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ALTERNATIVES TO FORMAL INSOLVENCY IN ENGLAND & WALES

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1 Obligations on Directors

The Companies Act 2006 imposes a duty on the directors of a company to act in a way that they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. When a company is clearly solvent, there is no requirement to consider creditors' interests as such. On the other hand, when a company is insolvent, directors must consider creditors' interests before those of the shareholders. Between these different requirements, there is clearly a grey area and it has always been unclear precisely at what point and to what extent a director's duty to promote the success of the company for the benefit of its shareholders is displaced by a duty to act in the best interests of the company's creditors. Because no two set of circumstances are ever quite the same, each case is different and turns on its own facts.

Directors can be held to account in many different ways. Leaving aside obvious cases of fraudulent trading, transactions defrauding creditors, transactions at an undervalue, voidable preferences, the creation of floating charges to connected parties and misfeasance, you have the concept of "Wrongful Trading".

Where a company has proceeded into insolvent liquidation the Court, on the application of a liquidator, can order a director and/or shadow director to make a contribution to the assets of the insolvency if the Court is satisfied:-

1.1 That before the commencement of the winding up, the director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation; and

1.2 Thereafter the director failed to take every step with a view to minimising the potential loss to the company's creditors which he ought to have taken.

The standard required as to what a director ought to know or ought to have known, in the specific circumstances, the conclusions which he reached and the steps which he took or ought to have taken is the standard of what would be known, reached or taken by a reasonably diligent person with the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as those of the director in relation to the company and with the general knowledge, skill and experience that the director has.

Wrongful Trading as well as the Formal Disqualification of company directors tends to attract much attention during the course of the so called Twilight Zone where a company may be subject to financial stress or distress but is not necessarily insolvent. It is essential for directors to take specialist legal advice.

Under English law the relevant test for insolvency is "inability to pay debts". A company is deemed to be insolvent if it is unable to pay its debts. In practice this means one or other of either a "cash flow" or "balance sheet test". The cash flow test applies if a company is unable to pay its debts as they fall due. The balance sheet test is satisfied if the value of the company's assets is less than the amount of its liabilities taking into account its prospective and contingent liabilities. Although please note there has been a recent case which is currently the subject of an appeal which may or may not re-define the "balance sheet test".

2 Formal Procedures

In descending order as to the general survival of the corporate entity as opposed to simply the business within it or the assets owned by it are the following:-

2.1 Scheme of Arrangement – most likely to survive

2.2 Company Voluntary Arrangement

2.3 Administration

2.4 Receivership of specific assets

2.5 Administrative Receivership

2.6 Creditors' Voluntary Liquidation

2.7 Compulsory Liquidation – least likely to survive

There is no formal requirement that a company has to be insolvent in order to be the subject of a formal Scheme of Arrangement, alternatively a Company Voluntary Arrangement. Either of these may be invoked simply because the directors believe that it is likely that the company <u>may</u> become insolvent and are taking steps to protect the business and assets of the Company at a relatively early stage.

Receivership of a specific asset, typically real estate, tends to happen when a company is unable to meet the formal demand of a secured creditor, typically a lender with a specific legal mortgage or charge either with a debenture in addition or without one – in most cases the debtor company will be insolvent although strictly speaking that is not necessary.

3 **<u>Informal/Restructurings</u>**

In the last few years lenders have become reluctant to pursue formal insolvency processes such as appointing administrators, administrative receivers or liquidators in relation to the debtor company. Lenders have come to realise that in many cases they would be better off if the debtor is reorganised without a formal process. Formal processes rarely, if ever, add any value and are typically only used as a last resort when every other avenue has been explored without success.

US based holders of UK corporate bonds increasingly expect restructuring outcomes similar to those achieved by a debtor in possession procedure under Chapter 11 of the US Bankruptcy Code. In many cases this can involve debt for equity swaps, the dilution of existing shareholdings and an additional injection of working capital. Of course these matters have to be tackled at an early stage because typically the debtor company will not have the benefit of a moratorium. All there may be is an agreement between the creditors involved and the debtor company. One of the key differences between US and UK law is the complete lack of a statutory basis for DIP finance. In larger cases a few years ago, creditors with competing interests were sometimes asked to subscribe to a code of conduct during a standstill period called the "London Approach".

Of course many different factors will impact on the ability of a company to negotiate a restructuring, the most important of which will be:-

(a) the fundamental viability of the underlying business of the debtor company together with its future prospects;

(b) the debtor company's ability to generate sufficient cash to service its debts;

(c) the terms of its facility agreements with one or more lenders including, in particular, event of default provisions and priority arrangements between the lenders;

(d) the involvement of distressed debt investors.

Some financing documentation may require a very high threshold of agreement, 90% if not 100% of lenders which can make an agreement difficult to achieve. In that case the company propose a scheme of arrangement, or alternatively a CVA to compel minority creditors to participate in the re-organisation.

KPMG in the UK have been quite successful in the last two years of implementing CVAs in large retail enterprises saddled with a diverse number of potentially unprofitable leasehold retail units where the rent is too high and there are long break clauses. They have been successful in providing different outcomes for different groups of landlords and the businesses have continued to operate in circumstances where a non-insolvency restructuring would have been impossible; on the other hand a formal restructuring would have lead to a break-up of the entire enterprize.

A debt for equity swap is a fairly common method of reorganising a struggling company. It involves one or more of the company's lenders converting their debts into one or more classes of the debtor company's share capital. Typically a debt for equity swap will be undertaken at the same time as issuing further shares or the sale of a percentage shareholding to a strategic outside investor. Of course there is no prescribed format for a debt for equity swap. Consequently the rights and restrictions attaching to shares issued to a lender may depend on a number of different factors although typically it is likely that the shares issued to a lender in a debt for equity swap, whether ordinary or preference shares, are likely to rank ahead in priority of the company's ordinary shareholders.

4 Pre-Packs

Pre-packs have become quite common and much used in the last 10 years. There is no specific legislative provision which governs pre-packs although there is an important code of practice – SIP 16 which provides mandatory guidance on the best practice for Insolvency Practitioners dealing with a pre-pack situation. Over the years pre-packs have evolved into one of the tools utilised to save a business. In its scope and procedurally it stands somewhere between an alternative to formal insolvency coupled with a formal insolvency procedure.

If a consensual non-formal restructuring cannot be achieved then the business and assets or the majority part thereof may be sold with the approval of the individual or individuals likely to be appointed administrator(s) with the sale being completed immediately after his, her or their appointment. In other words, the sale is organised, structured and finance arranged before the formal insolvency, completion of the deal taking place immediately after the appointment of the administrators. Whereupon it becomes a formal insolvency.

The aim of this exercise is to maximise the value of the business because the outside world is typically unaware of the negotiations taking place behind the scenes. It is essential for the proposed administrator who is subsequently appointed to ensure that maximum value for the company's business is achieved and an Insolvency Practitioner in the UK is subject to strict reporting and evaluation requirements imposed on him by his formal licensing body under a code referred to above - Statement of Insolvency Practice No. 16.

The prospective purchaser may be a connected party; alternatively an unconnected third party. It is particularly important for the appointed administrator to be able to justify the pre-pack sale if it is to a Newco which is owned by some or all of the existing owners or directors of the debtor company. In other cases of course the newco might be owned by an entirely unconnected party or by the debtor company's existing lenders as a variation to convert their debt into equity.

5 International Angles

The following are relevant:-

5.1 The EU Regulation on Insolvency Proceedings 2000 (EU Council Regulation EC 1346-2000) of 29 May 2000

5.2 The UNCITRAL Model Law on Cross Border Insolvency (The Cross Border Insolvency Regulations 2006

5.3 Section 426 of the Insolvency Act 1986

The EU Regulation Insolvency became operative on May 31, 2002. It applies within the whole of the European Union apart from Denmark. For the purpose of the Regulation the UK is regarded as one jurisdiction plus Gibraltar. Note that the United Kingdom has three separate legal jurisdictions: England & Wales, Scotland and Northern Ireland.

Insolvency proceedings opened in any EU member state (apart from Denmark) are recognised throughout the EU without any further formality as soon as the proceedings are opened in a member state. A substantial body of case law has developed and is developing around the EU Regulation. The Regulation does not seek to harmonise the substantive insolvency laws of the various member states. By enlarge it enshrines the general principle that the applicable law shall be that of the state in which the particular insolvency proceedings are being conducted. The Regulation applies to both individual and corporate insolvencies. Key to understanding the EU Regulation is the concept of COMI – the "centre of a debtor's main interests".

The Cross Border Insolvency Regulations 2000 enacted the UNCITRAL Model law into the law of England & Wales on April 4, 2006. The Regulations provide for the recognition of a foreign proceeding commenced in any foreign country in most cases whether or not that foreign country has enacted a version of the model law.

Section 426 of the Insolvency Act 1986 provides for cooperation between jurisdictions within the United Kingdom and also cooperation between the United Kingdom and other designated jurisdictions, which mainly includes Commonwealth countries and UK colonies. Where Section 426 of the Act applies, it provides an alternative means of relief and assistance to the Model Law. It is likely that the countries or territories that have the benefit of Section 426 of the Insolvency Act 1986 will continue to use it until there is sufficient certainty about the operation of the recognition proceedings under the Cross Border Insolvency Regulations 2006 and where it confers advantages over and above the Regulations.