



WHITE PAPER

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UK's Proposed Corporate Restructuring Regime Follows European-Style Chapter 11 and Debtor-in-Possession Trend

The UK Government recently announced proposals to introduce a new UK restructuring plan and moratorium, together with certain other changes to the corporate governance regime relevant to companies in distress. In addition, insolvency termination clauses will in certain circumstances no longer be enforceable in the event that one party to a contract enters into an insolvency proceeding.

When implemented, the proposals could have a significant impact on the UK restructuring landscape and are likely to be of crucial importance to all stakeholders. The proposed changes reflect the general European trend in favour of debtor-led restructuring proceedings, and they mark a notable shift in the UK away from creditor-led processes that have historically dominated the UK restructuring market.

This Jones Day *White Paper* reviews the proposals and explains the possible next steps towards implementation.

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The framework for corporate insolvency in England and Wales has remained largely unchanged for 15 years. Changes to the commercial landscape, including those to the corporate debt market since the global financial crisis, and the forthcoming EU Harmonisation Directive which proposes a 'Chapter 11' style restructuring regime for Europe, have precipitated the need for a redesigned restructuring process.

Correspondingly, in the context of episodes of large-scale corporate failure and asset-extraction as seen in the respective demises of Carillion and BHS, it is politically an opportune moment for the UK Government to review its regulation of corporate governance matters.

Following the conclusion of the March 2018 consultation on insolvency and corporate governance, and the 2016 review of the corporate insolvency framework, the Government has published a response outlining proposed reforms to both corporate governance regulation and the domestic insolvency regime, including a new "restructuring plan" for companies in distress ("Response Paper").

THE TWILIGHT MORATORIUM

In service of their ambition to "reduce the costs and risks" of restructuring, central to the Government's apparent mind-set in the Response Paper is the maxim that "most companies do not become financially distressed overnight". The revised regime will thus encourage debtors to engage with creditors before their level of risk becomes problematically high and insolvency inevitable.

The Response Paper therefore recommends the introduction of a moratorium period in the style of an administration equivalent (preventing creditor enforcement), with an insolvency practitioner acting as a "monitor", but one that is entered into *before* the debtor is cash-flow insolvent. In order to qualify for the moratorium, the debtor must:

- have a real prospect of rescue;
- be financially distressed to the extent that the debtor would become insolvent were action not to be taken;
- not have entered into a moratorium, administration or company voluntary arrangement ("CVA") within the preceding 12 months; and

- have sufficient funds in order to carry on trading during the moratorium.

Assessment of the above factors will be the responsibility of the "monitor", who will also be under an obligation to notify the debtor's creditors and the Registrar of Companies of the moratorium. Costs associated with the monitor, and indeed all other costs associated with the moratorium, will be borne in the same way as would administration expenses, thereby ranking in priority to floating charge realisations in the event of the subsequent administration or liquidation of the company.

The standard length of a moratorium will be 28 days, with a debtor eligible to apply for a further 28 days subject to the monitor's confirmation that the criteria set out above remain fulfilled. Subsequent extensions may be granted with the consent of at least 50 percent in value of each of the company's secured and unsecured creditors. In addition, if a company commences an insolvency procedure, such as a scheme of arrangement or CVA, prior to the expiry of a prevailing moratorium, the relevant moratorium will be automatically extended until the outcome of the relevant proceeding is determined. Where it is not feasible to obtain creditor consent to extend the moratorium, the debtor may apply to court. In many restructuring situations, a contractual standstill or judicial stay is often granted by the court in order to provide companies the breathing space within which to propose a plan. The new statutory moratorium therefore arguably codifies this market practice, which has evolved in recent years.

THE NEW RESTRUCTURING PLAN

The Government's proposal for a new restructuring plan, or "super-scheme", essentially takes the form of an amended scheme of arrangement: It will be for the debtor to categorise classes of shareholder and creditor, which (subject to objections) a court will accept and order that the parties convene for a vote on a specified date. If the required thresholds are met by the vote, the court will confirm the plan and make it binding on all creditors and shareholders.

At least 75 percent (by value) of each class of creditors and shareholders will be required to vote in favour of the plan in order for it to be approved. The Government is also planning to incorporate the "connected creditor" rule currently applied

to CVA voting under section 249 of the Insolvency Act 1986. Therefore, more than half the creditors by value voting in favour of the restructuring must be “unconnected” pursuant to the definition in the Insolvency Act 1986. The numerosity test applicable to schemes of arrangement will not apply to the new restructuring plan.

The new restructuring plan will incorporate a “cross-class cramdown” feature. Cross-class cramdown can be imposed where one class of impaired creditors votes in favour of the plan, provided that the absolute priority rule is applied. However, the court will have the power to sanction a restructuring plan even if the absolute priority rule is not applied, if it is: (i) necessary to achieve the aims of the restructuring; and (ii) fair and equitable to do so.

Accordingly, whilst the new plan is envisioned as being one which will adhere to the logic that dissenting creditor classes must be paid in full before more junior classes receive any payment, it will retain the requisite flexibility to depart from conventional “waterfall” distribution when pragmatically necessary. The absolute priority rule is controversial in jurisdictions such as the United States, where some argue that its inflexibility makes the prospect of a restructuring in some situations less viable. With this in mind, the UK Government wants to ensure that the court has the power and flexibility to sanction certain restructuring plans where it is appropriate to do so. From a policy perspective, this makes sense; however, in practice, this level of flexibility potentially creates a level of uncertainty which sophisticated financial investors in particular may not appreciate.

Only a debtor (or any relevant insolvency practitioner) will be entitled to propose a restructuring plan. However, creditors will be entitled to submit an alternative proposal. In these circumstances, the court will have an absolute discretion to determine if the proposal should be put to the creditors to vote.

CORPORATE GOVERNANCE REFORM

Among the Government’s proposed reforms to corporate governance regulation is an aim to streamline unnecessarily complex group structures, making it easier to dissolve companies that are functionally redundant.

The Government also plans to pursue the case for a comprehensive review of the UK dividend regime in an effort to curb value-extraction schemes that carry a high risk of damaging creditor interests. Amendments to dividend-related legislation could include a requirement for companies to disclose and explain capital allocation decisions and to reassess the criteria under which dividends can be authorised solely by a board of directors.

As well as promoting training regimes for directors, the Government is considering making training for directors of large companies mandatory.

The Government will look to introduce disqualification penalties for directors of parent companies where a subsidiary is sold in the 12 month period prior to its insolvency. The court’s assessment as to liability will be based on the reasonableness of director conduct and whether sufficient care was taken to preserve stakeholder interests. The courts will be directed to consider, amongst other things:

- whether professional advice was sought in respect of the sale;
- the extent to which the board of the holding company engaged with the stakeholders of the company due to be sold; and
- whether other steps were taken by the director to ensure, as far as was within their means, that the sale offered no worse prospects to stakeholders than a formal insolvency.

The above provisions shall be limited to the sale of large companies (i.e. not a small or medium company pursuant to the Companies Act 2006). During the consultation process, market participants expressed considerable concern as to the impact of the proposed reforms. In particular, directors of a parent company could potentially find themselves in a position of conflict where they are required to consider stakeholder interests relevant to its subsidiary in addition to the interests of its own stakeholders. In response, the Government has watered down the proposals but there remains a general concern that the proposals will (ironically) result in more companies filing for insolvency proceedings. The potential for conflicts of interest to arise, particularly in circumstances where common directors are appointed to both the board of the parent and its

subsidiary, is likely to bring directors' duties into sharp focus, particularly in the zone of insolvency.

Whilst the proposed changes have been largely welcomed by the restructuring community, creditor organisations are broadly opposed to the proposals. In particular, concerns have been expressed with regard to the increased cost of lending and the potential for greater creditor insolvencies as a knock-on consequence of the proposals. The potential for abuse has also been cited, in particular with regard to the proposed new moratorium. In response, the Government has said that it will introduce sanctions to deter any potentially abusive behaviour, the details of which have not as yet been provided.

We do not know at this stage if the proposed restructuring plan will be available to foreign companies. Foreign companies may continue to use schemes of arrangement in the usual way, but the Government had advised that it will set out the basis for jurisdiction once the outcome of Brexit becomes clear.

INSOLVENCY TERMINATION CLAUSES

Insolvency termination clauses (which permit one party to terminate a contract as a result of the insolvency of another party) will no longer be enforceable if a company, being the recipient of goods and services, enters into any insolvency proceedings, including the proposed new moratorium.

Suppliers will retain the right to terminate contracts for reasons other than insolvency, for instance as a result of non-payment, failure to perform or in accordance with contractual notice provisions.

The new proposals will extend to the use of licences, such as software or patents. However, licences issued by public authorities will not be caught by the new provisions. The Government is also proposing to exclude certain financial products and services, the details of which have not as yet been provided.

In the case of undue financial hardship, a supplier may apply to court seeking an exemption from the requirement to continue supply. The Government envisages that relief would be granted only in rare circumstances. In the event of insolvency proceedings, amounts incurred to suppliers during the course of the proceedings would in any event be payable as an

expense of the relevant insolvency proceeding, payable out of floating charge realisations. Financial hardship will therefore typically depend on the extent of arrears owed by the debtor to the relevant supplier prior to the commencement of the relevant insolvency proceeding.

The proposed changes could in theory greatly increase the prospect of companies being rescued on a going-concern basis, given that insolvency termination clauses often make it impossible for certain companies to continue to trade once they have entered into an insolvency proceeding. However, in practice, we should expect contractual terms to be amended, for instance by shortening contractual notice provisions, in order to better manage risk for suppliers and other contractual counterparties which may limit the scope of the Government's intentions.

THE PRESCRIBED PART AND CROWN PREFERENCE—ADDITIONAL CONSIDERATIONS FOR FLOATING CHARGE HOLDERS

The Response Paper acknowledges that the "prescribed part" rules on a company's insolvency have remained unchanged since 2003, and thus the current allowance of up to £600,000 of ring-fenced funds for unsecured creditors is likely to be adjusted for inflation to around £800,000.

In addition to the proposed increase to the size of the prescribed part, in the Autumn Budget, the Government announced that it intends to reinstate Crown Preference in respect of employee national insurance contributions, PAYE income tax, Construction Industry Scheme deduction and VAT. Crown Preference was historically discharged from floating charge realisations, and therefore the Government's restoration of this priority will potentially further compromise the rights of floating charge creditors in the event of a company's insolvency.

TIMING OF IMPLEMENTATION OF THE PROPOSALS

The Government has advised that it intends to introduce the above proposals as soon as parliamentary time permits. In view of Brexit, it's hard to predict when these changes might be implemented. However, given the rising levels of insolvency and distress in the UK market and the prevailing political attention on corporate failure, insolvency reform remains

a high priority for the Government, which could result in the proposed reforms being implemented sooner rather than later.

KEY TAKEAWAYS

- The UK Government is set to introduce a new restructuring plan which will enable debtors to propose a restructuring plan to all of its creditors and shareholders in one proceeding. The UK court will have the power to impose a cross-class cramdown and disregard the absolute priority rule in certain circumstances.
- A new moratorium will be available to companies prior to the onset of insolvency.
- Insolvency termination clauses will no longer be enforceable in certain circumstances in the event of insolvency proceedings.
- The proposals, when implemented, could result in a significant change in direction for the UK restructuring market, away from creditor-driven processes and in favour of debtor-led proceedings.
- The proposed changes, whilst highly criticised by creditor organisations, are nevertheless consistent with the general trend in European restructurings and insolvency reform towards a European-style chapter 11 and a debtor-in-possession restructuring landscape which appears set to stay.

LAWYER CONTACTS

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