Analysis

Rescue Culture: **Playing the Devil's Advocate**

Howard Morris, Morrison & Foerster
Amrit Khosa, Morrison & Foerster
Hee-Chan Kang, Morrison & Foerster

In our efforts to save companies, businesses and jobs, have we gone too far? Is the 'rescue culture' a victim of its own success? Would it be healthier for the economy overall to put 'zombie' companies out of their misery?

Howard Morris, head of the business restructuring and insolvency group at Morrison & Foerster in London, **Amrit Khosa**, Of Counsel, and **Hee-Chan Kang**, trainee solicitor, debate these issues.

The second quarter of 2023 saw a total 6,342 formal corporate insolvencies in England and Wales, representing a staggering 13 per cent increase from the previous year.

Yet only 157 were companies with a turnover of over UK£10 million. Despite the quarterly insolvency numbers being the greatest since the 2009 financial crisis, we have yet to see larger companies enter insolvency, and challenging times do lie ahead for many companies.

High inflation and rising interest rates continue to impact business profitability and liquidity.

Will these companies fail or will investors hungry for a return continue to throw them a lifeline?

> It feels almost heretical to wonder if our 'corporate rescue culture' has gone so far that we are expending too much time, effort, and cost to rescue some companies that, for the good of the wider economy, should not be saved.

For nearly 40 years, insolvency law and practice have been increasingly informed by the concept of corporate rescue.

From time to time we all wonder if that's entirely right or might it be a groupthink that it's time to review. Remember, it was people who didn't subscribe to received wisdom who made fortunes from betting against sub-prime debt and investing in oil shales, and it wasn't Big Pharma that developed the COVID-19 vaccine.

'Debtor repression to debtor protection'

The UK insolvency and restructuring regime has been on a steady path of turning the tide from 'debtor repression' to 'debtor protection', starting with the Cork Report of 1982 which led to the passing of the Insolvency Act 1986, followed by the Enterprise Act 2002, the increased use of schemes of arrangement, and more recently the Corporate Insolvency and Governance Act (CIGA 2020).

Each was a step further away from favouring one or more creditors towards preserving the business and value for all stakeholders or as many as were above the point where value breaks and/or were essential to the business.

The recent CIGA 2020 brought the UK's insolvency regime more in line with US chapter 11 procedures (the World Bank's favoured insolvency law model), and the EU's most recent directive on an EU-wide framework of common minimum standards for insolvency law.

Most notably, the UK now has the 'cross-class cramdown' with an ability to bind dissenting creditors so a viable restructuring can be undertaken where a fully consensual solution is not possible.

Preserving viable enterprises

Receivership, with its focus on the interests of the secured creditors, earned an increasingly bad name with the perception that those creditors would pull the trigger on appointment when it suited them without regard to minimising the harm of the debtor's failure to the debtor's other stakeholders.

With the transformation of lending, away from banks to direct lenders, investment funds, capital markets, and alternative financiers, there has come a shift in mindset favouring an approach of commerciality when faced with distressed credit.

These lending approaches are often seen as opportunities to create greater value and returns, whilst also allowing lenders to justifiably claim the moral high ground of saving companies and preserving jobs.

> It is thus easy to see the attraction of a strong corporate rescue culture since it first and foremost preserves 'viable' enterprises, and by extension, jobs.

And when we think of the social felicity of saving a company, not simply the jobs of its own workforce but those in supplier companies and the wider locality, as opposed to the sale of its business or assets alone, then rescue becomes an even more appealing goal.

But has this goal become inflexible dogma?

Thanks to CIGA 2020, 54 companies obtained a moratorium and 21 companies a restructuring plan between 26 June 2020 and 30 June 2023.

Misallocation of resources?

That is not to say, however, that there is not a significant cost to expansive corporate rescue, especially when governments deem that 'desperate times call for desperate measures', as we have seen in the Pandemic's temporary measures (e.g., restrictions on winding-up petitions where unpaid debt is attributable to COVID-19) under CIGA 2020. Although those measures enabled many struggling businesses to avoid insolvency, the UK government's budget reached a peacetime record of

continued on page 10

continued from page 9

UK£303 billion in 2020/2021.

Let's put aside the extraordinary circumstances of the Pandemic, about which the argument can be made that without government financial support and inhibitions on creditor remedies, the political, social, and economic consequences may have been so severe that re-starting the economy may have posed the gravest problem, and consider private funders.

As a company gets into increasing financial distress, its sponsor will invariably be turned to first to provide rescue funding.

Financing agreements commonly include an "equity cure" permitting the sponsor to subscribe for new shares to cure a financial covenant breach.

> There's no legal mechanism that can (or should) intervene to judge whether additional investment, instead of letting the company fail, should be allowed.

The sponsor and creditors, for whatever reason, can decide to save the company and, if necessary to achieving that goal, employ the broad range of rescue mechanisms that the law provides.

In retrospect, some rescues may prove to be unsuccessful and be seen as a misallocation of resources. Sponsors and debt investors with a poor record of investment, for unsuccessful rescues, will not be able to raise new funds or attract new funders.

The market will take care of this misallocation of resources. Governments that support businesses and industries that simply are not viable (or have no strategic necessity for the nation) rightly receive academic criticism.

Their generous corporate rescue measures operate on the tacit dogma that businesses should "live forever" rather than acknowledging that they should last "only until their functional utility is exhausted", according to The (Implicit) Dogmas of Business Rescue Culture by Tim Verdoes and Anthon Verweij.

Life support or liquidation?

Shouldn't efficient enterprises be able to acquire the resources and market share of the inefficient, so those inefficient companies will not be enabled to stumble on as obstacles to growing companies?

This is a reasonable question to pose, but such a 'hands-off' approach to the corporate ecosystem overlooks the fact that so long as a company's business is viable, its going-concern value will exceed the liquidation value of its assets; accordingly, notwithstanding the cost of business rescue, the price that is paid for inefficient liquidation is value destruction.

> A key rationale for the inception of CIGA 2020 was the need for a specific insolvency process that would efficiently enable a wider range of corporate rescues that would otherwise be stymied by a single class of creditors.

The professions have done brilliantly over the last 25 years-plus in deploying the venerable scheme of arrangement to meet the needs and challenges of modern business, but the lack of the cross-class cramdown had become conceptually unjustifiable – especially in the competition to maintain the UK's attractiveness as a centre for international restructurings.

> And in rejecting any version of an absolute priority rule, the UK has given its restructuring plans a flexibility beyond Chapter 11.

Since the underlying rationale for the flexible and debtor-friendly rescue culture that we now see in the UK insolvency regime is to ensure that distressed companies can select from a variety of rescue tools (e.g., restructuring plans, CVAs, and schemes of arrangement) to reach a suitable compromise with their creditors, it would be rather reductive to rely more heavily on liquidation instead of a rescue plan.

Kicking the can down the road?

A perhaps more powerful criticism of the UK favouring a rescue culture is that innovative measures such as CIGA 2020 merely serve to delay failure and wider market corrections. This is certainly true to an extent: we are all familiar with the High Street restaurant chains and gym companies that repeatedly come up to restructure every few years again and again.

Rescue culture tends to focus more on right-sizing the balance sheet and can ignore the operational challenges the business needs to manage. Use of insolvency processes can be useful in addressing operational as well as financial challenges. Empirical data seems to indicate that corporate rescues involving pre-packs, administration, and receiverships are, more often than not, successful.

The average survival rate for companies five years post-rescue sits at around 69 per cent. It is too early to obtain similar data on how companies that are restructured via CIGA 2020 will perform, but the restructuring has been widely praised by stakeholders in the Post Implementation Review of CIGA 2020. Given its success in restructuring plans, and in raising additional capital for businesses, it can only be assumed that the statistics will be favourable.

Conclusion

It's a relief to find that the rescue culture isn't wrong, especially for professionals who have sweated so hard to devise and implement clever restructurings.

By no means is our corporate rescue culture a silver bullet: after all, businesses can still fail after a rescue and governments must often bear the wider social cost.

These common objections, however, overlook the fact that the UK's corporate rescue culture never sought to offer distressed companies an absolute solution, but rather the necessary toolkit to seek solutions tailored to their individual needs.

This approach has clearly been vindicated on a practical level, as highlighted by the data above, and companies and their stakeholders, particularly their creditors, can be trusted to select the right tools by which to rescue themselves.