contracts deemed essential to businesses facing financial difficulties by limiting the ability of key suppliers to terminate their contracts (on "ipso facto" grounds) in an insolvency scenario.

If enacted, these proposed reforms would represent the first significant change to the U.K. insolvency regime in over a decade. Some of them are radical in their novelty. The stated intention of the government's consultation is to "enable more corporate rescues of viable businesses and ensure that the [U.K.] insolvency regime delivers the best outcomes." The deadline for responses to the consultation was on July 6, 2016; on September 28, 2016, the Insolvency Service published a summary of the responses and recommendations received.

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This article provides a summary of the key features of each of the four main proposals, as well as the responses to them received to date.

A NEW PRE-INSOLVENCY MORATORIUM PROCEDURE

The first proposal is a new restructuring moratorium to give companies breathing space by staying certain creditor actions while stakeholders assess their options and devise a rescue plan. The essential features of this new moratorium would be as follows:

- Entry into the standstill procedure would be optional at the discretion of the company's directors, acting as a gateway for the company's entry into a scheme of arrangement, administration, company voluntary arrangement ("CVA"), or a contractual compromise/consensual work-out with creditors.
- The moratorium would prevent enforcement of security and the appointment of an administrator. Arrears owed to creditors would be frozen, but the debtor would be obliged to meet ongoing trading costs.
- The moratorium would take effect through the filing of papers at court. No court hearing and no creditor consent would be required. Creditors (secured and unsecured) would have the right to apply to court within 28 days of the filing to challenge it.
- The moratorium would last three months, subject to agreement by 100 percent of secured creditors plus over 50 percent of unsecured creditors to extend it. It would end sooner if the company successfully reached an informal agreement with creditors or entered formal insolvency proceedings.
- The moratorium would be overseen by a supervisor (an insolvency practitioner/solicitor/accountant) proposed by the directors but directors would remain in control of the company.
- Not all companies would be eligible to take advantage of the new moratorium; only those which are on the cusp of financial difficulties or insolvent could use it. Banks, insurance companies/certain other financial companies would not be eligible, but otherwise the new moratorium would be available to all debtors regardless of size.
- Costs and debts incurred in running the business during the moratorium period, including the supervisor's costs, would be paid in priority to creditors as an expense of the process (similar to the treatment of professional fees/expenses in an administration) and would be characterised as a first ranking charge in the event of the company entering a formal insolvency process.

RESPONSES TO THE PROPOSAL

As part of the responses received from a range of interested organisations and individuals, over two thirds of respondents agreed in principle that the introduction of a pre-insolvency temporary moratorium would facilitate business rescue. However, the vast majority of respondents disagreed with the proposed length, extension and cessation mechanics of the moratorium, with most responses taking the view that the moratorium period should be shorter than three months. Several alternatives have been put forward, such as a 21-day period (subject to extension), or a variable period depending on the size of the company. Most respondents disagreed with a requirement for 100 percent secured creditor consent to an extension and were in favor of some form of majority consent requirement (for example, 75 percent in value and over 50 percent in number of creditors).

In practice, if the proposals came into effect, many companies seeking a restructure would continue (as now) to negotiate a consensual "standstill" agreement with creditors and to consult with significant creditors in advance of any application for a moratorium.

A NEW 12-MONTH RESTRUCTURING PROCEDURE AND CRAM-DOWN MECHANISM

A statutory, 12-month restructuring procedure has been proposed, to provide companies with the ability to bind secured creditors and cram down any dissenting classes of creditors. As with the proposed new moratorium, the option to introduce a restructuring plan would be available to all companies, regardless of size, other than banks, insurance companies and certain other financial companies. Key features of the restructuring plan would include:

- The company dividing its creditors into separate classes to vote on the plan (not unlike the existing scheme of arrangement procedure under Part 26 of the Companies Act 2006), based on the similarity of creditors' rights against the company or their treatment under the plan.
- The company would then apply to court for approval of the class composition. Provided the court agrees with the class constituencies, creditors would then vote on the plan by class, with over 50 percent in number and 75 percent in value of all creditors of each class required to vote in favor to approve the plan.
- As with a scheme, the company would then apply for a second court hearing to confirm the plan but also, where appropriate, to cram down and impose the plan on any dissenting creditor classes (a feature not

available under the scheme procedure). The court would only have power to cram down creditors if it was satisfied that:

- ○ at least 75 percent in value and more than 50 percent of each remaining class of creditors have agreed to the restructuring plan; and
- ○ the plan is in the best interests of creditors as a whole, in that it recognises/evidences that all creditors would be in no worse a position than they would be in a liquidation and junior creditors do not receive a distribution in excess of that available to more senior creditors.

If approved by the court, the restructuring plan would be binding on all creditors.

The proposals envisage that this new restructuring procedure could either form a new type of plan within the existing CVA regime, or it would be a separate process available to debtors.

RESPONSES TO THE PROPOSAL

Overall, the responses received to date supported a new cram-down mechanism and restructuring plan procedure, as well as the proposed voting thresholds for approval (which mirror those applicable in schemes of arrangement). The chief concerns which have been raised relate to the need to guard against any unnecessary infringement of junior creditor rights and whether the plan should operate as a standalone procedure (the favored approach amongst respondents), as opposed to being bolted onto an existing process, such as a CVA. Concerns have also been voiced around the most prudent valuation test to determine the fairness of a plan being crammed down on dissenting creditors, with the current proposal favoring a liquidation valuation as a minimum requirement. The government has promised to consider these issues further.

SUPER-PRIORITY RESCUE FINANCING

The review sets out some possible options for lending to distressed companies:

- Loans provided to companies in administration proceedings would enjoy super-priority status, ranking ahead of other administration expenses in the insolvency waterfall.
- The government is particularly concerned that negative pledge clauses discourage rescue finance and has proposed a mechanism for such

clauses to be overridden in circumstances where a secured lender unreasonably refuses to consent to new security which would not (objectively speaking) adversely affect it.

- Granting security to new lenders over property of the company which is subject to existing security, with the new security ranking as either a subordinate charge, or where the existing charge holder does not object or if the court permits, a first ranking or equal first ranking charge. Where the secured assets are insufficient to discharge the company's debts, the shortfall would rank above preferential creditors and floating charge holders.

RESPONSES TO THE PROPOSALS

The majority of responses received by the government disagree with its proposals for rescue financing. In the view of several respondents, it is misleading to suggest that a lack of debtor finance is inimical to the rescue of businesses and there is little market evidence to suggest that there is a shortage of willing lenders to provide funding to distressed companies. A concern has also been raised that borrowing costs may increase if lenders perceive there to be a risk of their securities being compromised by a rescue lender being awarded priority creditor status. Though it remains a commendable goal, if such financing comes at the expense of altering the existing creditor waterfall (and therefore creditor recoveries) it will be difficult for the government to strike the right balance between these competing interests.

EXPANDING THE RANGE OF CONTRACTS ESSENTIAL TO A DISTRESSED COMPANY'S BUSINESS

Under existing U.K. insolvency law, certain suppliers of essential goods and services, such as IT services, can be required to continue supplying a company notwithstanding its insolvency. The government is proposing to widen the scope of those contracts that can be deemed "essential" by enabling a distressed business to file a court application to prevent the use of "ipso facto" insolvency termination clauses in certain designated contracts. Responsibility for deciding which contracts are essential would lie with the officeholder (or the company if used in conjunction with the proposed new moratorium, summarized above).

The requirement for a relevant supplier to continue supplying its services to the company would remain in place (provided the company continues to pay for those supplies) until a restructuring plan was agreed upon or, if the company entered into a formal insolvency process, for as long as the officeholder deemed necessary. To provide some protection for suppliers, a contractor would have the

right to challenge its designation as an essential supplier by applying to court.

RESPONSES TO THE PROPOSAL

Although ensuring the continuity of essential contract supplies to distressed businesses is likely to be the least controversial of the government's proposals, opinion has been split amongst respondents over the preferred criteria for determining whether a contract is essential or not. Some have suggested that the proposal as currently drafted is too debtor-friendly whilst others question how such a provision would be enforceable on international suppliers. As a result of these concerns, the government has undertaken to refine this proposal.

COMMENT

Despite recent case law, which has helped to bolster the U.K. scheme of arrangement as an effective restructuring tool, many of the U.K.'s insolvency procedures have remained generally unchanged since 2004. Other European jurisdictions (including France, Germany, and Italy) have recently reformed, or are in the process of updating, their insolvency regimes and the government's reform proposals should therefore be welcomed for their potential to maintain the U.K.'s standing as a leading jurisdiction for creditors and debtors alike.

The introduction of a cram-down restructuring plan for the U.K. would represent a radical new development in English law, bringing it closer to resembling the restructuring tools available in the United States under Chapter 11 of the U.S. Bankruptcy Code. However, two important aspects of the government's proposals remain unclear in terms of their implementation in practice:

- First, the government has yet to make clear how the new restructuring plan would slot into or sit alongside existing U.K. insolvency procedures.
- Second, unlike the U.S., the U.K. does not have a sophisticated or tried-and-tested method developed by the courts for assessing competing valuations when determining the fairness of a plan (which is particularly important when junior creditors raise objections). There are a mere handful of English cases on this topic and the courts may therefore look to the content of any new legislation for detailed guidance.

To the extent the moratorium proposal is implemented, it will be important for the government to ensure that it is harmonized with existing U.K. legislation concerning the enforcement of security. For example, the Financial

Collateral Arrangements (No. 2) Regulations 2003 currently allow a creditor which has taken security over a company's cash or shares to enforce that security notwithstanding the moratorium that would otherwise be in place on that company's entry into administration proceedings. Any new legislation would need to take this into account as well as any other enforcement "loopholes" which would need to sit alongside, but which could also impede the effectiveness of, the new moratorium.

A final point to bear in mind on the proposals is a recurring concern raised in a number of responses received by the government: court overload. Many of the reforms propose introducing new court applications for debtors and creditors, such as opposing essential supplier status and the right to challenge a debtor's application for a moratorium. At a time when U.K. judges are already voicing concerns over court workloads and funding, it is questionable whether the introduction of additional inroads into the court system will be viable.

Once the government has finished considering in detail the responses it has received, the next step will be for it to consult further with key stakeholders, with a view to eventually setting out final proposals for possible inclusion in primary legislation.