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UK CORPORATE INSOLVENCY REFORMS: LOOKING BEYOND BREXIT

Looking beyond Brexit is a clear focus for the Department for Business, Energy and Industrial Strategy. This is apparent from the recent proposals for corporate insolvency reforms in the UK. In a government response to a consultation on insolvency and corporate governance published at the end of the Summer, they set out wide ranging proposals for future reform in the UK restructuring and insolvency market. The purpose of the reforms is to ensure that the UK remains a jurisdiction of choice when it comes to restructuring. There is no definite timetable for the introduction of the reforms – and the proposals are currently expressed in high level terms. The detail of the legislation will become clearer once the parliamentary process is pursued.

Key issues

UK corporate insolvency reforms including:

- 28-day standalone moratorium (extendable)
- Prohibition of contractual termination clauses based on insolvency events
- Restructuring plans, including cross class cram down

Philip Hertz, global head of our restructuring and insolvency group, comments: "*these proposals are on the whole very welcome and it's encouraging to see that, as a number of other jurisdictions are developing their regimes and in fact taking inspiration from the English scheme of arrangement model in their proposed national reforms, we are looking to enhance further the restructuring tools we have available here in the UK. The introduction of a standalone moratorium will be a useful addition to facilitate restructurings and create a useful breathing space for debtors. Perhaps the most significant aspect of the reforms, however, will be the ability to cram down creditors across different classes using the new restructuring plan – the flexibility in the UK proposals seems to go beyond what is currently available in the US Chapter 11 procedure and will be extremely useful in complex restructuring cases*".

In common with reforms taking place at an international level (in particular, the Proposal for an EU Directive on preventive restructuring frameworks, second chance, and measures to increase efficiency of restructuring, insolvency and discharge procedures (Draft EU directive on preventive restructuring frameworks)), the focus of the proposals is on promoting opportunities for distressed debtors to restructure. The UK government seeks to do this by introducing legislative mechanisms "as soon as Parliamentary time permits" and one envisages that this will not be pursued before March next year at the very earliest. The proposals include: a standalone moratorium; provisions requiring suppliers to continue supplying businesses that are trying to restructure; and the creation of a new restructuring plan. A table comparing the restructuring regimes in key jurisdictions (including their latest World Bank

Ranking for Doing Business and Resolving Insolvency and the current EU draft directive reforms) can be found at the end of this Briefing.

THE STANDALONE MORATORIUM

Availability of moratorium

The entry criterion is expressed in the proposals in general terms. The standalone moratorium is not available to companies who are already insolvent. Instead, companies must be solvent but face the prospect of insolvency if action is not taken. The language in the proposals is not entirely clear, and some may take the view that imposing a requirement that the company must be solvent may prove to be a very limiting factor and result in a mechanism that is little used. The company must also be in a position during the moratorium to meet its current obligations and any new obligations incurred during the moratorium (see further below). Interestingly, on 24 September, the Council of the European Union published its general approach to the Draft EU directive on preventive restructuring frameworks. At article 4 of the latest draft (from 1 October) there is an option for Member States to maintain or introduce a viability test under national law for those debtors seeking to use the preventive restructuring frameworks. This may have provided some inspiration for the entry criterion for the UK moratorium. The exceptions to the small companies' moratorium currently available for Company Voluntary Arrangements (CVAs) will equally apply to the new standalone moratorium, so for example banks, insurance companies, project companies, or those who have entered into capital market arrangements will not benefit from it. As part and parcel of the UK reforms, the existing small companies' moratorium (which is rarely used) will be replaced by the standalone moratorium available to all eligible companies no matter what size.

Moratorium period

The moratorium will be triggered automatically by the filing of papers at court (no hearing is required) and will last for an initial period of 28 days but may be extended. For the period of the moratorium, a monitor (who must be an insolvency practitioner) will be appointed to ensure the company continues to meet the necessary requirements and where appropriate agree to extend the moratorium for up to 28 days. The monitor will also have the power to terminate the moratorium, to agree to significant disposals, or grant security, otherwise the management remain in control. Extensions beyond 56 days are possible but must be approved by more than 50% of both secured and unsecured creditors by value (it is not clear whether this will include future or contingent creditors) or where this is not possible, by the court. By way of comparison, the Draft EU directive on preventive restructuring frameworks includes at article 6 of the latest draft, a proposal for Member States to have a stay of individual actions as part of the preventive restructuring frameworks for up to 4 months, with the possibility to extend this for up to 12 months. Again, this may have provided some inspiration for proposals for the UK moratorium.

Effects of the moratorium

The new standalone moratorium is to be modelled on the existing administration moratorium. Essentially it includes a stay on security enforcement and other proceedings (including formal insolvency proceedings). Creditors will have the ability to challenge the moratorium on the basis that the company does not satisfy the qualifying conditions (i.e. the company must be able to meet its current obligations as they fall due) or there is unfair prejudice to creditors. This would appear to mean that the standalone moratorium would

not be available where there is already a loan default but, depending on the exact wording of the legislation and how forward looking it is, could possibly include debtors where there are pending maturity or loan defaults.

Aims of the moratorium

The proposals suggest that the typical outcome anticipated from a moratorium is either an informal restructuring or a formal insolvency (e.g. a CVA or liquidation). Further the monitor appointed under the standalone moratorium will be able to act as a supervisor in respect of a subsequent CVA or assist with the implementation of a restructuring plan (see below for more details of the new restructuring plan) but they will not be allowed to act as an administrator or liquidator in respect of the same company. The rationale for this approach is to avoid potential conflicts, although it is recognised that it will add to the costs by involving more professional advisers in a subsequent formal insolvency.

Costs incurred during the moratorium get super priority

Unpaid costs incurred during the moratorium are also addressed in the proposals – they will benefit from a super priority in a subsequent administration or liquidation. The ranking of those costs as between themselves will be subject to a separate hierarchy, with the monitor's costs last in line and existing suppliers who have been prevented from terminating their supply agreements (see further below) first in the queue.

PROVISIONS REQUIRING SUPPLIERS TO CONTINUE TO SUPPLY

Taking inspiration from the US and other highly-ranked insolvency regimes, the government has indicated that it will introduce legislation to prohibit reliance on termination clauses which are based on insolvency events. The legislation will not include a prohibition on varying or amending contracts. Nor will the prohibition apply to other termination grounds such as non-payment, termination by notice, or other termination provisions which are not based on a moratorium, restructuring plan or insolvency procedure. (Similar statutory prohibitions already apply in the context of CVAs and administration cases in relation to a defined list of essential supplies.) The purpose of these new provisions is to assist businesses and allow them to continue to trade during the rescue and restructuring processes. The prohibition will not apply to all supplier contracts, and certain types of financial products and services will be exempted. For example, one would expect the range of exempt agreements to include loan agreements, netting arrangements and derivative products. But of course, until the details of the exemptions are set out in the legislation, the exact scope remains unclear. For those suppliers who are not able to rely on termination provisions, ongoing payments due under the contracts will have to be made. Where there is a requirement to continue to supply, this may be challenged if the supplier itself is subject to undue financial hardship - however the supplier must seek the court's permission to do this. The government considers that such applications would be limited. In practical terms its seems somewhat unfair that those suffering hardships are put to the expense of making a court application. In such situations, one can see that suppliers may simply be unable to comply with the obligations to continue to supply notwithstanding the prohibition on termination. Again, by way of comparison, the Draft EU directive on preventive restructuring frameworks includes at article 7 of the latest draft a proposal for Member States to ensure that creditors do not withhold performance, terminate, accelerate or modify in any

other way, any executory contracts which are to the detriment of the debtor and are based solely on the debtor making use of the preventive restructuring procedures including the stay. The current UK proposals, which whilst limited to a prohibition on termination based on insolvency events, could still result in an unhelpful restriction on the freedom of contract, and certainly merits further consideration before any steps are taken to introduce such measures.

RESTRUCTURING PLANS WITH CROSS CLASS CRAMDOWN

Perhaps the most significant aspect of the announcement is the introduction of a new restructuring plan. To those familiar with the existing restructuring regime they will recognise that it closely resembles a scheme of arrangement, which is available under Part 26 of the Companies Act 2006 and where creditors vote in separate classes to approve a scheme by the requisite majority vote, which may then be sanctioned by the court.

The new restructuring plan, which is to be a separate process included in the insolvency legislation, provides for even greater flexibility than a scheme of arrangement. Under the proposals, a restructuring plan may be approved by the court, overriding the votes against in other classes of creditors (and we assume shareholders), if at least one creditor class, which is affected by the plan, votes in favour by a 75% majority in value. This is often referred to as a "cross class cram down". The main provisos are that the creditors are better off under the plan than the best alternative and that the restructuring plan must ensure that a dissenting class is satisfied in full before a more junior class. This is akin to the absolute priority rule used in the US Chapter 11 procedure. However, the UK reforms are to go further, by allowing the court discretion not to adhere to the absolute priority rule in all cases. So, where it can be justified on the basis that it is "necessary to achieve the aims of the restructuring and it is just and equitable in the circumstances" a restructuring plan may still be approved by the court even though it does not adhere to the absolute priority rule. Certain categories of debt will be exempt from being the subject of a cram down for public policy reasons for example fines and confiscation orders. (It is also worth noting that, the proposals indicate that a further requirement to protect against potential abuse is that more than 50% of the total value of unconnected creditors vote in support of the plan. This additional threshold seems unnecessary in a process conducted and ultimately sanctioned by the court which is already responsible for ensuring that the plan is fair.)

Additional creditor protection under the proposed restructuring plan is provided by the fact that the creditors must be better off under the plan than the "next best alternative". This would take the form of a valuation and comparing what is being offered under the plan to the alternative should the restructuring not be agreed. This will often be the administration or liquidation value, but it is not to be prescribed by the legislation. This reflects the approach in the jurisprudence relating to valuation in the context of schemes and whilst a flexible approach is to be welcomed, it may also provide disgruntled creditors with opportunities to challenge the restructuring plan based on the approach to valuation. Creditors will also benefit from an additional safeguard of being able to present a counter proposal for restructuring in certain circumstances. The complex rules on voting for cross class cram down are also being grappled with in relation to the Draft EU Directive on preventive restructuring frameworks, the latest draft includes at article 11 (a) the ability for one class to bind all classes (with the valuation of the debtor being based on going concern rather than liquidation values); or (b) a majority of all classes. Both

options are subject to various tests including the 'best interest test', the 'fairness test' and the 'absolute priority rule', although the absolute priority rule may be derogated from in relation to (a) in certain circumstances. Such tests are defined in the current draft and are undoubtedly inspired by US Chapter 11 reorganisation procedure.

As mentioned above, the restructuring plan procedure will be contained in the insolvency legislation and will follow the application style of a scheme including two court hearings - one to formulate the class composition, the second to approve the plan. It will sit alongside the other procedures already available under the Insolvency Act 1986 and schemes of arrangement under the Companies Act 2006.

Other changes

In addition, the government will implement new measures to hold directors in group companies accountable for distressed sales. (See our earlier briefing from August "UK Government announces insolvency and corporate governance reforms" see link.) There are also enhancements to be made to the legislation which will allow insolvency practitioners to challenge transactions that have resulted in value being wrongfully extracted from distressed debtors. The Insolvency Service is also to benefit from new powers to investigate the directors of dissolved companies. Certain aspects of the government's initial consultation (again taking their inspiration from the US and other jurisdictions), such as debtor in possession finance, were considered unnecessary and therefore do not form part of the government's proposed reforms.

Coming soon?

The announcement of the reforms could not be timelier and will ensure that the UK restructuring regime is equipped for the future. Whilst the reforms take their inspiration from other jurisdictions (the US Chapter 11 and the Draft EU directive on preventive restructuring frameworks), the announcement as to the form and approach of these future enhancements, illustrates a sophistication and flexibility which go beyond what is currently available in most regimes. The proposals are described at a fairly high level, and the effectiveness of the reforms can only really be properly assessed once the detail is set out in the draft legislation, and of course put into practice. Given current demands on Parliamentary time considering Brexit, it is unlikely that we will see the reforms developed before March next year at the earliest and could in fact be some time off, but at least the government has got the ball rolling and is looking at life beyond Brexit.

KEY ASPECTS OF LOCAL COMPOSITIONS INCLUDING THOSE IN THE UK REFORM PROPOSAL AND DRAFT EU DIRECTIVE ON PREVENTIVE FRAMEWORKS

	UK	US	Germany	France	Italy	Spain	The Netherlands
World Bank ranking: For Doing Business 2018	7	6	20	31	46	28	32
World Bank Ranking: For Resolving insolvency 2018	14	3	4	28	24	19	8
Is a standalone moratorium available?	× New proposal: ✓ Includes 28 day (extendable) standalone moratorium	✓	× New draft EU harmonisation Directive: ✓ Art 6 includes 4mth standalone moratorium	× New draft EU harmonisation Directive: ✓ Art 6Includes 4mth standalone moratorium	× New draft EU harmonisation Directive: ✓ Art 6 includes 4mth standalone moratorium	× New draft EU harmonisation Directive: ✓ Art 6 includes 4 mth standalone moratorium	× New draft EU harmonisation Directive: ✓ Art 6 includes 4 mth standalone moratorium
Prohibition on contractual termination	× New proposal: ✓ Includes prohibition	✓	✓ New draft EU Directive: ✓ Art 7 includes provisions that ensure creditors do not withhold performance, terminate, accelerate, or modify executory contracts based on opening restructuring measures	✓ New draft EU Directive: ✓ Art 7 includes provisions that ensure creditors do not withhold performance, terminate, accelerate, or modify executory contracts based on opening restructuring measures	✓ New draft EU Directive: ✓ Art 7 includes provisions that ensure creditors do not withhold performance, terminate, accelerate, or modify executory contracts based on opening restructuring measures	✓ New draft EU Directive: ✓ Art 7 includes provisions that ensure creditors do not withhold performance, terminate, accelerate, or modify executory contracts based on opening restructuring measures	✓ New draft EU Directive: ✓ Art 7 includes provisions that ensure creditors do not withhold performance, terminate, accelerate, or modify executory contracts based on opening restructuring measures
Key composition procedures?	• Schemes of arrangement • Company Voluntary Arrangements (CVA) • New proposal: Restructuring plan	Chapter 11 reorganisation proceedings	Insolvency Plan	• Safeguard • Accelerated safeguard • Accelerated financial safeguard • Rehabilitation	• *Concordato preventivo* • Debt restructuring arrangements under Art 182 Bis • Reorganisation plans (pre and post-insolvency)	• Refinancing agreements out of court and court sanctioned • *Convenio*	• Draft Dutch scheme • Post insolvency composition
What majority of creditors needs to vote/agree in favour?	• Schemes: 75% in value, over 50% in number in each class • CVA: 75%; cannot bind secured creditors without consent • New proposal: restructuring plan: 75% in value and 50% unconnected, at least one class must vote in favour	66⅔ At least one class must vote in favour	50% in value of each class of creditors	66⅔ in value in each of the classes	• *Concordato preventivo*: 50% in value in majority of classes • Out of court (Art 67): not prescribed • Restructuring arrangements (Art 182 bis): 60% must sign the agreement (no voting) • Debt restructuring with 50% debt due to finance creditors (Act 182 *septies*): 75% finance creditors • Post-bankruptcy	• Out of court protected refinancing: 60% all creditors or 51% financial creditors • Court sanctioned refinancing between 60-75% unsecured 65-80% secured • *Convenio*: 50% majority or between 50%-65% ordinary liabilities and between 60%-75% secured (depends on nature of cram down)	• Draft Dutch scheme: 50% +1 votes representing at least $^{2}/_{3}$ of relevant debts or shares • Post insolvency composition 50% +1 votes representing at least 50% of the unsecured claims, alternative cram down possible with 75% majority votes and court approval

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	UK	US	Germany	France	Italy	Spain	The Netherlands
					composition: majority • Large companies post administration: 50% majority		
Can the Court impose a restructuring (i.e. cross class cram down)?	Currently: Not under CVA or scheme Yes: under the new restructuring plan where at least one creditor class approves, absolute priority rule may be overridden by the court in certain circumstances	Current position: Yes, but only if at least one class approves the plan and it provides that no junior creditor is paid before senior creditors are paid in full and the plan ensures that no creditors are worse off than in a liquidation	Current position: Yes, if non-concurring class is no worse off than in liquidation New draft EU Directive: Art 11 where either: (a) at least one of the affected parties' classes votes in favour (subject to the valuation of the enterprise being based on a going concern rather than a liquidation value); or (b) a majority of voting classes approve (at least one must be secured or senior to unsecured) Both options are subject to a fairness test, and the absolute priority test, with a possible derogation from the absolute priority rule in (a)	Current position: Yes, but only for rescheduling of debt for up to 10 years New draft EU Directive: Art 11 where either: (a) at least one of the affected parties' classes votes in favour (subject to the valuation of the enterprise being based on a going concern rather than a liquidation value); or (b) a majority of voting classes approve (at least one must be secured or senior to unsecured) Both options are subject to a fairness test, and the absolute priority test, with a possible derogation from the absolute priority rule in (a)	Current position: Yes, if non-concurring class is no worse off than in liquidation New draft EU Directive: Art 11 where either: (a) at least one of the affected parties' classes votes in favour (subject to the valuation of the enterprise being based on a going concern rather than a liquidation value); or (b) a majority of voting classes approve (at least one must be secured or senior to unsecured) Both options are subject to a fairness test, and the absolute priority test, with a possible derogation from the absolute priority rule in (a)	Current position: Yes, if non-concurring class is no worse off than in liquidation New draft EU Directive: Art 11 where either: (a) at least one of the affected parties' classes votes in favour (subject to the valuation of the enterprise being based on a going concern rather than a liquidation value); or (b) a majority of voting classes approve (at least one must be secured or senior to unsecured) Both options are subject to a fairness test, and the absolute priority test, with a possible derogation from the absolute priority rule in (a)	Current position: Not yet (draft Scheme legislation includes option for court to declare Scheme universally binding) New draft EU directive: (a) at least one of the affected parties' classes votes in favour (subject to the valuation of the enterprise being based on a going concern rather than a liquidation value); or (b) a majority of voting classes approve (at least one must be secured or senior to unsecured) Both options are subject to a fairness test, and the absolute priority test, with a possible derogation from the absolute priority rule in (a)

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