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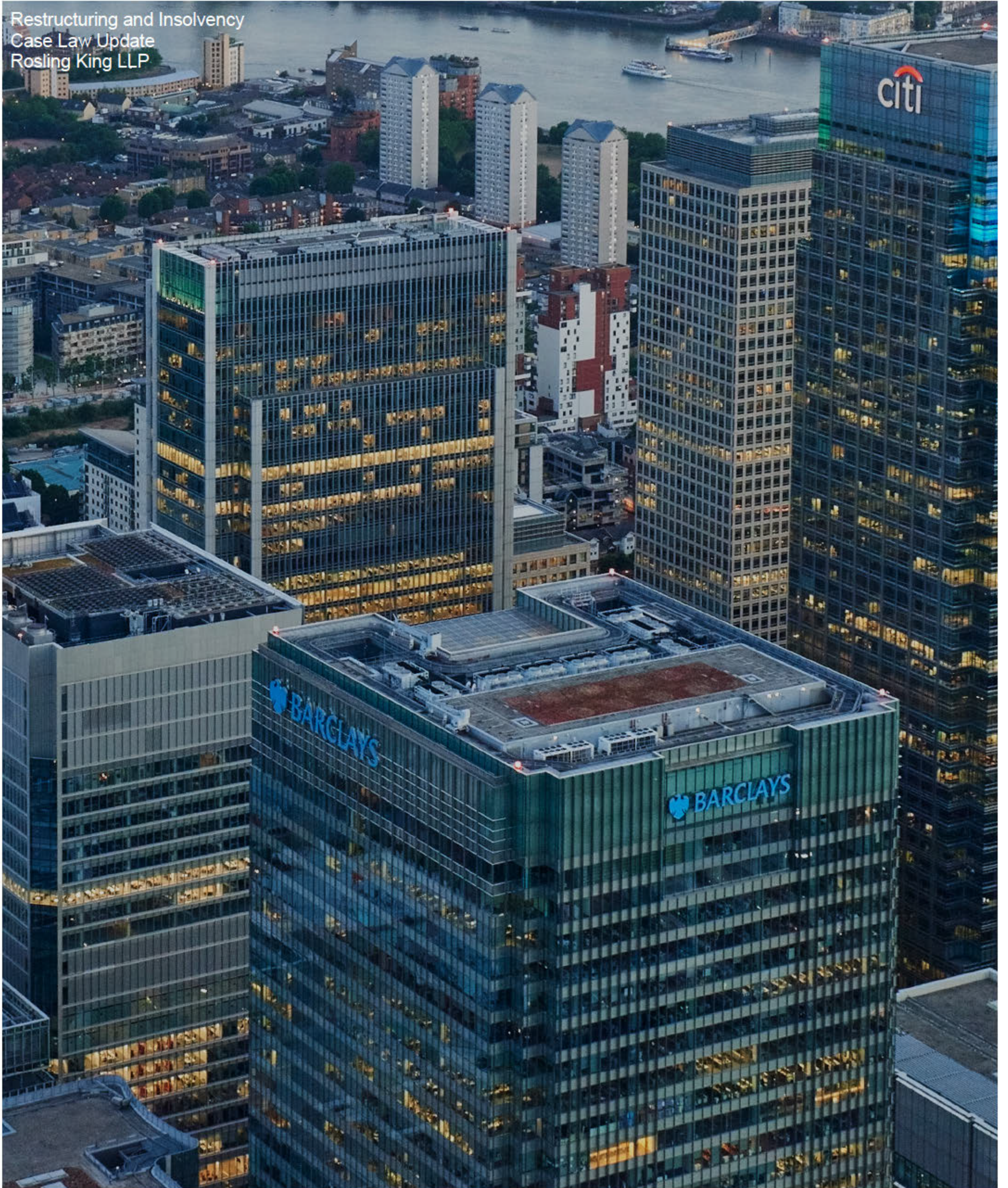

The Consultation

In March 2018, the Government published a consultation on its proposed reforms to the UK's insolvency and corporate governance landscape. It sought views on ways to reduce the risk of company failures occurring through poor governance, whilst improving the insolvency framework to create a stronger business environment. The Government has now published its response to the consultation and we consider the key changes below.

Parent Company Director Accountability

The Government intends to implement a new liability for parent company directors selling a subsidiary if that subsidiary enters liquidation or administration shortly after the sale. There will be a subjective test, which would be applied to a "look-back period" of 12 months (beginning with the date of the sale), as to whether the directors could have reasonably believed that the sale would "likely deliver a no worse outcome" than placing the subsidiary into administration or liquidation. Under the proposed reforms, the director disqualification process is to be extended to include former directors of dissolved companies, so that action can be taken against such a director without having to restore the company to the register first.

This change is born from the fallout of the sale of BHS. Under the auspices of Sir Philip Green, BHS's parent, Taveta Investments (No.2) Limited, sold its entire shareholding in BHS Group Limited to Dominic Chappell's Retail Acquisitions Limited. Chappell, who had no retail experience, bought BHS for only £1 in March 2015 but it subsequently collapsed into administration in April 2016 with a reported loss of 11,000 jobs and a circa £570 million pensions black hole. The change is also seeking to address the practice of "phoenixing" where a company is dissolved and another is created soon after to avoid payment of liabilities.

However, some are concerned that the proposals are a heavy handed response. In particular, most professional directors would probably seek advice to support their "reasonable belief" defence but this advice will be likely caveated to the point of making it virtually useless. Furthermore, the proposals do not address the scenario where there could be a conflict between the holders of the parent company and those of the subsidiary. As a result, these measures may drive parent directors to put companies in administration, or run approved pre-packs, as the safest way of discharging their obligations; which is what the Government is actually trying to avoid.

New Moratorium

The Government has introduced a new moratorium to help business rescue. It will allow those financially distressed companies which are solvent, a period of time to prevent creditors (including secured creditors) taking action against the company and therefore allowing the company to make preparations to restructure or seek new investment. A company is eligible to apply for the moratorium if it will become insolvent if action is not taken, but which is not yet insolvent and is able to carry on business and meet current obligations and expenses during the moratorium.

The moratorium period is for an initial 28 days which can be extended by a further 28 days and extended further if approved by more than 50% of secured creditors by value and more than 50% of unsecured value by creditors. Creditors may object to the moratorium at any time during the moratorium period through the court.

Despite the apparent helpfulness of this new moratorium, it is questionable when this would be used. A board may be more willing to put the company in administration than run the risk of applying the criteria for the new moratorium incorrectly. Furthermore, the company will always need to meet debt service and suppliers, so the company has to hold cash to deal with the knock on effects of the moratorium. As a result, the popular alternative of a standstill agreement may be more useful than the new moratorium. On a positive note, perhaps the moratorium could be used tactically where it could stop a covenant breach but the shareholder/sponsor has cash to cover suppliers. It also may help institutionalise an approach where time can be spent focussing on rescuing the company rather than negotiating a standstill.

New Scheme of Arrangement

The Government is planning to introduce a new scheme of arrangement that would allow a company to bind all creditors, including junior classes of creditors even if they vote against the plan, through the use of a cross-class cram down provision. The new scheme appears to be a construct of existing and new concepts. Solvent and insolvent companies will be able to use the process and the courts would be heavily involved in examining and approving a proposal. The company will have to propose plans it thinks it will be suitable for creditors and creditors and shareholders can submit counter-proposals. There will be no automatic moratorium but the new moratorium (discussed above) could be used with it. Approval (similar to Company Voluntary Arrangements) requires (a) the approval of creditors with more than 75 % in monetary value and (b) at least 50% of unconnected creditors in each class of creditor to agree to the plan. The cram down is particularly radical and appears to be a modified version of the absolute priority rule under US Chapter 11. The suggestion is that it can be applied provided the dissenting classes of creditors are no worse off than under the next best alternative.

The devil will be in the detail as to how this will all work and how the Government has married the intended flexibility of this new scheme with protecting minority creditors. It is assumed that the threshold of at least 50% of the unconnected creditors is in each class (and not across all classes as this would not work) but could this lead to gaming by creditors as they seek to reduce their debt in the different rounds of approval. Similarly, with the cram down, it looks like the Government is trying to build in a level of pragmatism to allow for rights to be taken away if it is just and equitable and part of a wider plan. However, this flexibility also creates uncertainty around when this deviation can happen, what is the next best alternative and where valuation of debt breaks, which would in turn lead no doubt to a lot of treading carefully and litigation.

Supplier of goods and services

Another key change is preventing suppliers of good and servicers enforcing termination clauses (so called “ipso facto” clauses) on the ground that the company has entered into a formal insolvency procedure, the new moratorium or the new restructuring plan. If, however, the supplier can establish a significant adverse effect on its own business as a result of continuing the supply, then it can apply to court to be exempted from the prohibition.

Commentary

The UK is traditionally viewed as a lender/creditor-friendly jurisdiction and the Government is seeking to redress some of this whilst maintaining some flexibility in the processes and protecting minority creditors. However, we will have to see the detail of how these proposals will work in practice. One reform that the Government may be missing a trick on is perhaps looking at so-called DIP (debtor-in-possession) financing (popular in US) which allows the insolvent company to raise capital to fund its operations as its restructuring runs its course. DIP financing is unique from other financing methods in that it usually has priority over existing debt, equity and other claims. The Government is looking into this so watch this space.

For further information, please contact Alexander Pelopidas or the Partner with whom you usually deal.