Global Restructuring Review

UK insolvency law reform: where do we stand?

Howard Morris
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Morrison Foerster

While the continuing Brexit negotiations leave many questions unanswered – not least in relation to the loss of the European Insolvency Regulation – it is also now clear that the UK is committed to reforming its insolvency law … and Chapter 11-Lite is the way we are headed says **Howard Morris**, head of the London business restructuring and insolvency group at Morrison Foerster.

Short months before the UK's Brexit vote, the government published a consultation paper on reform of our insolvency laws. It was proposing little short of adopting a system much like the US's Chapter 11.

Then came the UK's Brexit vote and the consultation period passed and it seemed that this project would fail for lack of government bandwidth, if not will. Notwithstanding vigorous lobbying, there was little expectation that unglamorous insolvency law would feature in Parliament's workload for the thousands of laws that would have to be replaced or reinstated on severing our legal tethers to Europe.

We were right and we were wrong.

There's no solution in sight to the loss of the European Insolvency Regulation, which provides that an insolvency law process in one EU state is recognised in every other EU state, helping the efficient sorting out of bust companies.

But we were wrong about Chapter 11-Lite: the UK *is* going to reform our insolvency law – and it is a potentially massive change.

The global co-chair of Morrison & Foester's restructuring group **James Peck** and I wrote about this in our July 2016 article *"Flourishing by becoming familiar: how to attract restructuring investors to the post-Brexit UK".* We argued that reforming UK insolvency law to make it like Chapter 11, which has become the World Bank's paradigm for an insolvency regime in its annual review of global insolvency systems, is a way of attracting investors into financially struggling businesses by making the risks of insolvency familiar – they'd know their way around. In judging the downside, pricing the risk, investors would be in an environment they know.

But government resources are stretched and no one thought that the proposals for this Chapter 11-Lite would go any further. Disappointment turned to apprehension when the European Commission published its own draft Directive to make member states reform their insolvency laws, so that a pan-European framework of minimum standards of insolvency law is created.

The prospect of a Europe-wide insolvency law very much like Chapter 11 would propel the EU towards the creation of its dreamt-of massive capital market, and by orders of magnitude increase the threat to the UK's dominance, along with New York, as a hub for international restructurings – with all the business and revenue that brings to the country.

A commitment to Chapter 11-Lite

Following the scandals of the BHS department store and Carillion public contractor failures, the government consulted in March this year. It asked questions about changes to corporate governance and stewardship, and in its response to that consultation there's a commitment to now reform UK insolvency law.

From the 2016 consultation three proposals will be made law:

- A new moratorium: a freeze on hostile creditor action while a company works to reach a deal with its creditors and, significantly, the company remains in the control of its existing management. Contrary to the custom in UK insolvency, the company isn't taken over by an administrator or liquidator or receiver.

- A bar on supplier contracts with the struggling company being terminated simply because it is insolvent. In other words, suppliers to the company must continue enabling it to continue trading. Unlike the *Ipso Facto* rule in Chapter 11, contracts with customers won't fall within the prohibition, perhaps something that will be regretted.

- A new type of restructuring plan (in addition to the CVA and the scheme of arrangement) that will not only allow a rescue deal that is binding on all creditors to be made, provided a 75% plus majority of creditors vote in favour, but in doing so will allow – subject to some protections – an entire class of creditors who do not vote for the deal to be "crammed down" and swallow it.

These changes will make our law much like Chapter 11 although one key characteristic of the US Chapter 11 hasn't been included – more on that later.

The impact of recent company collapses on the reform

Three other changes are to be made in response to those recent, much criticised company collapses:

- Changes to the law on directors' duties so that they must, when considering the sale of a financially struggling subsidiary, take into account the interests of the stakeholders in that subsidiary.

- Updating the law on preferences and extortionate credit transactions to make it easier to attack and unwind value extraction schemes, the improper taking of value out of a company that is left to rot into insolvency.

- Extending the directors' disqualification regime so that directors of dissolved companies that are simply struck off the register of companies will also be subject to scrutiny and actions for disqualification.

The first and third innovations pose serious practical problems. The government protests too much that there will be no legal conflict between parent company directors having a duty to pursue the best interests of its shareholders (or creditors if it is in financial difficulty) and the stakeholders in the subsidiary the parent company is considering selling. That can be made legally so – the law can say that the cognitive dissonance between what's in the interests of one group, but not the other isn't a breach of duty. But how does the director decide between those opposed interests? What if the sale is in the interests of the parent's shareholders, but not the subsidiary's? Or what if the sale is in the interests of the subsidiary, but won't serve the parent's stakeholders well?

I can't help but smile about introducing the ability to investigate directors of dissolved companies. Without an infusion of resources, the Insolvency Service really can't do more than it does right now. The government's paper boasts that, last year, 1,200 directors were disqualified. The fact is that every year 1,200 directors are disqualified: it doesn't matter how many reports liquidators and administrators submit calling for a director's disqualification, 1,200 is the number each year!

The idea that the Insolvency Service will be able to turn to the directors of dissolved companies is cloud cuckoo land, when in insolvencies the initial investigation work is done by the liquidator or administrator.

What's missing?

My focus is on the "Chapter 11-ish" proposals, and I welcome them – albeit I am disappointed the original idea of a super priority security to enable DIP lending was abandoned very quickly in the consultation process. This time, as in 2009 when last proposed, the existing finance market objected heavily. Without the opportunity for a company to shop for DIP finance, it must fall back on entreating its current lenders. A reason why we see so many pre-pack sales is because companies in administration can't get finance to carry on trading. Now, pre-packs are a fabulous way of saving businesses, but the purpose of the revisions to our law is to help rescue companies.

Conclusion

That so many international, large, complex restructurings are achieved in the UK is an ornament to our system. In truth, that's so in spite of our insolvency law.

We've taken the fusty, arcane scheme of arrangement and made it into an efficient tool. In the hands of a community of excellent legal and financial professionals under the aegis of an outstanding judiciary and judicial system, we've become a centre of restructuring business.

But we must reform to stay relevant and to attract capital to invest in restructurings, and the government has got the point that a number of countries are converging on systems with key features resembling Chapter 11. To stay relevant, to prosper, this country, too, must reform.

When will this be? Sometime after May 2019, so long as a suitable bill can be found onto which to tack the insolvency reforms.

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