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ARTICLE

Proposed UK Insolvency and Restructuring Reforms: A Deeper Dive

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Synopsis

In volume 15 issue 5 of *International Corporate Rescue* we published a 'what you need to know at a glance' on the UK Government's August bank holiday announcement. The Government stated that new legislation for restructuring would be introduced as soon as parliamentary time permits. These measures could have a very significant effect on the UK's restructuring and insolvency framework – aligning (at least in theory) the UK's restructuring framework much more with the US Chapter 11 regime.

In this article, we delve deeper into the reform proposals and provide a critical analysis of the provisions (in so far as it is possible given that so far there is merely a Government announcement and no detailed drafting).

New restructuring tools

Two new restructuring tools will be introduced: (i) **a restructuring plan**; and (ii) **a restructuring moratorium**. The former represents a major change to the restructuring toolkit introducing cross class cram down and is an exciting and long-lobbied for development for the UK.

The restructuring plan

A new restructuring tool will be introduced, modelled on the scheme of arrangement in the Companies Act 2006, but with some very important differences. In terms of what the restructuring plan can do, the proposals are flexible, but with a minimum prescription as to what type of proposals may be put to creditors and shareholders. A plan may provide for a debt write down, debt postponement or 'a change in the management team'[1] – whatever is required in the commercial scenario. This breadth is good news.

So, what will the restructuring plan look like, how will it deviate from a 'traditional' scheme and, importantly, will it be worth the effort? The table [overleaf] sets out a comparison between the traditional scheme and the restructuring plan.

Who proposes the plan? The Government's intention is that it will be the company's prerogative alone to propose the restructuring plan. However, creditors and shareholders will have the ability to submit a counter-proposal if they disagree with the company's proposal.

Does the company need to be insolvent? The Government has listened carefully and, in line with the traditional scheme, there will be no financial entry criteria. This is to be welcomed as a company will maintain the flexibility to propose the plan when it is appropriate to do so.

Who has jurisdiction? Will the company need to have its centre of main interests in the UK or will the existing test for schemes of 'sufficient connection' be retained? On this, the announcement is vague and merely states that 'the Government will continue to consider the issue of jurisdiction in the context of the UK's departure from the European Union'. Whilst a little unhelpful, to be fair, there is little else we could expect at this juncture.

What is the process? Two court hearings will take place and creditors (and shareholders) will be divided into classes based on rights and interests (like in a scheme). Creditors will need to be provided with sufficient information to make an informed decision ('something like the explanatory statement used in schemes' to quote the Government). Creditors and shareholders may challenge class formation at the first court hearing. Once satisfied, the court will order that a vote of creditors and shareholders is to be taken on a specified date. Subject to the voting threshold being passed (see later), a second court hearing will follow where the court will consider whether to sanction the plan. Appointment of a supervisor is not required – although companies are free to engage such a person.

There is some uncertainty as to the role of shareholders. The announcement clearly states that creditors and shareholders will be provided with information

Notes

1 See paragraph 5.140 of the announcement.

	'Traditional scheme' under Part 26 of the Companies Act 2006	**New restructuring plan**
Who can propose the scheme?	The company, any creditor, an administrator or liquidator	Prerogative for directors – shareholders and creditors may only put forward a counter plan
Shareholder / creditor information	Explanatory statement	'Something like an explanatory statement'
Voting		
Who can vote?	Secured and unsecured creditors, shareholders	Same as scheme
How is a class established?	Principles derived from case law. Creditors whose rights are not so dissimilar as to make it impossible for them to consult together form one class	Class principles same as scheme
Voting per class	– 75% in value of the claims held by creditors/ shareholders in each class voting; and – >50% in number of creditors or shareholders voting in each class	– Same as scheme – >50% of the total value of unconnected creditors vote in support
Cram down and court approval		
When is the scheme/ restructuring plan accepted?	All classes approve the scheme and Court sanctions scheme	Same as scheme (subject to cross clam cram down)
Cross class cram down?	No. All classes must approve the scheme	Yes – At least one class of impaired creditors accepts the plan; and – Absolute priority rule is met (subject to below) Absolute priority rule can be overruled by the court and plan sanctioned despite not meeting it if: – Necessary to achieve the aims of the restructuring; and – Just and equitable
What will the court consider in order to approve the plan?	Courts consider fairness, class composition and overall jurisdiction of the court	Same as scheme For fairness: court will need to consider next best alternative for creditors if the restructuring plan was not to be agreed
Jurisdiction	Sufficient connection	Undecided as to sufficient connection or COMI depending on Brexit negotiations

and will vote, but it is not clear how the shareholders' vote will count (see later).

What are the voting thresholds? The voting threshold for each class will be *75% by value* to vote in favour of the plan. While the announcement does not spell this out, we understand that this is 75% by value of those voting, as is the case in the traditional scheme. There will be *no majority in number test* (unlike a scheme) but, instead, a connected party subtest will be introduced. This is loosely modelled on the test currently found for company voluntary arrangements and will require 'more than half of the total value of unconnected creditors to vote in support'. There are quite a few questions and points on this test, including:

– Will it actually be the CVA test, as this requires an active vote against the CVA by connected parties? The CVA wording is different to the wording used by the Government in the announcement although it is assumed that the announcement wording is merely shorthand.

– Will it be half of the total value of unconnected creditors in each class, or the total affected unconnected creditors or, even more broadly, total unconnected creditors? The issue with using the

CVA test is that in a CVA there is only one class – so this will need to be transposed into the multi-class plan process. The correct framing of this connected creditors test has the potential to make or break the restructuring plan as a viable alternative.

– The move away from the requirement to have a majority by number is to be applauded. This numeracy test has in practice done little, if anything, to ensure that minority creditor interests are adequately safeguarded.

What about cross class cram down? Crucially, this will be permitted (unlike in a scheme). More precisely, this means that if *at least one class of impaired creditors votes in favour* and the *absolute priority rule is followed* (namely, dissenting classes of creditors must be satisfied in full before a more junior class may receive any distribution), then the court can sanction the plan. The court can also sanction the plan if the *absolute priority rule is not met* where non-compliance is: (i) necessary to achieve the aims of the restructuring and (ii) just and equitable. In order for the court to assess whether the absolute priority rule has been met, the regime will look at the 'next best alternative for creditors' if the restructuring plan was not agreed. Often administration will be the comparator, but liquidation may sometimes be the only realistic alternative – each decision will depend on the facts of the case.

This aspect is clearly the most interesting and long-awaited of the proposals. It does, however, pose many questions such as:

– ***How will shareholders fit in with cross class cram down***? The announcement mentions only creditors. If shareholders have a vote and vote against, this is not expressly included in the provisions for cross class cram down. However, we can probably assume that a shareholder vote can also be overridden (query with what majority). It would be absurd if there were provisions for essentially disenfranchising junior creditors but shareholders could retain equity. That said, it is unclear whether this is a drafting omission or an omission from the announcement.

– The courts have often made clear that they do not want to become the arbiter of value in a complex valuation dispute. The restructuring plan with the inherently disputable concept of the 'next best alternative' has the potential to result in such a dispute; at least until a first test case has determined some parameters. How much work will need to be done by the company to demonstrate the 'next best alternative'? In practice, this is likely to result in engaging financial advisors to produce more valuations and business plans from which to then decide on the next best alternative.

When would you need to decide what process to use? The Government announcement states that the restructuring plan would be closely modelled on the existing scheme. In most cases there would seem to be little downside to using the new restructuring plan instead of the classic scheme. The exception here being the connected party subtest. In large capital structures it is unlikely that there will be an issue on connected parties, however, the test that the Government has indicated and as set out in section 249 of the Insolvency Act 1986 is extremely wide[2] and does have the potential to lead to unintended consequences. In those circumstances, a company may consider to use the classic scheme instead. Debt trading would need to be dealt with to ensure that at the point at which the company needs to decide which to use, the restructuring plan or the classic scheme, it is possible to decide whether the connected parties test is an issue.

Overall, the restructuring plan has the potential to be a game changer for UK restructuring. Much will depend on the drafting, e.g. of the voting threshold – which can make or break the success of the process.

The restructuring moratorium

A company which meets the following qualification conditions will be able to file documents at court triggering a moratorium on enforcement action. The company is:

– 'prospectively insolvent', i.e. will become insolvent if no action is taken, but companies 'that are already insolvent' are excluded (referred to as an 'eligibility' condition);

– has a prospect of rescue; and

– can demonstrate that it has sufficient funds to carry on its business during the moratorium, meeting current and new obligations as they fall due (the rescue and sufficient funds condition being referred to as the 'qualifying' conditions).

The directors will appoint a 'monitor' (which is, at least in the initial drafting, expressed to be a qualified insolvency practitioner – with the potential to review whether to broaden this in the future). The monitor's task is to assess whether the qualification conditions are met. If at any point the conditions cease to be met, the monitor will have the power to terminate the moratorium by notifying the court, the company and the creditors. Creditors may apply to court to challenge

Notes

2 For an article discussing the connected parties test, see D Pollard, 'Who is "connected" or "associated" within the meaning of the Insolvency Act 1986', *Insolv. Int.* 2009, 22(3), 33-44.

the moratorium if the qualification conditions are not met or they can demonstrate that they suffer unfair prejudice. At the outset, the moratorium will be for 28 days but extensions will be possible. Initially, this can be for up to a further 28 days if the eligibility criteria continue to be met. A further extension will then be possible with consent of either (i) more than 50% of secured and more than 50% of unsecured creditors (seemingly irrespective of any contractually agreed security ranking); or (ii) the court (if creditor consent is 'impracticable').

A good step – but is it worth it?

The introduction of a restructuring moratorium will no doubt be a welcome and significant addition to the restructuring toolbox. At the moment (aside from an insolvency filing or a small company CVA), companies need to either agree a consensual standstill or implement a Companies Act scheme of arrangement to effect a standstill contractually. This adds significant costs – as the whole scheme process is then repeated to implement the actual restructuring some time down the line. The fact that the moratorium will be a standalone tool, rather than a single gateway for all insolvency processes is also to be welcomed. However, looking at the eligibility condition and the interpretation of insolvency post *Cheyne*,[3] we know that cash flow insolvency is not a snap shot but looks into the future. This means that a company would need to trigger the moratorium a long time before it actually (in layman's terms) runs out of cash. If the company already had unpaid liabilities (e.g. it had stretched its suppliers without their consent), then it would appear to be at risk of failing the eligibility condition such that it could not qualify.

While the eligibility condition is only assessed at the point of filing, the qualifying conditions are assessed on an ongoing basis so the moratorium will not protect from any liquidity crisis. One might be excused from asking what exactly the moratorium will protect the company from – not historic payment defaults (eligibility condition) and not ongoing liquidity pressure. Then what? However, as is often the case, not all things make sense on day one and much will depend on the drafting – we may yet see the restructuring moratorium develop into a more useful tool than might appear on first sight.

Ban on ipso facto clauses

Alongside the two new regimes, contractual termination rights that can be triggered upon a counterparty entering a formal insolvency process (including the two new ones) will be unenforceable. Termination on grounds 'connected with the debtor company's financial position' will also not be enforceable (but no detail as to what this comprises is available yet).

Certain types of financial products and services are to be exempted (again no further details are available at the moment). We note that suppliers will retain the ability to terminate contracts on any other ground permitted by the contract (e.g. non-payment of liabilities or the giving notice of termination).

Counterparties may apply to court to be permitted to terminate if they can demonstrate undue financial hardship.

Another step forward – but is it enough?

Conceptually this is a big step: for the first time in mainstream insolvency (special rules already exist for special administration regimes) the UK will move away from the sanctity of the contract and actually override contractual termination provisions in all contracts. Previously, the approach was to restrict such override to supplies that were considered to be essential. These initially were gas and electricity, water etc – and then slowly broadened to capture the modern world of business (e.g. chip and pin devices). The 2016 consultation had then proposed a more piecemeal amendment by making the debtor specify which contract it regarded as essential. Instead, there will now be a general ban on termination right for suppliers and service providers. This is a good first step. However, the proposal is, in our view, still too limited:

– the regime will be easy to circumvent – by having contractual termination rights not connected to the insolvency and which remain exercisable;
– what about customers? The restriction is stated to only apply to suppliers – but these may not be the debtor's prime concern.

Overall, it might be necessary to take the conceptual big step first and then ensure the legislation slowly catches up. But, as it stands, the restriction will not be nearly as wide as for example a Chapter 11 ipso facto rule would provide.

Sale of businesses in distress – a tale of tensions

This proposal follows on from the March 2018 consultation and is one of the less welcome measures that will be introduced. It is here that one can feel the tension between the 2016 consultation (focussing on corporate rescue and improving the restructuring tools)

Notes

3 *Re Cheyne Finance plc* [2007] EWHC 2402 (Ch).

and the 2018 consultation (focussing on director accountability and protection of creditors). Directors of holding companies will be legally obliged to take into account whether the sale of a *large* subsidiary is in the best interests of the subsidiary's stakeholders – as opposed to placing the subsidiary into formal insolvency proceedings. The threshold test for a large company would be those companies that do not qualify as a small or medium sized company. The proposed look-back period to assess whether the subsidiary's creditors have been worse off will be 12 months. Sanctions for non-compliance will include disqualification for directors.

The Government has clearly read and carefully considered the consultation response. However, the measures will be taken forward, despite some of the responses highlighting that the proposal could lead to the unintended and, indeed, counter intuitive result that more companies will be prepacked.

So, while the Government's intentions to ensure that directors are accountable and act on proper advice are laudable, what are the issues with the proposed measure?

Conflict of interests for directors. Directors will have an internalised conflict between the duties owed to the company's own creditors / shareholders and the duties they will owe to stakeholders of subsidiary. The Government's answer is that directors have to act within the law and that the new legal framework will provide that the interests of the subsidiary's stakeholders are to be taken into account. In practice, this probably means that the interests of the subsidiary's stakeholders would override the interests of the company's own stakeholders.

The defence of reasonable belief. What will be the standard against which directors are measured? They will need to see some form of business plan by the proposed buyer to assess whether the sale is better for the subsidiary's stakeholders than an insolvency. If information is not provided, will they have to decline to sell – thereby risking immediate unemployment for the subsidiary's workforce? How will different stakeholders' interests be measured (subsidiary's suppliers vs subsidiary's employees)?

Jurisdiction. How will this play out with overseas companies who are selling, what rules will they be bound to? Will the regime have or purport to have extraterritorial effect?

Value extraction schemes – no news is good news

No new legislation will be introduced in relation to value extraction schemes (as had been proposed in the March 2018 consultation). However, existing insolvency legislation (e.g. in relation to extortionate credit transactions, transactions at an undervalue and preferences) will be tweaked to address the concerns raised in the consultation. This must be the right approach – although we might be expecting quite some overhaul of the existing claw back provisions, with revisions to the insolvency presumption and the details of the clawback regime as a consequence.

Conclusion

So, where do the reforms leave us? On balance, they are good news. The proposed restructuring plan – if implemented properly – has the potential to be a real game changer to restructurings. This is exciting. While we are more sceptical about the impact of the moratorium and the changes to the ipso facto regime, they are somewhat positive. Maybe here it is the case that small steps must be taken first. As regards the sales of distressed subsidiaries – only time will tell how the conflicts that are inherent in this regime will play out and whether the unintended consequence (from the Government's perspective) of more prepacks will materialise.

In light of Brexit and the EU proposals to reform insolvency and restructuring law, it is paramount that the UK stays at the fore of good restructuring practice, so these measures are a welcome start. However, indirectly Brexit may prove to be the very stumbling block as it is difficult to see Parliamentary time being devoted to these proposed wide ranging reforms any time soon.

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