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Proposals for a Restructuring Moratorium - A Consultation. Response of City of London Law Society Insolvency Law Committee

INTRODUCTION

1. We refer to the Insolvency Service consultation paper entitled "Proposals for a Restructuring Moratorium" published in July 2010 (the **Consultation**). This response has been prepared by the City of London Law Society (**CLLS**), Insolvency Law Committee.

2. The CLLS represents approximately 14,000 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.

3. The CLLS responds to Government consultations on issues of importance to its members. The CLLS Insolvency Law Committee, made up of solicitors who are expert in their field, have prepared the comments below in response to the restructuring moratorium proposal, contained in the Consultation. Members of the working party listed in the Schedule attached will be glad to amplify any comments if requested.

4. In this response, we have made some general comments in relation to the relevant sections of the Consultation rather than confining our comments to the particular questions raised. This is because we consider that there are some key points not covered by the consultation questions. We have set out in the Appendix a summary of our responses in relation to the consultation questions although these should be read in the light of this response as a whole.

GENERAL AND OVERRIDING COMMENTS

5. Initiatives aimed at assisting the restructuring of viable businesses facing financial difficulty, particularly where such initiatives may reduce the costs inherent in that process, are to be welcomed. We are grateful that this latest proposal takes on board many of the comments made in response to the earlier proposals in the June 2009 consultation paper on "Encouraging Company Rescue". In particular, we welcome the fact that the proposed restructuring moratorium is not limited to scenarios where a CVA is being considered but is much wider in scope.

6. That said, we consider that a strong case needs to be made out for introducing any legislative changes (and the period of uncertainty that such changes inevitably brings about). Legal certainty in a restructuring scenario is even more important in a period of economic downturn. The detail is essential and, for the reasons set out in this paper, we are concerned that some of the detail in relation to the proposed moratorium (particularly in relation to the priority of moratorium debts, international scope or recognition and who should be consulted in relation to, or asked to approve, the moratorium) has not yet been worked through and could prove problematic when it comes to pinning down the detail.

7. Members of our committee are divided in relation to whether a strong case can be made out for the proposed restructuring moratorium. As discussed further below, some members have given examples of restructurings where it was necessary to use the stay inherent in a formal insolvency process in order to bind dissenting creditors. Others have cited restructurings which almost failed as a result of last-minute creditor action. There are also concerns that, without a statutory moratorium, creditors may commence insolvency proceedings in order to trigger credit default swap (CDS) protection and in circumstances where such proceedings are not in the interests of the stakeholders as a whole[1].

8. On the other hand, some members question whether the moratorium is the right focus for any legislative change. They suggest that the greater risk is not so much that individual creditors may threaten to destabilise a restructuring at the negotiating stage by refusing to sign up to a standstill but that such creditors can derail a restructuring altogether by refusing to consent to it. In other words, the key challenge in a

1 Ironically, for the reasons given in paragraph 10(a) below, the moratorium might itself be used to trigger CDS protection without the need for the company to be placed into any insolvency process. While this would not necessarily be a bad thing (if it prevented the company from going into formal insolvency proceedings), we doubt that this is the intention behind introducing the moratorium.

restructuring (and the area more worthy of legislative reform) is imposing on dissenting creditors (with differing or unrealistic economic objectives) a restructuring plan that is generally acceptable to the company's stakeholders in cases where a fully consensual solution is not achievable.

9. There is greater consensus that, in practice, the moratorium is only likely to be used in relation to a holding company rather than an operating company. Most restructurings of financial indebtedness are done at the holding company level in order to minimise the impact on the operating companies (for example by triggering contractual termination rights). This may make some of the proposals regarding the notice that is to be given to creditors regarding the moratorium more workable (as discussed below). It could also have an impact on whether it is necessary to introduce the concept of super-priority debts incurred during the moratorium (see below).

IS A CASE MADE OUT FOR A COURT-IMPOSED MORATORIUM?

10. As stated above, the views and experience of the members of our committee differ as to whether the benefits of the proposed moratorium would outweigh the potential disadvantages (including any period of legal uncertainty and adjustment while the new legislation is tested by the courts and practitioners seek to establish what the new provisions mean in practice). In general, however, it is agreed that the moratorium would only be used in large and complex cases and so the assumption in the Impact Assessment (that on average only 10 companies would use the moratorium procedure in any year) may be at the high end[2]. On the other hand, even if the moratorium is only used in a small number of cases, its existence may be useful in agreeing a consensual standstill in a greater number of cases.

11. Where it is not possible to agree a contractual standstill, it may be necessary (under the existing legislation) to commence insolvency proceedings in relation to the company in order to take advantage of the stay on creditor action that arises as a result of such proceedings (our members are aware of at least two high-profile restructuring cases where this was necessary). There are two main concerns in this regard:

(a) First, the commencement of such proceedings may trigger termination rights in leases and other key agreements. However, the proposed moratorium may be no better in this regard as the events of default in some finance documents

[2] It is possible, however, that the attractiveness of the proposals in retaining management control, particularly in relation to owner-managed companies, may result in a greater number of companies using the procedure.

are already wide enough to be triggered by the proposed moratorium[3]. Where existing documents are not so widely drafted, the market may react to the changes by including the obtaining of a moratorium (as well as the commencement of insolvency proceedings) as a termination event in key contracts and CDS[4].

(b) Secondly value might be lost as a result of the stigma associated with, or adverse consequences of, such insolvency proceedings. The key question here will be whether the moratorium (which by its very nature will be a public affair unlike the consensual, contractual standstill) carries with it the same stigma[5] or adverse consequences. It is hoped that this will not be the case as the moratorium will be used to try to achieve a restructuring but it should be noted that administrations and CVAs (which are part of the rescue culture) seem to carry with them a certain amount of stigma nonetheless.

12. Other members give examples of restructurings which have almost failed due to last-minute creditor action (although in each case the restructuring was eventually successful despite the hostile action). There is a concern that some creditors may wish to commence formal insolvency proceedings in order to trigger CDS protection, in circumstances where a restructuring may be in the best interests of the stakeholders as a whole. In these cases it is felt that the proposed moratorium would be beneficial, provided the detail can be sorted out.

13. There is a question, however, as to whether the proposed moratorium would solve the issue of dissenting creditors or whether it would simply postpone that issue for three to six months when such creditors come to vote on, or are asked to agree, the restructuring proposals. Indeed, it may be that the proposed moratorium would strengthen the negotiating position of the junior creditors as sometimes it is the threat of insolvency proceedings that drives a restructuring through whereas, if the

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3 It is an event of default under the LMA loan agreement, for example, if any moratorium is declared in relation to any indebtedness of a company which is arguably wide enough to be triggered by the proposed moratorium.

4 We note that it is not proposed that the restructuring moratorium would prevent contractual termination. While we agree that the proposed restructuring moratorium should be no wider than the existing administration stay, and that any changes in relation to the administration moratorium would require extensive thought and consultation, it may prove one of the greatest challenges to the successful operation of the restructuring moratorium that counterparties are able to terminate key contracts, particularly if the moratorium is used in relation to a trading company rather than a holding company.

5 The word "stigma" is used in this context to describe two separate concepts. First, there is the reaction of creditors and counterparties to the moratorium (and whether such creditors and counterparties would be prepared to continue to deal with the company following the moratorium); in this context, it is possible that trade creditors would be more likely to terminate contractual relationships than financial creditors, particularly if the latter are prevented from accelerating their lending arrangements as a result of intercreditor provisions. Secondly, there is the attitude of management towards the moratorium. The fact that the directors remain in control is likely to be a key factor in this regard but it will also be relevant whether the moratorium triggers any reporting obligations in relation to the directors' conduct.

dissenting creditors consider that they have the luxury of an additional three to six months, they may insist on achieving a greater return through the restructuring proposal.

14. In relation to the restructuring proposals themselves, the Insolvency Service may wish to consider the existing cram-down mechanisms (such as a pre-packaged administration, the company voluntary arrangement[6] or the scheme of arrangement) for binding dissenting creditors. A key issue is whether those who no longer have any economic interest in the business (for example shareholders or junior creditors) should still be able to veto the restructuring proposals. This raises the question as to how a business should be valued in order to determine who has the economic interest or where the value breaks.

15. The issue of valuation is a topical one and crops up in a number of different contexts including voting and fairness issues in schemes of arrangement (see the *Re Tea Corporation* [1904] 1 Ch. 12; *My Travel* [2004] EWHC 2741 (Ch) and [2004] EWCA Civ 1734; and *IMO Carwash* [2009] EWHC 2114 (Ch)) and the price paid for the assets in a pre-packaged sale through an administration or receivership. Notwithstanding the judgment in *IMO Carwash*, valuation issues remain unresolved and, indeed, the *IMO Carwash* case perhaps illustrates just how wide-ranging the valuation evidence can be, depending on the underlying assumptions. It may well be felt that these matters are best left to case-law as each case turns on its own facts. Given the importance of the issue, however, we wonder whether some thought should be given to whether the legislation could set out some underlying principles.

INTERNATIONAL RECOGNITION

16. Most large restructurings take place in an international context and therefore the proposed moratorium is only likely to have any real benefit if it is recognised (and is capable of being enforced) in other jurisdictions. We comment below on the proposed eligibility requirements which could (unhelpfully) restrict the use of the moratorium to companies incorporated, or with their centres of main interest or an establishment, in the UK. This section of the paper focuses on whether the restructuring moratorium would benefit from the recognition processes available under the EC Regulation on Insolvency Proceedings 2000 (the **EC Regulation**) and/or the UNCITRAL Model

6 The absence of any ability to cram down dissenting secured creditors in a CVA may mean that the use of the restructuring moratorium is more limited as, in some cases, the value of the enterprise will preclude the high costs of the scheme of arrangement process.

Law on Cross-Border Insolvency (the **Model Law**). This issue is not addressed in the Consultation.

17. As regards the EC Regulation, there is a question as to whether the restructuring moratorium should be listed in Annex A to the EC Regulation as it could be argued that the moratorium is not a collective insolvency proceeding which entails the partial or total divestment of a debtor and the appointment of a liquidator (as required by the EC Regulation). That said, it would clearly be very helpful in terms of recommending the UK as a suitable forum for restructurings in the future if it were so listed and it is up to the Member States to list the proceedings to which they consider Annex A should apply. We note that the French Sauvegard procedure (which is also a pre-insolvency procedure that does not involve a divestment of the debtor) is listed in Annex A. One downside of listing the moratorium in Annex A is that it could have the result that (in relation to a company with its centre of main interests ("**CoMI**") in the EU) the moratorium could only be used (as a main proceeding) where the company has its CoMI in the UK. For the reasons given in paragraph 22 below, it would be undesirable to limit the use of the moratorium in this way[7].

18. Whether the restructuring moratorium would be recognised in a jurisdiction that has implemented the Model Law would depend upon the implementing legislation and is not something that the UK can seek to control. For any jurisdiction that has simply copied into its implementing legislation[8] the definition of a "foreign proceeding" in the Model Law (i.e. a collective judicial or administrative proceeding in a foreign State, including an interim proceeding, pursuant to a law relating to insolvency in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganisation or liquidation), there may be concerns in this regard. In relation to Chapter 15 of the US Bankruptcy Code, where there is reference to a law relating to the "adjustment of debt", there may be a greater prospect of recognition.

19. Even if the moratorium does not benefit from the recognition processes under the EC Regulation and the Model Law, it may be possible to bind overseas creditors who are subject to the *in personam* jurisdiction of the English court. In order to do so, it is important that the moratorium purports to have worldwide effect and to prevent

7 One potential issue with listing the restructuring moratorium in Annex A is that a scheme of arrangement, which the moratorium may seek to facilitate, is not listed. There would be some merit in seeking to add schemes of arrangement to Annex A (particularly where they relate to companies that are or are likely to become unable to pay their debts) notwithstanding that these procedures are included in the companies legislation rather than the insolvency legislation, although thought would have to be given to whether this would restrict the use of schemes where the CoMI was in the EU but not the UK.

8 This is the approach Great Britain took.

creditor action outside the UK. In the context of an English administration, we note the unhelpful case of *Harms Offshore AHT "Taurus" GmbH & Co KG v Bloom* [2009] EWCA Civ 632 in which it was held that, as a matter of domestic insolvency law, the moratorium that arises in an English administration has no extra-territorial effect and it would be useful if this defect could be fixed for both administrations and the proposed moratorium.

ELIGIBILITY REQUIREMENTS

20. In summary, the Consultation provides that a company will only be eligible to apply for a restructuring moratorium if: (i) it is eligible to propose a company voluntary arrangement or a scheme of arrangement; (ii) it is not a subsidiary of a company whose CoMI is in another EU member state and which is subject to a winding-up procedure recognised by the EC Regulation; (iii) it is not a bank (including a bank holding company), an insurance company or other company involved in special financial market transactions; (iv) it is not a party to a capital market arrangement; and (v) it is not subject to a pending winding-up petition.

21. We have a number of comments to make in relation to each of these requirements.

Eligible to propose a CVA / scheme of arrangement

22. Given the number of international restructurings that are done in the UK, we think it is important not to restrict the eligibility criteria to UK incorporated companies, companies incorporated in another EEA State or companies with their CoMIs in a EEA State (which is the current definition of a "company" under section 1(4) of the Insolvency Act 1986). This would exclude (for example) companies incorporated in Asia, the United States or a tax jurisdiction such as the Cayman Islands. In circumstances where a moratorium might be sought in relation to a group of companies (including holding companies or subsidiaries incorporated in these jurisdictions), this might be unhelpful. On the other hand, if (as we suggest) the moratorium is available in respect of companies with their CoMIs outside the UK, further thought will need to be given to the interaction of the moratorium with a later main proceeding in the jurisdiction of the CoMI, perhaps instituted by dissenting creditors.

23. The concern with linking the eligibility criteria to a company that can be subject to a scheme of arrangement is that the case-law is conflicting in this regard. It has been argued that, as a scheme is only available in respect of a company that can be wound

up under the Insolvency Act 1986, the court's jurisdiction to sanction a scheme should now be construed in light of the EC Regulation which provides that, where the company has its CoMI in the EU, it can only be wound up in England if it has its CoMI or an establishment there[9]. However, this is not the approach taken in a number of other cases where the test applied was whether there was "sufficient connection with the jurisdiction"[10]. To avoid any debate in this regard, we consider that the eligibility criteria should be expressly linked to the "sufficient connection" test (as a restructuring of English law governed finance documents ought to satisfy this test).

24. We assume that LLPs would be eligible but it would be helpful if the position could be clarified in relation to limited and general partnerships. This is particularly so given the increased use of these vehicles in private equity, real property and hedge fund sponsored structures.

Not a subsidiary of a company whose centre of main interests is in another EU member state and which is subject to a winding-up procedure

25. The reason for this exclusion is not clear. Indeed, if the expression "winding-up procedure" is intended to cover both liquidation and reorganisations proceedings under the EC Regulation, there could be real merit in having a parent company in a reorganisation proceeding in the place of its CoMI and the subsidiary subject to a moratorium in the UK in order to achieve a "group" restructuring. There is (presently) no concept of a group CoMI and the analysis as to whether a group company may be subject to an English insolvency process (or by analogy a moratorium) must be conducted on a company by company basis.

Banks and insurance companies

26. In light of the special resolution regime (SRR) applicable to deposit-taking banks, we agree that banks should be carved out of the restructuring moratorium. We consider that building societies should be carved out on the same basis. Although not companies, they are eligible for CVAs (as modified by the Building Societies Act 1986), but not schemes of arrangement but in light of the SRR, we do not consider that it would be appropriate for the moratorium to extend to them. Furthermore, assuming the proposals in the September 2010 Treasury consultation paper on investment firms are implemented in their current form, there would also be a case for excluding investment firms from the eligibility requirements.

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9 See by analogy the obiter dicta in *Re Sovereign Marine & General Insurance Co* Ltd [2006] EWHC 1335.

10 See *DAP Holding NV* [2005] EWHC 2092 and the more recent case of *La Seda de Barcelona SA* [2010] EWHC 1364.

27. However, it is less clear why insurance companies should be excluded from the scope of the moratorium. There are no special insolvency or stabilisation procedures applicable to insurance companies and, indeed, schemes have traditionally been the procedure of choice for dealing with struggling insurance companies. Moreover, one of the reasons insurance companies historically applied for provisional liquidation before negotiating a scheme of arrangement was to obtain the benefit of the stay on proceedings in a liquidation (this can now be done by putting the insurance company into administration). We would suggest, however, that any restructuring moratorium of an insurance company should be subject to FSA or other regulatory consent.

Not a party to a capital market arrangement

28. Although express reference is made in B.4 to a capital market arrangement, we assume that the other exceptions to the prohibition on appointing an administrative receiver (including the project finance exception) would apply.

29. It will also be necessary to have carve-outs and protections pursuant to European law (e.g. with regard to the enforcement of financial collateral arrangements pursuant to the Financial Collateral Directive and market and system charges pursuant to Settlement Finality Directive). It is important that these protections are properly drafted as the Financial Collateral Arrangements (No 2) Regulations are giving rise to a number of problems in practice due to uncertainties as to their terms. When reaching their decision as to whether the company is likely to have sufficient funds to carry on its business during the moratorium (or indeed whether the moratorium has a reasonable prospect of success), the directors will clearly need to take into account the fact that a secured creditor with security over the company's cash may be able to enforce its security over that cash, notwithstanding the moratorium, if the security agreement constitutes a financial collateral arrangement. In light of this, thought should be given to whether specific buy-ins should be required from the holders of financial collateral or whether the company needs to confirm expressly that the moratorium has a reasonable prospect of success despite any action such holders may take.

30. Thought should also be given to whether it is necessary to grandfather existing security in order to avoid Human Right Act challenges regarding the retrospective interference with property rights. This could lead to complex situations where there is different security over the same assets which, depending on when the security was created, may or may not be subject to the moratorium.

Company is not subject to a pending winding up petition

31. While this condition is clearly intended to safeguard creditors' rights, it is possible that the inclusion of such a restriction may actually encourage dissenting creditors to present a winding up petition earlier than would otherwise have been the case. If a hold-out creditor knew that it could prevent the company from being eligible for a restructuring moratorium simply by exercising the low cost option of presenting a winding up petition, it may be encouraged to do so at the first suggestion by the company that a restructuring was on the cards.

32. An alternative would be to give the court the power, when approving the moratorium, to deal with any winding up petition that has been presented. Where the petition is in relation to a valid, undisputed debt, the test might be whether the moratorium would have an unfairly prejudicial effect on the petitioning creditor. If so, the court could be required not to approve the moratorium (and instead to place the company into liquidation). If not, the court could be given the power to approve the moratorium notwithstanding the winding up petition. If on the other hand the petition is disputed by the company, the court could be given the power to dismiss it and to approve the moratorium.

QUALIFYING CONDITIONS

33. Two qualifying conditions for a restructuring moratorium are proposed: (i) the company must be able to demonstrate that there is a reasonable prospect that a compromise or arrangement can be agreed with its creditors; and (ii) the company must be able to show that it is likely to have sufficient funds to carry on its business during the moratorium. While we would support the general thrust of these conditions, there are a number of issues which we would expect to be addressed in greater detail prior to any implementation of the restructuring moratorium proposal.

Reasonable prospect

34. It is difficult to comment on this aspect of the proposal as the Consultation only suggests what may be required in very general terms i.e. that the company should be able to demonstrate support "in principle" for some form of compromise from its senior secured creditors. It would be helpful to have guidance as to what level of "in principle" commitment would be required, and from what percentage of creditors.

35. In our view an "in principle" threshold is too low, and/or needs to be more clearly defined. Most responsible lenders, if given a choice between a restructuring or an insolvency procedure, would favour the former so does this mean that, in every case, there is support "in principle" for a restructuring? In any event, we would suggest that the imposition of a moratorium should require a greater degree of stakeholder engagement than a mere willingness to consider the principle of a restructuring, particularly given the identified risk of directors using the moratorium procedure "to buy time with creditors, when there is no realistic prospect of rescue".

36. We acknowledge, however, that finding an alternative threshold that works in practice is not easy (and indeed is possibly the most difficult aspect of the restructuring moratorium proposal). The questions are which (if any) creditors should be consulted in advance in relation to the moratorium and what approvals (if any) should be required in order for the company to be satisfied that the "reasonable prospects" test is met. Possible options in this regard include[11]:

(a) requiring the company to consult with, and/or to obtain the consent of, all or a prescribed majority of secured creditors (say 75% by value) before the moratorium can be approved. This option is attractive in terms of clarity and simplicity but may not reflect the reality that, for most large restructurings (where the restructuring moratorium is most likely to be used), the secured borrowings and financial structure of the company will be extremely complex, often involving many layers of secured debt (for example, senior secured, junior secured, second lien, mezzanine and other subordinated debt) and not all secured creditors will necessarily have the same approach to the restructuring. Obtaining unanimous or even majority consent may not be straightforward in practice. Furthermore, depending on where the value of the business breaks, not all secured creditors will have an economic interest in the restructuring – so is it appropriate that creditors who do not have an economic interest (even though secured) should have a say in the moratorium process?

(b) requiring the company to consult with, and/or obtain the consent of, all creditors who have an economic interest in the restructuring. This approach (whilst fair on its face) would give rise to a number of practical difficulties. In particular, it would require evidence (before the moratorium application is

[11] These are in addition to any approvals which might be required from the holders of financial collateral for the reasons given in paragraph 29 above.

submitted) as to where the value of the business breaks so as to determine who has an economic interest and would therefore have the effect of "front-loading" the valuation issue (normally dealt with at the scheme fairness hearing) to a much earlier stage in the restructuring process. It would also require agreement as to which valuation methodology should be used. Without guidance on valuations (as to which see our comments in paragraph 15 above) we have concerns as how this would work in practice. It would almost inevitably delay the moratorium process, result in an increase in costs and could possibly even risk paralysing the moratorium application altogether.

(c) requiring the company to consult with, and/or obtain the consent of, any lender with the benefit of a qualifying floating charge. Given the protections for a qualifying floating charge-holder that were built into the Enterprise Act 2003, it might be argued that such a charge-holder should have the same right of veto in relation to the moratorium (or failing that, the right to choose who is appointed as monitor);

(d) not imposing any requirement to consult and, instead, leaving it to the monitor to form a view in his or her professional opinion as to the "reasonable prospects" test. This may be difficult, however, if no communications have taken place with the creditors; or

(e) as for option (d) but with a requirement that the moratorium to be ratified by certain creditors after the event. This approach would offer the advantages of speed and ease (and hence reduced court costs) but, as with option (d), would impose a much more onerous role on the monitor. Furthermore, the requirement for ratification would give rise to some of the same issues as those set out above – that is, how do you determine who should have the right to ratify?

Sufficient funds to carry on business during the moratorium

37. In view of this condition, it seems likely that, at the very least, the lender or lenders providing any funding during the moratorium would need to have consented to the proposals. In practice, this is most likely to be one of the existing lenders.

38. It would be helpful if guidance could be provided as to whether, for the purpose of assessing whether a company has sufficient funds to carry on business during a

moratorium, account needs to be taken of any scheduled interest or amortisation payments, rental payments due under a lease, redundancy costs due to any downsizing in this period or payments under contribution notices or financial support directions imposed by The Pensions Regulator (see below in relation to post-moratorium debts).

39. There is also a risk that, if the restructuring moratorium becomes law, counterparties (including lenders, landlords and derivative counterparties) will seek to amend their events of default so as to allow them to accelerate any outstanding obligations in the event that a moratorium is obtained. It is one thing for a company to reach the view that it has sufficient funds to carry on business on a going concern basis but does the company also need to be satisfied that it can meet any such accelerated payments?

SAFEGUARDS FOR CREDITORS

40. Although paragraph 4.5 does not expressly say so, we assume that the intention is that all known creditors will be given notice of the moratorium (in which case it may be necessary to build in provisions for notice by way of advertisements, websites etc to avoid the very significant costs of notifying each creditor individually). When are the obligations of the directors satisfied in this regard – is it enough that they take reasonable steps to notify all known creditors[12]? What is the effect if particular creditors are not notified? As stated above, we suspect that, in practice, most restructurings will be done at the holding company level where there will be no trade creditors and so the only creditors who will need to be notified are the financial creditors but, where these creditors include bondholders, it may still be difficult to give individual notices.

41. Subject to the point made above regarding most restructurings being done at the holding company level, as the Consultation identifies, the downside of the notice provisions is that creditors (and in particular trade creditors) may seek to terminate their contracts or may insist on better terms as a condition of continuing to deal with the company. We suspect that many creditors will seek the repayment of all or part of their pre-existing indebtedness as a condition of continuing to supply the company (we have considered this point below in the context of the priority of post-moratorium debts).

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12 We note that the Consultation is not consistent as to whether it is the directors or the monitor that is required to give the notices in this regard.

42. There will also be issues for listed companies when a moratorium is obtained. Will it be necessary for the trading in the shares of such a company to be suspended during the moratorium?

Three month moratorium

43. The Consultation suggests that a three month moratorium period should, in most cases, be sufficient but provides for the possibility of an extension, subject to a further court hearing. In particular, it states that "the extra period would only be required in a small minority of cases". Our experience suggests that complex, cross-border restructurings (which is where the moratorium is most likely to be used) often take longer than three months, particularly where the creditors require an independent business review (from a firm of accountants) of the company's business and prospects as part of the restructuring process or where the moratorium period is to include any internal discussions regarding a scheme of arrangement, as well as the implementation of the proposals for a scheme.

44. In light of this, we wonder whether any extension should be automatic (thereby avoiding further court costs) unless opposed by an agreed percentage of the company's creditors (perhaps 10%), in which case a court hearing could be required. In terms of what the extension should be, there is some merit in having a long-stop date (of, say, six months) so as to prevent abuse by the directors. However, it is important not to be too inflexible in this regard, particularly if the company is close to proposing a scheme or other restructuring solution in the proposed six month period.

45. As stated in the Consultation, one of the purposes of the moratorium is to prevent hold-out creditors from seeking to destabilise the negotiation process in order to extract some commercial advantage. Our concern, however, is that a three month moratorium may not significantly alter the behaviour of such "hold-out" creditors as their main leverage arises from the fact that they are in a position to block or hinder the implementation of a restructuring solution. What is needed in order to solve this problem is clear cram-down mechanisms. The ability to sell the business through a pre-packaged administration is very useful in this regard and it is hoped that the separate consultation on pre-packs does not prevent or hinder the use of this restructuring tool in appropriate circumstances. Furthermore, the scheme of arrangement would be greatly enhanced as a restructuring tool if there was a mechanism to override the interests of existing out-of-the-money creditors or

shareholders (for example via an amendment or clarification of section 900 of the Companies Act 2006[13]).

46. The Consultation suggests that the restructuring moratorium will reduce the time taken to conclude restructuring negotiations (and the cost benefit analysis is done on this basis). However, on the basis that it will still be necessary to negotiate and implement a restructuring solution, possibly on the basis of some cram-down mechanism, we query whether the proposals will lead to any time savings in this regard.

Role of the monitor and directors

47. We consider that the role of the monitor, and his or her powers and duties, should be considered further. In particular, it would be helpful if the proposals in the Consultation could be expanded to deal with the following questions:

(a) Who will choose the monitor? The Consultation suggests that this is the company but do the creditors get any right of veto if (for example) they are concerned about the independence of the monitor[14]?

(b) Does the monitor need to be a licensed insolvency practitioner? Paragraphs 4.9 to 4.14 of the Consultation appear to assume that this is the case but the technical experience of the proposed monitor may ultimately be more important than a license.

(c) Who decides on the remuneration of the monitor? Is this the company or the creditors?

(d) Is the monitor's role limited to ensuring that the qualifying conditions remain satisfied? If so, how does the monitor decide whether there is still a reasonable prospect of a restructuring, particularly if one of the creditors is playing hard-ball? What protections are there for the monitor in this regard? Surely it should be sufficient if the monitor acts in good faith.

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13 The predecessor of this provision was considered in the My Travel restructuring and the court held that it could only be used where the transferee company had the same capital structure as the transferor company, thus robbing the provision of any usefulness.

14 This assumes that there is a requirement that the monitor be independent which would make sense. In practice, however, there may be issues where each of the different creditor groups and the company already has its own firm of accountants and/or financial advisors as it may be difficult to find someone truly independent but with the relevant experience. experience in this regard.

(e) Should the monitor (whether through the court or otherwise) have step in rights giving him or her increased level of controls in certain circumstances? The perceived role of monitors in small company moratoria as having responsibility without power is often cited as a reason why the process is used infrequently.

(f) There is a suggestion that the directors need to be authorised to make a payment in relation to a pre-moratorium debt. Who gives such authorisation – the monitor or the court? As stated above, it is possible that creditors will insist on the payment of some or all of their pre-existing indebtedness as a condition to providing new credit, supplies or services to the company and so such authorisations could be required on a regular basis.

(g) If the restructuring fails, is the monitor able to take a subsequent appointment as insolvency officeholder?

48. We assume that the directors (and, in the case of fraudulent trading, other participants) will remain liable, during the moratorium, for wrongful and fraudulent trading. We think this is important in order to prevent directors and other stakeholders from using the moratorium to buy time with creditors when in practice there is no realistic prospect of a restructuring being achieved.

POST-MORATORIUM DEBTS

49. In our view, paragraph 4.25 of the Consultation requires much more thought. We can see that, given the publicity surrounding the moratorium, there may need to be some incentive to encourage trade creditors and other counterparties to continue to deal with the company but, for the reasons given above, we doubt that the moratorium would be used in relation to an operating company in any event. In a consensual restructuring, this does not tend to be an issue because the financial restructuring (and any contractual standstill in relation thereto) is done in private and trade creditors are paid in full[15]. However, if the proposed moratorium were to be used in relation to an operating company, in view of the requirement that notice be given to all the creditors, counterparties may well seek to negotiate better terms, or the payment of pre-moratorium debt, as a condition to continuing to deal with the company. The question arises as to what (if any) of these re-negotiated terms should be given super-priority if the restructuring subsequently fails.

15 Furthermore, in leverage deals, the intercreditor agreement is likely to prevent junior creditors from taking enforcement action in any event..

50. The Consultation also refers to new funding that has been advanced during the moratorium period. The most likely source of this new funding is the existing lenders who may seek to roll-up their existing facilities into any new lending. Again the question arises as to how "new lending" is to be defined for the purposes of any super-priority provisions. Would any restrictions in existing credit or security agreements restricting new lending on a priority basis be disapplied? Would there be any cap on the amount which could be borrowed, or any restriction on its uses? If not, there could be a serious erosion of the rights of existing floating charge creditors and concerns in this regard could have an adverse impact on the cost of credit.

51. Questions also arise in relation to statutory or contractual debts that arise during the moratorium period but by virtue of arrangements that existed prior to the moratorium. Consideration should be given, in particular, to the following payments or obligations accruing during the moratorium period: interest payments accruing to secured and unsecured creditors; rental payments; rates; taxes; obligations arising in relation to contribution notices and financial support directions issued during the moratorium period; redundancy and unfair dismissal costs as a result of any downsizing during the moratorium period; judgment debts; and close-out amounts.

52. Furthermore, the Consultation suggests that these debts would only have priority status if the moratorium comes to an end prematurely. Not only might this incentivise certain counterparties to seek to stall any restructuring negotiations but it also leads to some uncertainty as to how these debts will be dealt with by the company. Furthermore, it would be important to ensure that, if the moratorium failed, the super-priority debts would not prevent the costs of any necessary insolvency process being met.

OTHER ISSUES

Set-off

53. The restructuring moratorium would not prevent the exercise of "self-help" set-off rights (such as contractual or equitable rights of set-off). However, there is a suggestion (at paragraph 4.25 of the Consultation) that, if a restructuring failed and the company went into liquidation or administration, the effective date for set-off would be the date of entry into the restructuring moratorium.

54. It is not clear whether paragraph 4.25 is proposing that a self-executing, mandatory set-off rule (equivalent to that in Rule 4.90 or Rule 2.85 of the Insolvency Rules

1986) would come into play on the date of the moratorium or whether the date of the moratorium would be used as the cut-off date (after which claims incurred or acquired by the solvent counterparty, or incurred by the insolvent counterparty, could no longer be included in the account for set-off purposes) if either Rule 4.90 or Rule 2.85 subsequently came into play. Either proposal would be problematic:

(a) If it is being proposed that the moratorium would trigger a self-executing, mandatory set-off rule, this could prevent any restructuring of the company as it would cause the hedging agreements to close out and any running accounts to be crystallised. It was precisely for these reasons that the original draft of Rule 2.85 was amended so that it did not come into play immediately upon the commencement of an administration but only if, subsequently, an administrator decides that rescue is not possible and instead that the administration is to become a distributing one.

(b) If instead it is being proposed that the cut-off date should be back-dated to the date of the moratorium in the event that either Rule 4.90 or Rule 2.85 comes into play, this will create a significant period of uncertainty during which it will not be clear to counterparties what set-off regime will apply. This could encourage counterparties (and in particular derivative counterparties) to close out through fear that they may lose their set-off rights if they do not do so.

55. We are aware that the FMLC is looking at these issues in relation to administration set-off and so we would encourage the Insolvency Service to look closely at these proposals in light of the FMLC's comments.

18 October 2010

Appendix

Question 1: Do you agree with the expected costs and benefits of the proposals, as set out in the Impact Assessment? Are there other benefits or costs that you believe should also be considered?

We consider that the assumptions regarding the number of companies that would take advantage of the new moratoria proposals are probably about right (see paragraph 10 above). The cost / benefit analysis is based on the assumption, however, that the proposals will lead to a reduction in time needed for restructuring and we query why this should be the case (see paragraphs 45 and 46 above).

In relation to the fees cited for preparing an initial report to court, this will depend on the contents of any such report. If this takes on a similar status to the old Rule 2.2 Report in an administration, the fees could be considerably more than the top end of £50,000 suggested in the Impact Assessment, particularly in a complex case. Likewise, the professional fees for a monitor will depend on what this role involves (see paragraph 47 above) but we suspect the fees may be more than the top end of £150,000 suggested in the Impact Assessment.

In terms of other costs, the moratorium will need to be dealt with in "industry" legal opinions (such as those relating to the ISDA Master Agreement) and in legal opinions given to rating agencies and regulators in structured finance transactions and therefore counterparties to these types of transaction will need to bear these legal costs.

Question 2: Do you agree that in order to help safeguard creditors' rights, a company should not be eligible for a moratorium if there is an outstanding petition for winding-up, unless it has a statutory compromise proposal (a scheme of arrangement or CVA) that it is ready to put to creditors?

We have concerns about this eligibility criteria – see paragraphs 31 to 32 above.

Question 3: At the pre-proposal stage, do you agree that the two proposed qualifying conditions provide the right balance in ensuring that a moratorium is only available to companies where the core business is viable but there is nevertheless a need to restructure their debts?

In general terms, we consider that these two conditions strike the right balance but please see paragraphs 33 to 39 above for areas in which we would like further clarification.

Question 4: Where the company has a proposal for a CVA or Scheme of Arrangement and wishes to apply for a moratorium (or extend the existing moratorium), do you agree that provided the existing statutory conditions are met, the only additional qualifying condition that should apply is that the company is likely to have sufficient funds to carry on its business?

This makes sense in relation to a proposal for a CVA where there is an existing statutory test that the CVA proposal has a reasonable prospect of being approved and implemented. In relation to a scheme of arrangement, there is no such existing statutory test and so the position is somewhat different. This could either be dealt with by requiring the court to consider, at the first hearing convening the meetings of creditors and/or members, whether there is a reasonable prospect of the scheme being approved or (if this is not clear at the time of the first court hearing) by requiring that both of the qualifying conditions referred to in paragraphs 3.16 and 3.17 should continue to be met while the scheme proposals are being put together and considered by creditors and/or members.

Question 5: Do you agree that any extension of the moratorium during the period while a compromise proposal is still being negotiated should require a further court hearing?

No. For the reasons given in paragraph 43 above, we consider that an extension will be required in a large number of cases and so, in order to avoid the costs of a second hearing, we would propose that an extension should be automatic unless opposed by a prescribed percentage of creditors.

Question 6: We would welcome views on whether an additional court hearing should be required for the extension of a moratorium to cover the formal approval of a CVA proposal.

We do not consider that a court hearing should be necessary provided the qualifying conditions remain satisfied.

Question 7: Do you agree that the proposed role of the monitor, together with the rights of creditors and the obligations on the directors, strikes the right balance in safeguarding the interests of creditors and deterring abuse, without imposing disproportionate costs or impeding the objectives of the moratorium?

See paragraph 47 above for the further detail we should like regarding the role of the monitor. In general, we consider that a limited role (i.e. ensuring that the qualifying conditions remain satisfied) is appropriate provided that the monitor is protected from liability in circumstances where he or she acts in good faith. We consider that a prescribed percentage of secured creditors should be required to approve the moratorium and consideration should be given to whether a qualifying floating charge-holder should have a right of veto.

Question 8: Do you agree with the proposals for treatment of moratorium debts in a subsequent CVA, and in any distribution undertaken in an administration or liquidation that immediately follows a moratorium?

We have concerns about these provisions as currently drafted. Please see paragraphs 49 to 52 for further details.

SCHEDULE

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