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Dear Sir / Madam

Response of the Insolvency Law Committee of the City of London Law Society to the consultation document on proposals to encourage company rescue

Introduction

The City of London Law Society ("CLLS") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

1.1 The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. The CLLS Insolvency Law Committee, made up of solicitors who are expert in their field, have prepared the comments below in response to the proposals, aimed at encouraging corporate rescue, contained in the consultation paper. Members of the working party listed in the Schedule to this letter will be glad to amplify any comments if requested.

2. PROPOSAL A: EXTENSION OF SMALL COMPANY MORATORIUM PROVISIONS TO LARGER COMPANIES

2.1 We are supportive of extending the use of a moratorium process. This includes extending the Company Voluntary Arrangement ("CVA") small moratorium provisions to larger companies. However, we believe that this would have little impact because of the limitations of the CVA procedure, described at 3.2 below, which means that very few larger companies (particularly in the current market) would be able to use a CVA as a restructuring tool even where the moratorium is available.

2.2 We also note that the small company moratorium is not recognised under the EC Regulation on Insolvency Proceedings 2000. Further consideration should be given as to whether Annex A should be amended if the small company moratorium provisions are extended to larger companies. There is more likely to be a need for cross border recognition with larger companies.

A1. Do you agree that it would be helpful for medium and large-sized companies to be allowed to benefit from the option of a moratorium from creditor action for up to 28 days?

Please see our comments above.

A2. How useful do you think this would be? Do you think it would encourage medium and large-sized companies to utilise the CVA procedures?

Please see our comments above.

A3. Do you think there are any risks or disadvantages to this proposal? If so, what are they and how would you suggest that they could be addressed?

Please see our answer to question B5 below.

3. PROPOSAL B: COURT SANCTIONED MORATORIUM

3.1 We agree that larger companies are likely to have more complex affairs than smaller ones, and may therefore need additional time to ensure that a sufficient number of creditors are in agreement with the terms of any restructuring proposal. In principle, we are therefore supportive of Proposal B.

3.2 However, CVAs are of limited use to larger companies as a restructuring tool. The main reason for this is that they cannot be used to compromise secured creditors without their consent. It is often not practical to obtain the consent of each of the secured creditors because of:

(a) the large number of lenders in the banking syndicate. Even where the restructuring is clearly in the interests of the secured lenders it may not be possible to get their consent because:

  (i) they have cross holdings in different levels of the debt structure; or

  (ii) they have not engaged in the restructuring process because of the small size of their stake or because of internal constraints; or

  (iii) they are seeking to receive preferential treatment by holding out; and

(b) where the value breaks. Where the junior secured lenders are out of the money there is no incentive for them to agree to a restructuring proposal unless they receive compensation (which amount would need to be agreed with the senior lenders who would themselves be out of the money).

3.3 In light of the inherent difficulties which are linked to CVAs, we would suggest that the Insolvency Service also consider amending Part 1 of the Insolvency Act 1986 and in particular section 4(3) to enable a CVA to bind secured creditors. We would suggest that the legislation is amended to enable secured creditors to be compromised provided that 75% of the secured creditors voted in favour of the CVA. Given the significant differences in the recoveries in an administration or liquidation between secured lenders with security with a different ranking of security, we would suggest creditors with different priority security should vote separately, as would be the case in a scheme of arrangement.

3.4 As a CVA cannot be used as a restructuring tool to compromise secured debt (as the legislation is currently drafted), the practice has developed of using a scheme of arrangement under Part 26 of the Companies Act 2006, sometimes combined with administration.

3.5 In addition to amending the CVA procedure, we would suggest that the court sanctioned moratorium is extended to cover the period during which the directors of the company are getting the buy in from a sufficient number of creditors to a restructuring proposal which may be implemented either consensually or via a scheme of arrangement.

3.6 There is no formal requirement for an Insolvency Practitioner ("IP") to be involved in either a scheme of arrangement or a consensual restructuring and therefore the requirements set out in paragraph 47 of the consultation paper would be difficult to satisfy. An alternative proposal would be for the company's directors to provide evidence to support their views that the restructuring had a reasonable prospect of success and to undertake to notify the court in the event that the conditions for making the moratorium are no longer satisfied. This is not dissimilar to orders which have been made by the court when making orders under section 127 Insolvency Act 1986 which in practice enable the directors to continue to trade in the interests of the creditors as a whole whilst a winding up petition is outstanding.

3.7 Even if an insolvency practitioner has been appointed to advise the company, for example when it is anticipated that a CVA will be proposed, IPs may be unwilling to agree to notify the court if the conditions for the moratorium are no longer satisfied prior to their appointment as nominee under a CVA. Without a formal appointment, IPs would not have any power over the company as the directors would remain in control and therefore would not be certain that they had received the necessary information to enable them to consider whether it was appropriate for the moratorium to continue.

3.8 It will also be difficult for an IP (or the company's directors) to give confirmation that "there is a reasonable prospect of a CVA being approved by the creditors" at a time when the CVA proposal has not yet been filed at court. At best this will need to be a subjective view based on ongoing negotiations. A moratorium should give the company a breathing space to reach agreement with its creditors on a suitable restructuring process at a time when it is unable to pay its debts or is likely to become unable to pay its debts.

3.9 To simplify the process, it may be preferable to combine Proposals A and Proposals B, such that there is one gateway procedure where an initial moratorium of 28 days is granted. This moratorium could then be extended to three months following a more comprehensive court hearing. To the extent that the formalities required under each provision are not radically different, and that the filings to be made for a court-sanctioned moratorium are not much more burdensome than those required under the small companies' moratorium provision, it is likely that the longer moratorium available under the court process will consistently be the more attractive option for companies in financial difficulty, possibly making the small companies moratorium redundant.

B1. Do you agree that it would be helpful to have a new Court sanctioned moratorium on creditor action?

Please see comments above. We agree that it would be helpful, but to ensure that this procedure is more widely used then the court sanctioned moratorium should be extended to other restructuring procedures and CVAs should be extended so that they bind secured creditors.

B2. Do you agree that the proposed moratorium period of 42 days, extendable to 3 months, is appropriate?

Please see comments above. It would be more straightforward if Proposal A and Proposal B were combined. Therefore it may be more appropriate to shorten the initial 42 day period.

B3. Do you agree with the proposed tests that the Court would need to consider and the suggested role for the Insolvency Practitioner? If not, what do you suggest?

Please see comments above.

B4. How useful do you think this procedure would be?

Please see comments above and answer to Question B1.

B5. Do you think there are any risks or disadvantages to this proposal? If so, what are they and how would you suggest that they could be addressed?

If this procedure was introduced secured lenders and landlords would be restricted from taking any action. However, certain unsecured creditors who had key contracts with the company that were necessary for the continuance of the business, for example IT contracts, would be in a position where they could seek to improve their position by threatening to terminate their contracts during the moratorium.

We note that section 233 Insolvency Act 1986 already applies whilst a moratorium under section 1A is in force and we have assumed that this would be extended to cover this new moratorium process. Section 233 provides that a supplier of key utilities is not entitled to request payment of outstanding charges as a condition of ongoing supply. We would suggest extending this clause to cover other key services which are necessary to the ongoing operation of many companies. However, we note that during the moratorium procedure an officeholder would be unlikely to agree to personally guarantee the payment of any charges in respect of the ongoing supply as the officeholder would not have control of the company's assets.

4. PROPOSAL C: SUPER-PRIORITY OF RESCUE FINANCE IN ADMINISTRATION EXPENSES

4.1 Proposals C, D and E consider various proposals to improve the availability of funding either when a company is in administration or has proposed a CVA. We have a number of comments on the need for such funding in general:

(a) funding is often available for larger companies which enter administration. However, mid-market companies are likely to find it more difficult to access funding.

(b) where funding is available, even where it is secured it is likely to be expensive.

(c) if the aim is to provide more readily available cheaper finance whilst a company is in administration then it will be necessary to provide the best priority possible for that funding. However, if Proposal C is adopted, this may have a consequential impact upon the company's ability to trade whilst in administration because:

  (i) the funding would rank ahead of necessary trading expenses and counterparties may be less willing to continue to trade with a company in administration; and

  (ii) administrators may be less willing to take appointments where they are concerned that their fees will not be met because of the super-priority nature of the rescue finance. In practice, the administrators would not enter into arrangements for rescue funding where they believed that as a consequence their fees would not be paid.

C1. Do you agree that finance properly incurred in attempting to rescue a company should rank in front of other administration expenses?

Yes. The additional comfort of ranking ahead of all other administration expenses may act as a useful incentive for lenders to provide rescue finance and may also have a positive effect on the terms on which they make such finance available. It would also be a useful opportunity to provide further clarity on what constitutes an administration expense, and in particular on what expenses fall into the different categories set out in Rule 2.67 Insolvency Rules 1986.

There could be an option for the lenders providing the finance to agree that they should rank behind the administrators' costs whilst still retaining the status of an administration expense. This may address the concern expressed at paragraph 4.1(c)(ii) above and may be used by existing lenders seeking to enhance their recoveries by funding the company during administration.

C2. How useful do you think this would be?

Please see comments above. This may be of use particularly to mid-market companies, although the administrators will still need to think carefully about the benefit to the estate as such rescue finance is likely to be expensive. As discussed above, administrators will not be willing to enter into rescue finance if there was a risk that this would lead to an administratively insolvent estate where the fees of the administrators and other administration expenses were not paid in full.

In practice the funding proposals set out in Proposal C may not have a significant impact because new lending already attracts super priority within the existing administration expenses regime (albeit that further clarity would be welcomed as set out in our response to C1 above).

C3. Do you think there are any risks or disadvantages to this proposal? If so, what are they and how would you suggest that they could be addressed?

Please see comments above.

5. PROPOSAL D: GREATER ABILITY TO CREATE NEW SECURED CHARGES IN AN ADMINISTRATION

5.1 This proposal is far reaching and seeks to incorporate some of the aspects of DIP Financing in a Chapter 11 in the United States into a UK administration. As we explain further at 5.5 below, it will be a considerable challenge to incorporate elements of the US legal system into the UK given the scale of the differences between the two legal systems. We are also concerned that this is a fundamental change to the order of priority and may therefore affect lending decisions prior to administration.

5.2 Proposal D notes that it would be a condition of such a scheme that "the interests of the existing fixed charge holders are adequately protected." However, the detail of what constitutes "adequate protection" is not clear from the consultation paper. In our view, adequate protection should result in the fixed charge holders being repaid in full or continuing to have security which would enable them to be repaid in full (or, to the extent that the security was already insufficient, to enable them to receive the same recovery as they would otherwise have received if the rescue finance had not been put in place)[1]. If this is the test it will still be difficult to establish that it will be satisfied.

5.3 In practical terms, it seems difficult to achieve "adequate protection" with a sufficient degree of certainty, so as to provide existing fixed charge holders with the level of comfort which they would reasonably require. The consultation paper does not consider:

(a) how the existing security would be valued to establish whether there was "adequate protection". Would it be valued on a going concern basis or would the administrator look at the valuation on a liquidation basis?

(b) when would the security be valued? Presumably this would be at the time the new security is granted, but should account be taken of the forecasted value at the time the new rescue finance is due to be repaid? There is a risk that whilst the existing fixed charge holders may have adequate security at the time the new security is granted, the value of the asset may subsequently deteriorate and which may result in a shortfall to the existing secured creditors.

(c) would accruing interest both under the rescue finance and the existing finance be taken into account when establishing whether or not the existing fixed chargeholder had adequate protection? As discussed above, the cost of such rescue finance is likely to be high.

5.4 The suggestion is that if existing fixed chargeholders disagreed with the administrator's view it would be open for them to challenge the matter in court. This would seem to add an undue burden on existing creditors and may result in an undesirable increase in litigation. Paragraph 68 of the consultation paper notes that "the burden of proof would be on the administrator to show that existing charge holders are adequately protected". From an IP's perspective it would be difficult to discharge this burden of proof – would existing chargeholders have a right to bring a claim against the IP if it subsequently turned out that they had not been "adequately protected". We do not believe that this mechanism would be used if the IP was left exposed in any way: it is most unlikely that an IP would be willing to take the risk of vouching that a particular creditor's interests are "adequately protected".

5.5 Instead, if this proposal was implemented, the determination of whether interests are "adequately protected" should be a matter for the court to decide. Such a court process, which would provide a forum within which creditors could raise their objections from the outset, would also bring the proposal more directly into line with the US Chapter 11 procedure from which it has been derived.

5.6 However, court involvement points to additional issues which have not been addressed in the proposal. In particular, this would raise issues in terms of (i) the valuation evidence to be provided (as

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1 We note however the suggestion in paragraph 77 of the consultation that becoming unsecured and voting on a CVA would be one means by which the interests of the existing fixed charge holders could be adequately protected. We do not agree that this would be adequate protection

discussed at 5.3 above) and (ii) the wider implications for our court system (for example the lack of specialist expertise as we do not have a separate bankruptcy court). This highlights the difficulty of trying to import elements of another judicial system without making the necessary background changes to support them.

5.7 These points combined lead us to the conclusion that creating super-priority for rescue funding ahead of existing fixed charges, without ensuring all the necessary safeguards are in place, would not be desirable.

5.8 We note that the consultation paper does not set out whether the ability to grant security in priority to existing fixed charges would be retrospective such that it would enable new security to be granted in priority to fixed charges which have already been granted. If they were not applied retrospectively, this would cause difficulties where security had been granted by the same company to different lenders at different times where the prior ranking security was capable of being primed by granting the new fixed charge but the junior security had been granted prior to the legislation coming into force. They would also have a limited impact during the present recession. However, we would have significant concerns if the proposal is implemented retrospectively in relation to charges granted prior to the legislation coming into effect. If it were perceived that the government was prepared to make a limited incursion of fixed charge security, the market would have to assume that a future government could treat it as a precedent that such rights could be overridden in line with its policy objectives.

5.9 As to the consequences which Proposal D may have on the terms on which lenders would in the future be willing to make finance available, there is an undeniable risk that, faced with the possibility of a weakening of their security at a time prior to administration when the company is in financial difficulty and therefore when security is most important, lenders will either be more reluctant to grant finance, or will reflect this added risk to them in the price at which they make such finance available. This may potentially force some companies into administration as the lenders are not willing to provide additional funding without the security which could be given if Proposal D were implemented.

5.10 We note that the consultation paper does not address how any new security would interact with the intercreditor arrangements for the existing security. If the new rescue finance took priority, the existing first ranking security would not be capable of being enforced. Is the intention that the rescue finance be repaid prior to the exit from administration? If not, what will happen to the arrangements between existing senior and junior chargeholders – typically the junior creditors are entitled to enforce if the senior creditors haven't enforced their security within a specified time period. Although these rights would be subject to the moratorium during the administration, what impact would there be on the existing intercreditor arrangements in the event of an exit from administration?

D1. Do you agree that there should be greater scope to secure post-insolvency financing by an ability to create new fixed charges?

Given the concerns expressed above, and in particular the difficulty of importing one element of Chapter 11 without more wholesale reform, our view is that it would be preferable to improve the administration expense regime rather than implement Proposal D.

As stated in paragraph 62 of the consultation document, we note that any agreement entered into by an administrator for rescue finance already ranks ahead of both floating chargeholders and unsecured creditors as a result of the existing administration expenses regime.

We also note that administrators already have a statutory power to grant security and therefore would be able to grant security for rescue finance despite the existence of a negative pledge. As such security would be second ranking or would be over unencumbered assets it would not affect the existing order of priority in favour of fixed chargeholders. We understand there is a divergence of views on whether an administrator has the ability to grant security where there is a contractual restriction under a negative pledge clause. Therefore we would welcome legislation to clarify the existing position that an administrator can validly grant security despite the existence of a negative pledge clause.

D2. How useful do you think this would be?

Please see our comments above

D3. Do you think there are any risks or disadvantages to this proposal? If so, what are they and how would you suggest that they could be addressed?

Please see our comments above.

In the event that the legislation was amended to permit the creation of new security in priority to existing fixed security, there is a risk that the existing fixed charge creditor will not be paid in full. We would suggest that any deficit in the recoveries to the existing fixed charge holder which arose as a result of the creation of the new security should be an administration expense.

6. PROPOSAL E: GREATER ABILITY TO CREATE NEW SECURED CHARGES IN A CVA

6.1 As discussed above, a CVA is of limited use as a restructuring tool because it does not bind secured or preferential creditors. It therefore cannot be used where there is a need to compromise secured debt and the secured lenders have not unanimously agreed to the restructuring. In addition, a CVA cannot be used to restructure the equity or implement a debt for equity swap without the consent of the relevant majority of shareholders.

6.2 In theory, if the existing lenders are over-secured then the proposals suggested in the consultation paper may be of use. However, in the current market, the lenders are unlikely to be over-secured and therefore there will not be any free collateral.

6.3 The concerns about the valuation of the existing security and the ability to give existing fixed chargeholders “adequate protection” will apply equally to Proposal E as to Proposal D.

6.4 However, if the proposed amendments to the CVA procedure set out in paragraph 3.3 above were made, we would be in favour of using a CVA to obtain the agreement of the existing secured lenders to the creation of new prior ranking security, provided that the requisite majority of those secured lenders had agreed to its creation.

E1. Do you agree that access to CVA financing should be facilitated by the ability to offer new security?

Not as currently proposed. Please see our responses to Proposal D above for more detailed concerns about implementation of this proposal.

E2. How useful do you think this measure would be for companies contemplating a CVA?

In principle, this measure would be useful. However, we do not believe it should be implemented in any given case unless it had been approved by more than 75% of the existing secured lenders.

E3. Do you think it is appropriate for the Court to have a role in ensuring protection is provided for existing fixed charge holders?

If new security is to be provided ranking ahead of existing fixed charge holders this should be approved by the Court.

E4. Is it viable to suggest that a company might be able to obtain insurance against the possibility that an existing charge holder is not repaid in full as a consequence of priority being given to a rescue finance provider?

It may be possible to obtain insurance. However, we believe that before insurance companies would be willing to quote for such insurance they would need to carry out extensive diligence on the risk. As this would be difficult to quantify, if they were willing to quote then it would likely involve a significant premium. In practice, this means that obtaining such insurance would be expensive and time consuming and it would therefore not be used.

E5. Do you think there are any risks or disadvantages to this proposal? If so, what are they and how would you suggest that they could be addressed?

Please see our comments above in relation to both Proposals D and E.

7. PROPOSAL F: CESSATION OF CERTAIN ASSET BACKED LENDING (ABL) ARRANGEMENTS ON ADMINISTRATION OR CVA

We have not commented on Proposal F.

Please contact the members of the working party listed in the attached schedule if you would like further clarification of any of the points raised above.

Yours faithfully

David McIntosh
Chair
City of London Law Society

Schedule: Members of Working Group

Ken Baird

Mike Woollard

Rita Lowe

Stephen Gale

Patrick Corr