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## Encouraging Company Rescue: Proposals for Reforming the UK's Insolvency Laws

On 7 September, 2009, a consultation (the "Consultation")<sup>1</sup> on significant proposals for reforming the current framework of UK insolvency law closed. This alert explores the proposals which have been put forward and anticipates the likely impact of any reforms which may result.

**At a glance****What the Consultation proposes:**

- Extending the availability of moratoria on creditor enforcement actions for debtor companies which seek to restructure using a Company Voluntary Arrangement ("CVA");
- Increasing the availability of rescue finance for businesses in administration or which have concluded a CVA, including by way of "super-priority" funding;
- By implication, an increase in the attractiveness of the UK for EU companies seeking to reorganise under UK jurisdiction; and
- By implication, an increase in the extent to which UK insolvency proceedings would be subject to the supervision of the courts.

**What the Consultation would not change:**

- Management would still be displaced when a business becomes insolvent in the majority of cases; and
- Creditors and suppliers would still be able to terminate their contracts with an insolvent business.

The UK has traditionally been perceived as a "creditor-friendly" jurisdiction. In keeping with this perception, its insolvency laws have tended to place efficient tools at the disposal of creditors – especially creditors with fixed or floating charge security – for extracting value from insolvent enterprises in order to satisfy their debts.

<sup>1</sup> *Encouraging Company Rescue – A Consultation*, United Kingdom Insolvency Service (June 2009).

In an attempt to increase the number of companies which are restructured or reorganised when financial difficulties are encountered – and hence encourage a "rescue" culture where corporate risk taking and enterprise are not unduly penalised if insolvency happens to result – several reforms have been introduced in recent years, which have steadily challenged this perception<sup>2</sup>. As a result of these reforms, the objective of enabling creditors to realise their security or, if unsecured, at least obtain timely payment or distribution in respect of their debts, is now balanced with the objective of rescuing businesses as going concerns wherever it is possible to do so.<sup>3</sup>

When judged by the speed with which troubled businesses can be dealt with and the amount which creditors are able to recover, the UK's regime compares favourably with rival jurisdictions.<sup>4</sup> If the UK Insolvency Service's latest, "targeted" proposals for reforming the UK's approach towards dealing with insolvent companies are enacted into law, however, the balance which the present law achieves between the objectives of rescue or reorganisation and the realisation of value looks set to be tipped in favour of the insolvent company.

The Insolvency Service's proposals fall into two distinct categories:

- First, it is proposed that the availability of "moratoria," or stays on creditor action, should be expanded to provide a larger number of companies which experience financial difficulty with time to seek agreement with their creditors to restructure their debts. In particular, it is proposed that the 28 day moratorium, which is currently available to small companies seeking to restructure their debts by means of a Company Voluntary Arrangement ("CVA"), should be extended to medium and large-sized companies.

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<sup>2</sup> Principally, the introduction of a new, streamlined administration procedure in 2003 as a result of the reforms enacted in the Enterprise Act 2002, which included: a) the prospective abolition of a floating charge holder's traditional right to appoint an administrative receiver to realise his security; b) the ability for a company's directors to commence administration proceedings by filing certain documents at court, instead of having to apply at a hearing; c) the introduction of the "prescribed part" in favour of unsecured creditors, which operates in many cases to limit the value that can be derived from enforcing a floating charge; and d) the abolition of the Crown preference, which had granted priority to the payment of outstanding tax debts at the expense of unsecured creditors.

<sup>3</sup> In the case of administration proceedings, paragraph 3 of Schedule B1 to the Insolvency Act 1986 provides that rescue of the company as a going concern is the administrator's primary objective upon being appointed. Only if it is not reasonably practicable for a company to be rescued is the administrator allowed to consider alternative strategies such as securing a better outcome for creditors as a whole than would be possible on an immediate winding-up, or making distributions to secured creditors.

<sup>4</sup> At page 11 of the Consultation, the Insolvency Service points out that the UK was ranked joint 8th and 9th out of 155 countries for the speed with which it deals with troubled businesses and the amount recovered for creditors in a recent World Bank report, compared with 23rd and 15th for the USA, 37th and 40th for France, and 20th and 33rd for Germany.

- Second, it is proposed that it should be easier for companies which enter insolvency proceedings to obtain finance to permit them to continue their existence in insolvency as a going concern and provide more time for them to reorganise or restructure their businesses on a sustainable basis. In order to achieve this aim, the key reform would be to enable insolvent companies to obtain super-priority funding, by enabling negative pledge clauses in loan agreements to be overridden and allowing such funding to rank in priority to existing obligations.

### **Expanding the Availability of Moratoria to Support the Conclusion of CVAs**

#### *Proposal 1: Extending the Scope of the Small Company Moratorium to Medium and Large-Sized Companies*

If consensus amongst secured and unsecured creditors comprising at least 75 per cent of a company's debt by value can be reached, a CVA enables a company to reach a binding agreement with its creditors to repay all or part of its debts over a specified period.

When introduced by the Insolvency Act 1986, no moratorium on creditor action was available to companies which sought to restructure their debts using a CVA. In the case of "small" companies,<sup>5</sup> this position was amended by the Insolvency Act 2000.

In the case of such companies, the moratorium keeps creditors at bay while a creditors' meeting is convened to approve the CVA. The company's directors achieve this short term moratorium by submitting a proposal for the CVA to their "nominee," who must be a licensed insolvency practitioner, or "IP." The nominee must provide a statement to the effect that the CVA has a reasonable prospect of success and of being approved. Documents are then filed at court for the moratorium to commence.

Nevertheless, it remains the case that the lack of a moratorium for the majority of companies which could most benefit from one, i.e., medium and large-sized companies with complex capital structures, means that, in practice, the procedure has rarely been able to offer a viable exit route from insolvency without being combined with the administration procedure.

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<sup>5</sup> A company will qualify as "small" for the purposes of the moratorium if it has a turnover of less than £6.5 million, has a balance sheet of less than £3.26 million and employs fewer than 50 people.

In recognition of this reality,<sup>6</sup> the first reform which the consultation proposes is that the availability of the small company moratorium should be expanded to medium and large-sized companies.

The intention behind expanding the availability of the CVA moratorium is to prevent companies that have good prospects of concluding a CVA from commencing administration proceedings simply for the purpose of benefiting from the moratorium that the administration procedure brings. In this way, time and expense would be saved, and the stigma associated with filing for administration would be avoided. In addition, the availability of a moratorium to assist with the conclusion of a CVA may lead more companies to address their financial difficulties at an earlier stage, as a key feature of the administration procedure is that existing management is displaced as soon as the administrator is appointed.

At the same time, expanding the availability of the out-of-court moratorium as it presently exists for small companies may not be sufficient to result in a greater number of CVAs being concluded for medium and large-sized companies. Medium and large-sized companies tend to engage in more complex financial arrangements and will inevitably have a far larger number of creditors, many of whom will be located overseas. In the case of such a company, a 28 day moratorium is unlikely to be long enough to enable complex negotiations between debtors and creditors, and between different classes of creditors, to reach a successful resolution.

#### *Proposal 2: Introducing a New Court Approved Moratorium*

Some recognition of the fact that a period of 28 days is unlikely to prove sufficient to enable a restructuring to take place where large companies with complex capital structures are involved is provided by the proposed introduction of a new court approved moratorium. Under the new procedure, the directors of a company would be permitted to apply to the court without providing notice to the company's creditors to ask that a moratorium of up to 42 days be imposed on creditor enforcement actions. It would then be possible for the company's directors to return to the court for an extension for a maximum period of three months.

The application for an extension would only be exercisable once and the court would need to be satisfied that (1) the company was

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<sup>6</sup> The Insolvency Service's decision to consult on reforms which would make moratoria more widely available to companies which seek to restructure their debts using a CVA are also likely to have been influenced by the high-profile campaign mounted by the European High Yield Association for a new procedure to be introduced, which could facilitate out-of-court restructurings, and comments made by members of the Shadow Cabinet in July 2008, which appeared to lend opposition party support to key features of that campaign.

technically insolvent, or likely to become so within three months of the hearing date; (2) there was a reasonable prospect that a CVA would be approved by the creditors; and (3) approving a moratorium would be in the interests of the creditors as a whole. An IP would also be required to submit a statement to the court to certify that the above tests were satisfied.

Here too, however, it would seem that the proposals have not given sufficient consideration to the practicality of a moratorium which would last for the length of time which has been suggested, especially when the time and expense of arranging for a court hearing to obtain approval for the moratorium are taken into consideration. Also, many companies which would benefit from the ability to restructure would wish to do so by way of a scheme of arrangement. As presently framed the moratorium would only be available to support the conclusion of a CVA, and a scheme may take far longer than three months to be brought to a successful resolution.

It is also worth noting that any company which would be eligible for the court approved moratorium would probably also be able to file for administration. Although the directors' loss of control in an administration may well be a crucial disincentive to following that route, since 2003, a company's directors have not been required to obtain the approval of the court in order to do so. As such, the proposals appear to provide for the somewhat counter-intuitive position that a company which would be eligible to file for administration – and hence enjoy a moratorium lasting for a minimum of 12 months – should be able to do so simply by filing certain documents with the court and waiting for a period of five days, whilst a much shorter moratorium to support a CVA would require court approval to be effective.

### **Increasing the Availability of Rescue Financing in Administrations and CVAs**

The second category of proposals aims to make it easier for companies to restructure or reorganise by improving their ability to raise funding after the onset of formal insolvency proceedings. The reforms which have been proposed are as follows:

- First, that the costs of financing provided to a company in administration should rank ahead of other administration expenses.
- Second, that an administrator should be able to create security for post-insolvency financing over assets which are free of security, over any assets (on a subordinated basis) or, subject to the agreement of existing fixed charge holders or the court (and only where there is no scope for new or subordinated fixed charges),

*pari passu* with or in priority to existing fixed charges, provided that the court was satisfied that such security was necessary to obtain financing, the interests of fixed charge holders were adequately protected and obtaining the finance was in the best interests of creditors as a whole.

- Third, that a company in a CVA should be able to create security for new financing (conditional on the CVA being agreed by the creditors) over assets which are free of security, over any assets (on a subordinated basis) or, subject to the agreement of existing fixed charge holders or the court (and only where there is no scope for new or subordinated fixed charges), *pari passu* with or ranking in priority to existing fixed charges, provided that such security was necessary to obtain financing, the interests of the fixed charge holders were adequately protected and obtaining the finance was in the best interests of the creditors as a whole.
- Finally, that asset based lending agreements or floating charges entered into prior to an insolvency event should be limited to the assets acquired or book debts arising prior to the insolvency (excluding long term receivables which have already been assigned and in respect of which loans have already been advanced).

The cost of entering insolvency proceedings is often extremely high. In addition, any company which is to be rescued will require a source of working capital to fund its operations whilst arrangements to effect its restructuring are put into place. Accordingly, measures which enable rescue finance to become more widely available may prove particularly important in assisting companies to restructure or reorganise successfully.

The first of the proposals which the government has brought forward would provide for finance costs (which are already considered to be administration expenses) to rank before other administration expenses. Given that administration expenses are almost always repaid in any event, it may be doubted whether this particular proposal would make it significantly easier for a company to reorganise or restructure in an administration than it would be at present.

By contrast, the proposal that a company in administration or which is successful in negotiating a CVA should be able to grant super-priority fixed charges over its assets, and thereby postpone the claims of those creditors which hold security, would, if enacted, represent a very significant departure from existing practice.

Certain practical issues associated with introducing this measure are not dealt with by the Consultation. For example, the position of creditors which have advanced funds on the basis of a financial collateral arrangement is simply not considered, although the likelihood is that such creditors would find their security unaffected by the proposals.

More pressing is the question of whether the changes would have retrospective effect if they were introduced. When the floating charge holder's right to appoint an administrative receiver was abolished under the Enterprise Act 2002, the rights of existing floating charge holders to appoint administrative receivers was expressly preserved in recognition that it would have been unfair to alter the legal basis on which a lender's decision to advance monies had been taken whilst the loan was still in existence. As such considerations would apply even more forcefully in the context of enabling existing security to be subordinated without creditors' consent, it is possible that any legislation which is brought forward to implement the proposals will only be brought into force in relation to recently granted security, meaning it may be some time before companies which restructure could begin to take advantage of the greater availability of rescue financing which would result.

## Conclusions

The proposals are still at an early stage of their gestation. Nevertheless, it seems possible to draw some tentative conclusions.

First, setting the question of their desirability to one side, the proposals represent a logical development of the attempts which have been made in recent years to promote rescue or reorganisation of the insolvent enterprise at the expense of the immediate realisation of value for creditors. Although creditors will naturally view these developments with regret, the UK's regime will become a more attractive place for debtors to reorganise than it is at present if the proposals are introduced, especially when compared with the approach of other jurisdictions in the European Union ("EU"). Implementing the proposals is also likely to accelerate the recent trend for debtors to move their Centres of Main Interest ("COMI") to the UK to enable the UK courts to take jurisdiction over their restructurings.<sup>7</sup>

Second, although some banks may well be reluctant to see the security on which funds have been advanced eroded, other lenders

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<sup>7</sup> Under the harmonised rules of jurisdiction and reciprocal recognition of insolvency proceedings which applies in the EU under Regulation 1346/2000 (EC). Perhaps the best known example occurred in 2007, when Schefenacker, a German car parts manufacturer, moved its headquarters to the UK to implement a debt-for-equity swap under English jurisdiction.

may welcome the prospect of a UK market for rescue financing, similar to the "debtor-in-possession" financing market in the US. In practice, such loans are also often viewed as amongst the safest that a bank or financial institution can ever make.

Creating a market for such loans will probably increase the amount of money which such companies are able to draw upon to continue trading and to finance the costs of their insolvencies.<sup>8</sup> At the same time, secured creditors have always had the certainty of knowing that their debts would be repaid in priority to other creditors on insolvency. This certainty has been an attractive feature of the London loan market in the past. Removing this certainty may have a detrimental effect on the willingness of banks to lend in the future, may increase the costs of lending, and may also increase the need for lenders to carry out due diligence to ensure the solvency of their customers. In addition, it may not be wise to introduce a set of reforms which will make life more difficult for the banks at a time in the economic cycle where the strength and sustainability of any recovery will depend on their ability and willingness to extend new credit to their customers.

Third, whatever form the proposals ultimately take, one consequence of their enactment is very likely to be an increase in the extent to which reorganisations take place under the supervision of the courts. Court challenges by disenfranchised creditors to rescue plans promoted by a company's management or an IP acting as an administrator or a nominee are also likely to become more common.

For example, a debtor company which applies to the court for approval of super-priority rescue financing will have to obtain a statement from an IP that the subordination of existing charge holders was both necessary and in the best interests of the creditors as a whole.<sup>9</sup> In a complex case where multiple layers of security were potentially to be affected by the restructuring, it is likely that detailed evidence would have to be presented to the court in order to demonstrate that unfair

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<sup>8</sup> It should be noted that the extent to which this would take place is not beyond doubt. In part, this is because many companies which would wish to take advantage of the new procedures for obtaining super-priority funding will have complex, cross-border international structures that include assets which are located overseas. In such cases, the ability of an administrator or a board of directors to grant super-priority security over assets which were located outside of the territorial jurisdiction of the UK courts would depend on the extent to which the UK insolvency proceedings were locally recognised. If the assets in question were located in the EU, such recognition would probably follow on automatically from a filing in the UK, but in other jurisdictions (e.g. Russia) it is not at all clear that this would be the result.

<sup>9</sup> It is unclear how this test would be applied in practice. Perhaps the most likely approach for the courts to adopt would be to consider the value of the creditor's security in the context of the present "pre-reorganisation" value of the business. If the value of the security after subordination was no worse than the value of the security pre-subordination, it is likely that the test would be satisfied. For a similar approach in the context of a scheme of arrangement, see the recent decision of the High Court in the "IMO Car Wash" case, *In re Bluebrook Ltd* and others [2009] EWHC 2114 (Ch).

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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harm to the existing charge holders would not result from the extension of new money on super-priority terms, especially given that the Consultation makes clear it is the administrator or the nominee who would bear the burden of showing that such harm would not result.

Equally, it is envisaged that the threshold condition for an IP-nominee's certification of the directors' proposals for the purposes of obtaining the 28-day/42-day CVA moratorium will be that the IP considers the directors' proposals have reasonable prospects of success and/or that approval of the directors' proposals would be "in the interests of creditors as a whole." At present, these tests are undefined in case law and the Consultation does not attempt to set out what satisfying the tests would involve. Given that the risk of unfair harm to creditors will only increase as the balance between the company and its creditors is shifted from the latter to the former to enable more complex debtor-creditor relationships to be crammed down or restructured, the pressure on the courts to adopt a more proactive role in policing the boundaries of what companies and creditors may achieve is only likely to increase as well.

Finally, it is worth noting what the Consultation does not propose. In many ways, the proposals could be viewed as attempting to cherry-pick aspects of the approach under the Chapter 11 procedure in the US to create a hybrid set of procedures under UK law. However, it is arguable that the two aspects of the Chapter 11 procedure which would do more than any others to alter traditional approaches to insolvency in the UK – namely, the US debtor's ability to rely on the stability of its contractual relationships with customers and suppliers, because automatic termination of such contracts is not permitted on filing for protection, and the fact that a US debtor's management is allowed (at least initially) to remain in place when a filing is made – are conspicuous by their absence.

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