Restructuring law reform back on the agenda

06 September 2018

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The 2016 consultation on reforms to restructuring law appeared to have stalled due to the impact of Brexit on the legislative priorities of the Government. However, a silver lining to the Carillion collapse is a renewed focus on insolvency which has brought the proposed reforms back onto the agenda.

On 26 August the Government published a response to the consultation process started post-Carillion. The response sets out proposed reforms, aimed at preventing major collapses, improving accountability and recovery of stripped value where collapses do happen and improving the tools available to companies to achieve rescue and restructuring. While an analysis of all proposals is beyond the scope of this commentary there are themes and issues which may have significant impact on the market which I consider here.

Restructuring law reforms

In 2016, the Government consulted on four potential reforms to facilitate the restructuring and rescue of businesses. These were:

- a moratorium to give companies breathing space to pursue a restructuring;
- the ability for companies in a process to designate critical suppliers who would be obliged to continue to supply;
- a framework for providing rescue finance akin to US DIP finance; and
- a new restructuring process with the ability to cram down dissenting junior classes in a manner that CVAs and scheme currently cannot achieve.

Of these, the Government has moved away (rightly, in my view) from a specific rescue finance framework beyond what insolvency priorities of payment currently enable. It is moving forward with the remaining three proposals to various extents.

Moratorium

The Government notes the practice of using successive notices of intention to appoint administrators as a means of protecting a company seeking a restructuring, and the courts have held this practice as invalid. A pre-restructuring moratorium is aimed at resolving the need for this practice, but will the proposal be successful?

The proposal provides for a moratorium similar to that available on administration to be obtained by an out of court filing, for an initial period of 28 days with the possibility of extension. An insolvency practitioner would monitor the moratorium as supervisor to ensure that creditors are not prejudiced. The supervisor would be obliged to terminate the moratorium if the company cannot meet its current liabilities. While more detail of exactly how the moratorium will work is required, the following points of note come out of the present position set out by the Government:

- The moratorium will not be available to a company that is “insolvent” and requires the company to continue to meet its current liabilities while the moratorium is in place. This suggests the role of the moratorium might be limited to protecting the company from financial creditors while seeking a financial restructuring, or where a restructuring of trade liabilities or rents is proposed, this will only be forward-looking. Although this arguably deems a company as “insolvent” and therefore ineligible, it would seem sensible and consistent with other processes that the moratorium could be used as a defence against overdue debts pre-dating the period. This will need to be clarified when the precise conditions for invoking the moratorium are met.

- This also suggests the practice of filing multiple notices of intention will be eliminated. A company may still need more than 10 working days' protection when seeking to plan an effective administration or pre-pack. However, in these circumstances use of the moratorium would seem difficult for the supervisor to approve, unless current liabilities are kept current, in what may be a preferential manner.

- The requirement for the supervisor to certify the ability of the company to trade without prejudicing creditors is one reason the exiting small companies moratorium has used been less than might have been expected. It remains to be seen whether the risks attendant for the supervisor are mitigated by the ability to terminate sufficiently, to make a supervisor role an attractive one to take.

- Potentially exacerbating the unattractiveness of the role of supervisor is that the supervisor would be precluded from taking an administration appointment if the restructuring being sought is not successful. In practice this could be a useful safeguard as it would encourage the use of a moratorium where there is a genuine restructuring prospect. However it may make the moratorium unavailable in borderline cases, where it would be of most use.

- The answer may lie in the identity of the supervisor. While the initial position is that this must be a licensed IP, the Government reserves the ability to extend qualification without primary legislation. This could open the door to the role of supervisor being taken by turnaround professionals or lawyers.

Designation of essential suppliers

The Government has previously proposed that in a moratorium or an administration, a company should be able to designate suppliers as critical. This would mean those suppliers would be obliged to supply during the term of the moratorium or administration, subject to being paid or their debts having appropriate priority on insolvency. At first blush this was a laudable attempt to block the use of a ransom position to leverage a better deal out of a company in distress.

That being said, being forced to continue supply where there may be significant outstanding debts could present a significant challenge and hardship for small suppliers, particularly against the

backdrop of risking losing a major customer. The Government originally proposed that court oversight and the ability to appeal a designation as critical would resolve this, although the time and cost of bringing such an application may make this prohibitive.

This is an area where the original proposals have been watered down. Rather than a company being able to designate critical suppliers that must continue, the Government proposes to block termination based on insolvency (including use of the moratorium). This would not preclude other bases of termination, such as non-payment so in practice it may be that this would provide limited protection as insolvency will rarely be the only trigger for termination.

It is a difficult balance to draw but my view, the presence of a supervisor or administrator in an oversight role could have provided an adequate safeguard to avoid abuse. The weakening of the reform in this area could be seen as a wasted opportunity.

New restructuring process

Further clarity is required on exactly how the new restructuring plan would work but all indications are that while a new standalone process, it will work broadly in the same manner as a scheme of arrangement with the added ability to compromise junior classes.

The Government proposes the cram down of junior classes should be based broadly on an absolute priority rule where no class would receive payment if the class above is not paid in full. They suggest this principle should only be deviated from if the court is satisfied this is necessary to achieve the aims of the restructuring, and is just and equitable.

While this mechanic may develop further, it’s currently difficult to see how this would work in practice. This would require creditors above the value break to remain unimpaired. This could result in a situation where the existence of a junior secured class of creditors means that unsecured creditors key to the ongoing business would need to be left unpaid, unless the court can be satisfied.

This issue aside there is a clear benefit in developing the flexibility of the current restructuring tools available to enable a cram down to be achieved solvently.

The key question and area for challenge will be that of valuation and of setting the level at which value breaks. This will always be an element of estimation unless a full marketing process has been run. An interesting development compared with case law on schemes is the valuation comparator is proposed to be the "next best alternative" rather than a liquidation outcome. This seems a logical and sensible approach in the circumstances.

Improvements to insolvency framework in the case of major failure

The post-Carillion consultation deals with initiatives in relation to corporate governance, to strengthen the skillset of directors and increase the involvement and stewardship of shareholders. In addition, certain proposals are made to deal with the aftermath of a failure, to challenge value extraction schemes and hold directors to account on dissolution, and for the sale of insolvent subsidiaries.

Extending powers to investigate directors to dissolution as well as liquidation closes a clear loop hole. The proposals around value extraction relate to tightening existing antecedent transaction controls, as well as modernising the way dividends can be declared.

More interesting is the proposal to hold directors of a selling company liable for a later insolvency of the disposed subsidiary. This provides for directors of the selling parent to be liable for the losses of the disposed subsidiary where:

- at the time of sale, the subsidiary is insolvent or would be insolvent but for guarantees provided by other group companies or directors;
- the subsidiary enters administration or liquidation within one years of completion (reduced from two years based on responses to the consultation);
- the interests of the creditors of the subsidiary have been adversely affected in the intervening period; and
- at the time of the sale the directors of the parent could not have reasonably believed the sale would lead to a better outcome than an immediate insolvency.

This proposal runs counter to the principle of limited liability and appears to be reactive to high profile failures rather than being grounded in principle. Responses to the consultation have highlighted the clear conflict that this places the holding company directors in between the interests of stakeholders of the company that they are directors of and those of the subsidiary. The Government response that such conflict will not exist where legislation requires directors to act with the interests of the subsidiary in mind do not convincingly address this point.

It would seem more appropriate to place the onus for deciding the solvency or otherwise of the subsidiary at the door of the directors of that entity. If the sale to a new shareholder will be prejudicial to creditors compared with an immediate insolvency then this is a decision for the subsidiary directors to make.

On the contrary, these proposals could severely hamper the ability to achieve the rescue of distressed businesses. They could also impact the opportunities available to distressed investors to buy stressed businesses to seek to unlock value from turnaround, where the shareholder directors are disincentivised to sell and risk liability if a turnaround plan entirely outside of their control is unsuccessful.

The Government recognises the measures should not result in deterring legitimate business rescue. It is possible there will be further clarification or amendment to mitigate the risks of the suggested approach, but as matters stand, unlike other proposals, this is not a reform that I consider necessary or desirable.

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