45 Insolvency and Restructuring – Focus on the English Law Regime

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Introduction

There are a number of criteria against which to evaluate the efficacy of a restructuring regime: these include accessibility, speed, execution, certainty and cost. A more fundamental test is, however, whether a regime can adapt to continually changing market conditions in order to continue scoring highly against those criteria over a sustained period. If not, the regime risks becoming stale as the combination of market factors that it was designed to address changes, and market participants, including lenders, look to other regimes that can respond more effectively to the factors in play at that time.

As this chapter demonstrates, by adapting existing tools under English company and insolvency law and, more recently, introducing new tools, the English restructuring regime has not only withstood market changes over the past 25 years, but has made England one of the most attractive jurisdictions in which to implement a restructuring. The regime has therefore kept pace with the UK's position as a financial hub and, due to its accessibility to debtors, provides investors in English law debt as well as English, and many overseas, companies, with a flexible, best in class framework to restructure financial liabilities.

The examples of such flexibility are too numerous for this chapter alone, which therefore focuses on three areas. First, it explains how practitioners have adapted the scheme of arrangement for use as a targeted tool to address financial distress before and after the Financial Crisis. Second, it examines how the market has overcome the scheme's inability to impose a restructuring on an entire group of out-of-the-money creditors or shareholders through the innovation of the pre-packaged administration and the new restructuring plan procedure. Third, it touches on how the claims of certain non-financial creditors (particularly landlords) are increasingly susceptible to compromise, despite a general desire to avoid restructuring operational liabilities where possible.

Financial restructurings

Almost all London market restructurings over the past 25 years have sought to address a debtor's financial liabilities without interfering with its day-to-day business. This trend has, in part, arisen as a result of the financial environment of the early 21st century, in which companies have sought to maximise shareholder returns through increasingly complex leveraged capital structures. Where these structures have included English law debt, lenders have (unless the deal is on 'covenant lite' terms), typically benefited from early warnings of potential distress – in the form of financial covenants – which enable distress to be addressed through a targeted financial restructuring before it spreads to (and damages the value of) the debtor's operations.

In the late-20th century, such restructurings were generally negotiated by commercial banks through the quasi-consensual 'London Approach'. However, by the early 2000s, the rise in leverage made this increasingly challenging. In particular, not only did the amount of debt requiring compromise increase, but the investors in capital structures diversified, including through the influx of specialist hedge and credit funds. Debtors and lenders therefore faced increasingly complex and less homogenous mixtures of participants in restructuring negotiations, many of whom had purchased debt in the secondary market at discounts to par. This decreased the likelihood of alignment of incentives between stakeholders and increased the risk of holdouts in respect of the types of financial restructurings which generally require very high or unanimous consent (e.g., maturity extensions and debt-for-debt or debt-for-equity exchanges).[1] The UK market therefore required the means to implement a restructuring, despite such holdouts.

Notwithstanding its origins in late-19th century corporate law, the scheme provides such a means by enabling a specified majority of creditors (and/or shareholders) to impose a restructuring on minority holdouts or those who simply cannot, or do not wish to, engage in the process. It does this by grouping creditors into 'classes' based on their rights going into the scheme (broadly, their rights under the finance instruments, including if the scheme is not sanctioned) and their rights coming out of the scheme (broadly, what they are offered under the terms of the scheme). If those rights are sufficiently similar, those creditors can vote on the scheme together in the same class and impose the restructuring on a minority within that class, despite not meeting contractually agreed consent thresholds under the finance documents. A minority holdout creditor within a specific class cannot therefore prevent the deal just because they do not like its terms.

As creditors whose rights are unaffected by the scheme can, with due justification, be excluded from its scope, a scheme also enables a debtor (with the support of a majority of its lenders) to compromise specified financial liabilities whilst leaving operational liabilities largely untouched. This, together with the fact that a scheme is not an insolvency process, and so not typically perceived to be symptomatic of distress, has helped to cement its position as the 'friendly face' of restructuring and limited the likelihood of counterparties seeking to enforce defaults under commercial contracts.[2]

Although a number of other features of the scheme – including its relatively short timeframe, proportionate disclosure obligations, low cost and generally low litigation risk compared to certain other restructuring regimes – also helped to enhance its popularity, perhaps as important as these factors has been the approach of the English courts. As in other areas of commercial law involving sophisticated parties, the courts have generally acted as 'supporting players' for commercial bargains implemented through a scheme. They have therefore been reluctant to restrict features of schemes which reflect the commercial reality of a restructuring process, provided that parties do not overreach and propose terms which undermine a scheme's fairness or transgress procedural parameters which they have established.

1. For example, in 1997/1988, US distressed debt funds traded into the debt of Barings and voted down a scheme negotiated between Barings and its bondholders.
2. This is particularly important for contract-based businesses where a perception of distress can rapidly lead to a 'run' on the business by concerned counterparties.

For example, lock-up agreements under which creditors agree to vote in favour of a scheme will not generally be problematic unless they result in locked-up creditors receiving significantly enhanced disclosure compared to creditors who have not locked-up. Similarly, despite increased scrutiny (including in the 2018 Noble restructuring), consent and other fees payable to locked-up scheme creditors may be permissible if they are objectively justifiable, in line with market rates, available to all creditors and/or sufficiently proportionate that they are unlikely to be determinative to a creditor's vote. Further, despite a recent hardening of tone against truncated scheme timelines (e.g., the ColourOz restructuring), the courts recognise that certain circumstances, such as an imminent liquidity shortfall, may require an expedited timeline and have deployed other safeguards to allow an expedited scheme to proceed, such as allowing creditors in the Swissport and Hema restructurings to raise legal challenges later in the process than would normally be permitted.

However, the scheme leaves open two significant questions: (1) what happens when an entire class of creditors fails to approve the restructuring, such that the scheme's cram-down power within a class cannot break the deadlock; and (2) what if a debtor's operational liabilities, as well as liabilities to financial creditors, need to be compromised?

Dissenting class

The first question commonly arises in a secured structure, where the value of a debtor's business breaks in its secured debt, leaving one or more junior creditor groups and the shareholders out of the money. In that scenario, a scheme does not allow senior creditors to impose a restructuring on junior creditors or shareholders in a different voting class ('cross-class cram-down'). Until the recent introduction of such a statutory power under the restructuring plan procedure pursuant to the Corporate Insolvency and Governance Act 2020 (discussed further below), the workaround was for senior creditors to flex the administration procedure under the Insolvency Act 1986 to strand those junior creditors and shareholders through a 'pre-packaged' administration.

Broadly, this involves the debtor (with the support of its senior creditors who are closely engaged in the process), entering into administration and the administrator immediately selling the debtor's assets to a new company owned by the in-the-money creditors (who, if the pre-pack has been combined with a scheme, might include hold-outs) in exchange for a release of all or part of their debt claims against the debtor. Creditors and shareholders who are out of the money are stranded at the former debtor and receive no interest in the go-forward group. This can also apply where shareholder consent for aspects of a restructuring (e.g., disapplication of pre-emption rights in a debt-for-equity swap) is required under English law, but there are doubts as to whether shareholders will consent. A pre-pack can be used either as a 'stalking horse' to encourage a positive shareholder vote or, ultimately, to circumvent shareholder hold-outs (see, for example, the Interserve and Valaris restructurings in 2019 and 2021, respectively).

This use of the administration procedure does not, at first glance, sit squarely with its intended origins as a 'company rescue' procedure, given that the debtor enters into what is effectively a terminal insolvency following the transfer of its assets. However, by separating the debtor's 'good' assets from the 'bad' and the new company largely assuming liabilities to operational creditors, employees and pension schemes, the pre-pack can facilitate operational continuity for the benefit

of many of the debtor's non-financial stakeholders, as well as those financial stakeholders with a continued economic interest in the debtor. It therefore rescues the elements of the business which those persons with an economic interest in it consider worth saving. A key question – and an early battleground for the pre-pack in the 2009 'IMO Car Wash' case – is therefore how to identify who has such an economic interest.

In the US, this question is typically determined by reference to the 'intrinsic' value of the business, being what it would be worth following the restructuring. As this approach may take into account improved market conditions, it arguably increases the possibility of a junior creditor participating in the restructured company. However, this is not the approach adopted by the English courts or administrators in the context of pre-packs. Instead, they look to the value of the business at the time of the transfer based on current market conditions, which may well be distressed if a restructuring is required. This potentially deflates value and, critics contend, may provide senior creditors with a windfall if the value of the restructured business increases on a subsequent market recovery. Although this has not been significantly litigated recently in the context of pre-packs, the spotlight is, as noted below, turning back to valuation issues in the context of the new restructuring plan procedure.

Before considering the impact of this procedure on the potential use of pre-packs, there is another factor which may impact its popularity, namely the introduction this year of regulations which impose additional hurdles on pre-pack transfers to 'connected persons'.[3] This follows legislative concern that pre-packs have been susceptible to abuse, particularly in the SME market, by owners or directors of insolvent businesses acquiring those businesses' assets where they oversaw their fall into insolvency. Although this is less likely to be a concern in the non-SME market, the regulations apply to all companies and, unlike prior regulation, do not exclude secured lenders from the definition of 'connected persons'. Whilst unlikely to prevent a pre-pack to such lenders, the imposition of additional hurdles may render this tool less attractive.

Expanding the toolkit

The more influential factor which may erode the role of pre-packs in complex financial restructurings is the introduction by the Corporate Insolvency and Governance Act 2020 of the new restructuring plan procedure in Part 26A of the Companies Act 2006. This is, especially in procedural terms, closely based on the scheme, and imports the concept of classes. However, crucially, it includes a cross-class cram-down power which allows the court to sanction a plan even where one or more classes vote against it, provided that the requisite conditions are satisfied[4] (or to entirely dispense with the vote of persons with no 'genuine economic interest'). This means that, unlike in a scheme, an entire hold-out class of creditors or shareholders can be forced to accept a restructuring. This potentially avoids the time and cost of implementing a pre-pack and offers an alternative means for debtors and senior lenders to disenfranchise or cram-down 'out-of-the-money' creditors and/or shareholders.

3. The Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021.
4. These are that (i) no member of the dissenting class(es) would be any worse off under the plan than they would be under the relevant alternative and (ii) at least one class who has a genuine economic interest in the relevant alternative has voted in favour.

For various reasons, and despite its relative novelty, lenders and debtors have enthusiastically engaged with the restructuring plan and a number have already been implemented. This is, in part, because the plan is closely based on the scheme and explicitly builds on existing scheme case law, meaning that certain of its mechanics are relatively familiar.

It is also because, perhaps as importantly as providing the ability to cram-down an entire class of hold-out financial creditors (as in the 2021 Smile Telecoms restructuring),[5] the cross-class cram-down power also significantly heightens the feasibility of a compromise of operational creditors alongside financial creditors. Even though their different rights against the debtor mean that it is still likely to be necessary to place operational creditors into a separate 'class' to financial creditors for the purpose of voting on the plan, the restructuring can (as in the Virgin Active and DeepOcean plans) now be crammed down on one or more dissenting operational creditor classes even if they do not support the plan as a class. This was not possible under a scheme and strongly disincentivised its use to effect a combined financial and operational restructuring, as the adverse vote of an operational creditor class could preclude a debtor's broader financial restructuring.[6]

By bringing operational liabilities into scope, the plan is therefore able to deliver restructurings which address both financial and operational distress. This is increasingly likely to be required as the Covid-19-related market downturn and 'covenant lite' lending mean that parties are more likely to come to the negotiating table at a time when distress can no longer be contained within the capital structure. The very threat of cramming down operational creditors through the plan also increases the bargaining power of debtors and lenders against key operational creditors such that consensual compromises may become more likely.

This does not, however, mean that all operational creditors are 'fair game', and it is unlikely that the plan will alter the desire to exclude business critical creditors, employees and pension schemes from its scope in order to avoid the death spiral into which a business can descend if the market perceives severe operational distress. Rather, as in the Virgin Active plan, it is expected that cross-class cram-down will encourage debtors to view certain relatively sophisticated non-financial creditors as susceptible to compromise, whilst explicitly excluding other critical unsecured creditors.

This is not an entirely new feature of the English restructuring landscape. In particular, liabilities owed to institutional landlords have long been susceptible to compromise in the retail and leisure sectors, including through company voluntary arrangements (CVAs).[7] Given the lack of court hearings in the CVA process unless there is a creditor challenge, court involvement in this procedure had – until recently – been relatively unusual and key features of the CVA process had largely developed through market practice, providing a flexible means by which debtors could restructure their retail estates.

5. The Premier Oil and Gategroup plans addressed financial creditors though cross-class cram-down was not required.
6. The market partially responded to this issue by pairing a financial restructuring through a scheme with a targeted operational restructuring through a company voluntary arrangement.
7. As a CVA cannot compromise secured debt without secured creditor consent, it is less able than a scheme to implement a financial restructuring of a structure containing secured debt.

However, since the late 2010s and the general downturn in the high street (and the corresponding loss of alternative uses for compromised leasehold premises), landlords have adopted a more litigious approach to elements of CVAs which they perceive as particularly egregious (e.g., the discount applied to landlord claims for voting purposes), including in the Debenhams and New Look CVA challenges. This approach has already been transplanted into the Virgin Active plan, which sought to compromise landlord liabilities, resulting in a contentious sanction hearing as to the exercise of the cross-class cram-down power.[8]

This increasingly contentious approach is unlikely to be restricted solely to landlords. Despite the familiarity created by applying scheme case law to plans, the two conditions to the exercise of cross-class cram-down are new and bring into focus fact-specific and technical questions, including as to valuation. For example, to satisfy the English court that no dissenting class would be worse off under a plan than if it is not implemented (i.e., the 'relevant alternative'), the debtor must demonstrate to the court's satisfaction what that 'relevant alternative' would be. Although this will very frequently be an insolvency process (as a debtor must have encountered or be likely to encounter financial difficulties to propose a plan), the nature and timing of that insolvency process, including whether some or all of the insolvent debtor's assets may be sold and for what price, may fundamentally alter recoveries for creditors and shareholders. As in the Virgin Active, and Hurricane Energy plans, this is likely to be heavily scrutinised by dissenting parties and the court. This question, and the related question of who holds a 'genuine economic interest' in the debtor, are also likely to increase the pressure on valuation evidence to support (or challenge) a plan. Even where lenders support the plan, they may increasingly be called on to support debtors, possibly with their own evidence, including as to the economic rationale of their behaviour, when these points are interrogated.

The plan does not, therefore, come without a degree of complexity and the English court has, in the Hurricane Energy case, already refused to sanction a plan which was considered to have pushed the boundaries too far. However, the likelihood of challenge may reduce in time as more plans implicating different capital structures are put before the English court and a more established body of cases develops.

Looking ahead

Over the past 25 years, the English restructuring regime has capably adapted to changing market factors. Despite focusing on targeted financial restructurings for much of this period, the shift to restructurings with a more operational element, which has been accelerated by the Covid-19 pandemic (and which may continue as government support rolls off in the coming months) has required the English toolkit to expand through the restructuring plan. The more contentious start to this tool's life is not unexpected and it will be interesting to see whether the next few years mark a decisive shift towards this more litigious style or whether the creation of a new body of cases, guided by the flexibility of English judges, leads to greater stability.

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8. The court was able to draw on established principles from existing case law regarding the compromise of operational liabilities in order to help navigate the parties' positions.

It will also be interesting to see whether, despite the restructuring plan's ability to address operational creditors, a desire to row back from more operationally-focused restructurings leads to the reintroduction of earlier warning triggers in documentation (e.g., more onerous financial covenants and information undertakings) to provide financial stakeholders with more information and time to evaluate restructuring proposals before the onset of serious operational distress.

The English regime will also probably be forced to compete with tools in other jurisdictions which increasingly offer compelling alternatives, possibly buoyed by competing views as to the recognition analysis in respect of an English restructuring following Brexit. However, the combination of accessibility of English procedures for overseas companies, restrictions on compromising English law debt pursuant to a non-English proceeding, and the commerciality and flexibility of English procedures, judges and professionals means that it can be expected to continue as a leading venue for restructurings.