The Strategic View: Corporate restructuring 2016

Tom Vickers and Megan Sparber reflect on activity in the restructuring market in England & Wales, and provide an overview of the tools available to restructure companies incorporated in the jurisdiction and elsewhere.

1. What trends, in terms of activity levels, affected industries or investor focus, have you seen in the restructuring and insolvency market in your jurisdiction over the last 12 months?

At the moment, we are witnessing relatively low rates of corporate default for a variety of reasons, including low interest rates, reasonable amounts of liquidity in the market, and the UK’s relatively buoyant economy.

Pockets of restructuring and insolvency activity do exist in certain sectors that are facing particular challenges. The UK’s struggling steel industry has suffered some high profile failures, but restructurings have been achieved (for example, Stemcor’s recent restructuring using a scheme of arrangement).

Energy companies are also in the spotlight. The focus has shifted from coal to oil and gas, and the well-publicised fall in oil prices that hit production and exploration companies has now reached their suppliers and others exposed to the sector. Yet there are relatively few insolvencies. Much of the work being done is still at the contingency planning stage.

Inevitably, a few instances of distress have arisen because of particular finance structures or business models. Over the last couple of years, we have worked on the restructuring of insurance broker Towergate, which experienced difficulties as a result of the impact of organisational change across the business, and also the administration of Phones4U, which was tipped into insolvency when key supply contracts were lost. These kind of situations can arise at any point in the economic cycle - although the prevailing mood will obviously have an impact.

We are also continuing to see debtors which are experiencing more challenging economic conditions elsewhere, seeking to restructure in the UK, particularly where the alternative is formal insolvency proceedings in their jurisdiction of incorporation.

2. What is the market view on prospects for the coming year?

We are anticipating much of the same, at least in the short term. The default rate is expected to remain relatively low, and those sectors already under stress are likely to continue to struggle. There is some speculation around other areas that may be challenged. For example, the increase in the national living wage in 2016 could have a significant impact on some sectors, such as care homes and retail.

It is hard to predict how the various economic and geopolitical uncertainties will play out - the likelihood of further interest rate hikes in the US, and of further declines in commodity prices, the possibility of Brexit and/or Grexit, the migration crisis and unrest, violence and generally uneasy international relations in various parts of the world. The existence of these uncertainties alone is likely to have some impact on behaviours in the markets.
3. What are the key tools available in your jurisdiction to achieve a corporate restructuring - are they primarily formal, court-driven processes, or are informal out-of-court restructurings possible? Do you feel that the tools you have available are effective in terms of providing speedy, fair and predictable outcomes?

A number of restructuring tools are available in the UK, but the two that have been used most effectively, in recent years, are schemes of arrangement (“schemes”) and pre-packaged administrations (“pre-packs”). Both have been available for some time, but came into their own in the last cycle, when the focus was on balance sheet restructurings.

A scheme is an extremely flexible tool, which can be used to implement a variety of “arrangements” between a company and its creditors or its members. In essence, all that you need is an element of give and take, structured so as to obtain a sufficient level of support from affected creditors. Creditors vote in classes, and each class must vote in favour of the scheme, but because the consent thresholds are lower than those prescribed in many financing documents, there is scope to cram down hold-outs within a class (however, it is not possible to cram down an entire class using a scheme alone). This means that schemes can be used simply to amend and extend, or to implement a complex restructuring, involving debt transfers and debt for debt/equity swaps. Insolvency isn’t a pre-requisite, which allows for restructuring at an earlier stage, and although two court hearings are required, schemes can be implemented quickly (the period from launch to sanction has been as short as 3½ weeks).

The involvement of a judge is helpful - he will consider a number of issues, including fairness, and once he sanctions the scheme, it is binding on all scheme creditors, with very little scope for appeal. This, together with the growing body of pragmatic judicial decisions, and the common practice of using lock-up agreements to secure support in advance, allows for a significant degree of certainty in many cases. The scrutiny of the court also helps to demonstrate that the scheme process is rigorous and worthy of international recognition. This is key now that practitioners are conceiving ever more innovative ways of establishing a “sufficient connection” with the UK, in order for overseas companies to be able to use schemes.

The other tool that has drawn a number of companies to restructure in the UK is the pre-pack. The sale of a distressed company’s business is negotiated before it enters administration, and executed shortly after an administrator is appointed. The aim is to minimise the delay, costs and destruction of value often associated with entry into an insolvency process. The other key advantage is that debts owing to out-of-the-money junior creditors can be left behind in the insolvent company. Unsurprisingly, this has made the pre-pack one of the more controversial procedures available, but also one of the more attractive. There are safeguards - an administrator is subject to a number of duties (most notably to perform his functions in the interests of creditors as a whole), and he is also an officer of the court. However, although court involvement is minimal, where the courts have been involved, they have generally been prepared to sanction pre-packs - even when faced with creative proposals to meet the jurisdictional hurdle (which is higher than for schemes, because administration is a formal insolvency process which brings into play the EU Insolvency Regulation, with its focus on a company’s “centre of main interests” or “COMI”).
When used in combination, the scheme and pre-pack become an even more powerful restructuring tool, which can be used to strand creditors in an insolvent company and transfer its business to a newco, usually owned by the senior lenders. There are numerous examples of this happening in practice, but the possibility alone may well be enough to encourage a consensual deal. We often work on schemes and/or pre-packs as a “Plan B”, in parallel with an out-of-court restructuring.

4. In terms of intercreditor dynamics, where does the balance of power lie as between shareholders and creditors, and as between senior lenders and junior/mezzanine lenders? In particular, how do valuation disputes between different stakeholders tend to play out?

English law has historically been senior secured creditor friendly, and despite some slight erosion of the position, this remains the case. The holder of a comprehensive security package can appoint an administrator and this gives them significant leverage in restructuring negotiations, as does their position at the top of the waterfall of payments that applies in a formal insolvency process. This forms the basis of the so-called “insolvency counterfactual”, which is used to justify the reallocation of debt and equity in many restructurings. There have been some high profile cases where it has been questioned whether this is the correct approach to valuation - particularly in the context of schemes, where the company is usually not yet insolvent. Where disputes have come to court, decisions have favoured senior creditors, but the door has been left open for a future challenge. This gives both junior creditors and shareholders some “nuisance value”, which could be enough to win them a slice of the equity in the new capital structure.

Senior secured lenders generally seek to bolster their position with contractual intercreditor arrangements. These agreements have become increasingly sophisticated. Many provide for senior lenders to authorise the release of junior creditors’ debt (including guarantee claims) and security in order to implement a restructuring in certain circumstances. There have been some challenges, but the courts have interpreted these agreements in a commercial and practical manner.

5. Have there been any changes in the capital structures of companies based in your jurisdiction over recent years caused by the retreat of banks from loan origination? In particular, have you found that capital structures now increasingly comprise debt governed by different laws (such as New York law governed high yield bonds)? If so, how do you expect these changes to impact on restructurings in the future?

Over the last few years, we have seen significant changes in the sources of funding used by corporate debtors. Banks, still feeling the effects of the financial crisis, and the burden of new regulation, have become less willing to lend and so companies have turned to a variety of alternative sources of liquidity, such as direct lending funds, private placements and the high yield bond market. The latter has been a key growth area. Capital structures now often include loan debt, together with senior secured notes governed by New York law. There are some key differences: high yield bonds are generally much lighter on covenants than traditional bank loans, and the high yield bond market is much more liquid than the secondary loan market. This has led to much speculation about how creditor dynamics will play out when these deals are restructured. Will covenant erosion, and difficulties coordinating a large and dynamic creditor body, lead to delays? Will restructurings be more contentious? The issuance of senior secured notes that rank pari passu with any bank debt will certainly give rise
to interesting questions about who controls the process, and in which class bank lenders and bondholders should vote in a scheme.

One of the key questions for us is where these restructurings will take place. “Good” forum shopping is now more widely accepted, and there is a real question to be considered as to which restructuring regime will be most effective in any particular circumstances. The law of the relevant jurisdiction still typically governs loan debt (although English law is often used in loan documents, even where there is no nexus with England), but high yield bonds are invariably governed by New York law. For years, the Chapter 11 procedure in the US has been viewed as the model restructuring regime - much weight is attached to its wide moratorium and cram down provision, in particular - and it is also relatively easy for overseas companies to access Chapter 11. Nonetheless, companies have so far turned to schemes to restructure their New York law governed high yield debt, either on the basis that their COMI is in England, or by amending the terms so that the bonds are governed by English law.

However, these funds are also keenly focused on maximising returns. They are prepared to hold out for greater recoveries if a restructuring proposal is not in line with their projections, or to withdraw support entirely, if they consider that the business has run its course.

The entry of distressed investors has also significantly altered deal dynamics. There are many more creditors involved, and they have competing interests (for example, some will have purchased debt at par, others at a significant discount, and others may, in addition, hold positions through the capital structure). There is a clear need for co-ordination, if a restructuring is to be agreed. Ad hoc, advisor-led committees usually form, and consensus - or at least the support of a sufficient majority - can be reached. If this proves elusive, then it may be necessary to use a scheme and/or a pre-pack.

6. Is there significant activity on the part of distressed debt funds in your jurisdiction? How successful have they been in entering the market, and how much has market practice (or law) evolved in response? If funds have not successfully entered the market, can you identify reasons why?

In the UK, there is a mature and active distressed debt market. London is the gateway to Europe, and beyond, for US hedge funds who are looking to invest capital. The arrival of the funds has fundamentally changed market practice. In some ways restructurings are easier to achieve - in a liquid market, creditors with no appetite to be involved in restructurings can easily sell their positions to distressed debt traders, who are engaged and familiar with restructuring processes.

In line with its senior secured creditor friendly approach, and strong emphasis on freedom of contract, the UK regime does not have very many features that would have a dramatic impact on credit analysis. Sometimes this comes as a surprise to investors familiar with insolvency regimes in other jurisdictions. For example, although the appointment of an administrator gives rise to an automatic moratorium on the enforcement of creditors’ rights, this is much narrower than the stay imposed in some other jurisdictions, and there is no general rule to prevent the termination of a contract on a counterparty’s entry into an insolvency process (except in the case of certain essential supplies).

The financial crisis did resurrect one rather arcane feature of English insolvency law, known as the anti-deprivation principle.
This rule prohibits the withdrawal of a company’s assets on its entry into an insolvency process, in certain circumstances. It caused some consternation when raised in litigation relating to a flip clause in a complex CDO programme, in the context of the collapse of the Lehman Brothers group. However, since the UK Supreme Court provided some practical guidance on the ambit of the rule in that case, it has caused very few issues in practice.

8. Are there any proposals for reform of the legal framework that governs insolvency and restructurings in your jurisdiction?

The financial crisis was a catalyst for reform of restructuring regimes in numerous jurisdictions, but, in the UK, few fundamental legal changes have taken place in relation to corporate restructurings. Some significant changes have been considered. The Government consulted on the introduction of a restructuring moratorium, but there was little appetite for this, and, in response to vociferous criticism by certain stakeholders, an independent review of pre-packs was commissioned, but the report recommended market-led, voluntary measures. Reforms that are being progressed have the aim of achieving a somewhat surprising pairing of de-regulation (e.g. moving away from physical creditors’ meetings) and increasing transparency and trust. Delinquent directors are in the spotlight for the latter, and it remains to be seen whether a market in claims against them will develop (and what impact this will have on how directors engage with creditors).

At supra national level, plans are more ambitious. A number of amendments have been made to the EC Insolvency Regulation to extend its scope to restructuring, as well as insolvency, law, and to encourage co-operation in group insolvencies. These reforms ignited some debate, as have UNCITRAL’s latest draft proposals on the insolvency of multinational groups, which have been perceived by some practitioners as a step towards harmonisation.

Proposals to harmonise insolvency and restructuring law have consistently been met with opposition. Setting aside issues of territoriality, fundamental changes to many other areas of law would be required (security, trust and contract law, to name the most obvious). It is hard to envisage this being achievable. Is it justifiable? We know that the EU Commission considers that differences in insolvency laws are a barrier to investment. What started as an EU recommendation, encouraging member states to implement a set of common principles for national insolvency procedures, has gathered pace and a legislative initiative is slated for the fourth quarter of 2016. There is certainly impetus for change.

9. If it was up to you, what changes would you make?

Growing pressure for national regimes to incorporate certain “key features”, has reignited the debate as to what constitutes an effective insolvency and restructuring regime. Would the ideal process allow the debtor to stay in possession, with a wide moratorium, protection for new financing and the ability to cram-down creditors? The current state of the UK restructuring market suggests not.

Innovative practitioners, supported by a highly regarded judiciary, have attracted many overseas companies to restructure here, where there is an active distressed debt market and levels of corporate insolvency are low. This suggests that we have a relatively efficient restructuring regime in place, which is able to meet the market’s demands for speedy, cost-effective, fair and predictable outcomes,
without those “key features” being enshrined in statute.

However, it has been over 30 years since the UK’s insolvency and restructuring regime was last comprehensively updated (when the Insolvency Act 1986 was introduced), and, whilst practitioners and the judiciary have moved on, the legislative framework has not. In places, there is a lack of intellectual cohesion: pre-packs have proved hugely useful, but it might be prudent to place them on a clearer statutory footing; overseas companies frequently use schemes, but the procedural rules do not address issues of international jurisdiction; and, ideally, it would not be necessary to combine two procedures to achieve an effective cramdown of creditors, where they are clearly out of the money. In that regard, as well as a single cram down mechanism, clearer guidance on valuation methodologies would no doubt assist. Now seems to be a good time for a review, to ensure that the UK continues to be able to meet the demands of an ever-changing market.

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