

Encouraging company rescue

The Government consults on proposals for reform

In 2002 the Enterprise Act re-invented the administration procedure in order to promote a new approach in dealing with companies in difficulty - to rescue them as a going concern. Fast-forward to 2009 and, whilst the new approach has had some success, a number of factors – not least the recent financial crisis – have caused the Insolvency Service to launch a consultation to establish what further reforms are necessary to further encourage the rescue philosophy.

Aim and objectives

The Insolvency Service's stated aim is to improve the corporate rescue culture. It notes that the insolvency regime in the UK rates highly against others (including the US) and has therefore rejected the wholesale incorporation of another system (such as US Chapter 11), in favour of an approach targeting key issues in the existing regime. Two of the objectives it believes critical to this aim are greater use being made of company voluntary arrangements ("CVA's") and the provision of credit to companies which have entered some form of insolvency procedure.

The Proposals

There are six proposals on which the Insolvency Service seeks a response. They fall into two distinct categories:

- development of new moratoria; and
- encouraging financing in administrations and CVA's.

Development of new moratoria

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. Under the Insolvency Act 1986 ("IA 1986") no moratorium on creditor action was available for companies in a CVA. This position was altered by the Insolvency Act 2000 which enabled small companies in financial difficulties to obtain a moratorium of up to 28 days by filing documents with the court whilst seeking agreement with their creditors to deal with their debts. The limitation of the procedure to "small" companies has meant that the procedure has rarely been used in practice.

Extending the "small company" moratorium

One of the current proposals is to extend the CVA moratorium so that it applies to all companies and LLP's, removing the need for those entities to enter administration solely to secure the protection of a moratorium (as is now the case), and therefore saving them money.

It is proposed that the existing provisions as to which companies are not eligible for a moratorium should be preserved and applied to all entities which can benefit from the moratorium. These provisions do not permit companies:

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- engaging in certain types of business (e.g. accepting deposits, carrying out insurance contracts, participating in certain financial markets, engaging in certain capital market transactions or being a public-private partnership with step-in rights); or
- in administration, administrative receivership or liquidation (or with relevant officeholder in place), where a voluntary arrangement is in place or where (in certain circumstances) a moratorium had been in effect in the preceding 12 months,

to benefit from a CVA moratorium.

Whilst the extension of the existing "short" moratorium does not give rise to any novel considerations, save for the consideration of its utility and the fact that its operation has arguably not yet been properly "stress-tested", given its infrequent use, the second proposal, for a new "long" moratorium, raises some interesting issues.

A new moratorium

Eligibility for a "long" moratorium would depend on the court being satisfied that:

- the company or LLP is unable to pay its debts (within the meaning of s123 IA 1986) or likely to be unable to pay its debts within three months of the hearing date;
- there is a reasonable prospect of a CVA being approved by the creditors; and
- in the circumstances, sanctioning a moratorium would be in the interests of the creditors as a whole.

The initial application would have to be supported by a statement from an Insolvency Practitioner ("IP") that, in the IP's professional view, the above tests were satisfied.

The IP would also be required to report to the court as soon as practicable if events had occurred resulting in the tests no longer being satisfied, in which case the court would have the discretion to remove, or amend the conditions of, the moratorium, move to another insolvency procedure or make another order (provided it does not extend the moratorium beyond three months).

Key issues for consideration relating to the new proposed moratorium include:

- whether, distinct from the existing administration moratorium, this would be a useful additional process;
- whether the prescribed period should be different or left to the discretion of the court;
- whether the tests are appropriate, too vague, or likely to prejudice individual creditors disproportionately; and
- whether an IP can adequately, or should, make the judgement that the moratorium is in the interests of the creditors as a whole.

The Insolvency Service estimates that, on the basis of likely numbers of entities which will use the proposed new moratoria, and the average turnover and headcount of such entities, the combination of the two moratorium proposals will preserve between £450 million and £8,500 million of turnover and between 3,000 and 57,000 jobs.

Encouraging financing in administrations and CVA's

The second category of proposals relates to issues of debt financing and security, and its priority, in administrations and CVA's. The proposals are that:

- the costs of financing provided to a company in administration should rank ahead of other administration expenses;
- an IP acting as 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 ranking prior to existing fixed charges, **provided that** such security is necessary to obtain financing, the interests of the fixed charge holders are adequately protected and obtaining the finance is in the best interests of the creditors as a whole;

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- 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 the new or subordinated fixed charges), pari passu with or ranking prior to existing fixed charges, **provided that** such security is necessary to obtain financing, the interests of the fixed charge holders are adequately protected and obtaining the finance is in the best interests of the creditors as a whole; and
- an asset-based lending agreement or a floating charge entered into prior to an insolvency event should be limited to the assets acquired or book debts arising prior to the occurrence of that event (excluding already-assigned long-term receivables in respect of which loans have already been advanced).

The objective of these proposals is to encourage financing of companies which have entered administration or CVA procedures by making such financing less risky, thereby promoting the rescue philosophy.

Super-priority of financing costs

The first proposal is relatively narrow, in that it would provide for finance costs properly incurred (which are already considered administration expenses) to rank before other administration expenses (it does not apply to CVA's, which can include such a proposal if agreed). Whether this change would have a significant impact in achieving the proposal's objective is clearly open to some debate.

Security for post-insolvency financing

Granting pari passu or super-priority fixed charges clearly affects the holders of fixed charges on the same assets, and granting (further) fixed charges effectively (further) postpones the claims of holders of floating charges in the context of an insolvency. Other legal, contractual and commercial issues arising from the second and third proposals include:

- under IA 1986, a CVA meeting may not approve, and an administrator may not propose, action which affects the right of a secured creditor to enforce his security;
- lenders are often granted negative pledges in their loan documentation, under which borrowers covenant not to grant security other than to those lenders (sometimes with limited exceptions); and
- the implementation of these proposals may give rise to upward pressure on loan pricing, given the possibility that pre-insolvency lenders may find their security rights competing with those of post-insolvency creditors.

Any new legislation would have to remove legal obstacles and, as the proposals suggest, override negative pledge clauses where appropriate. Much more difficult will be formulating the grounds on which an administrator or the directors of a company (as the case may be) make the judgements that the interests of the fixed charge holders are adequately protected, and obtaining the rescue financing is in the best interests of the creditors as a whole. Both proposals contemplate the ability of fixed charge holders to challenge the proposal of new security, but the scope of such challenge, and the complexity of the process (particularly in the context of a CVA) are open to question and would be likely to give rise to litigation.

Limitation of assets available to asset-based lenders and floating charge holders

The aim of this final proposal is to enable companies to secure post-insolvency financing on assets acquired or arising post-insolvency, by limiting the reach of pre-insolvency asset-based lending arrangements or floating charges (excluding where loans had been advanced pre-insolvency on the basis of long-term receivables arising post-insolvency). This may again lead to higher financing costs, as described above, although the consultation suggests that creditors should be able to appeal if they feel they have been unfairly treated.

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Termination of contracts and licences

There is a further issue which in practice can make it difficult to achieve a rescue through a formal insolvency process, namely the ability of a contract counterparty or licensor to rely on clauses allowing them to terminate a contract or licence in the event of insolvency. In some jurisdictions insolvency law restricts the operation of such clauses, but the Insolvency Service's proposals do not currently deal with this issue.

Your views

The objectives of the reform proposals are not controversial. However, as noted above, there are legal, commercial and practical complications, in particular relating to balancing the rights of existing and "post-insolvency" lenders. We would be very interested to hear from you if you have any comments on the consultation.

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