Private equity restructuring

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In this chapter we consider the key elements of a debt restructuring in England as it relates to an unlisted UK company. We also review recent developments and their effect on the implementation of a restructuring.

1. A changing restructuring landscape

Since the last edition of this book, the leveraged buyout market has been characterised by a surfeit of liquidity, allowing sponsors and borrowers to negotiate increased leverage and, generally, to secure more favourable and relaxed documentary terms. This trend has been accelerated by the increasing presence of private debt funds and direct lenders with an appetite to lend, for example, on a sole or unitranche basis.[1]

Lenders have traditionally relied on financial covenants to enable them to monitor a borrower's financial condition and to pick up signs of distress at an early stage, thereby enabling them to instigate and lead restructuring discussions. However, lenders have increasingly relinquished some of the protection afforded by financial covenants and by the end of 2019 the vast majority of syndicated leveraged loans could be classified as 'covenant-lite' – that is, loans with no ongoing maintenance financial covenants.

In the years following the global financial crisis, restructurings have grown in number and, it is probably fair to say, complexity. The increasingly uncertain macroeconomic environment looks set to continue. Consumer-led sectors in particular are subject to significant financial distress. Retail continues to suffer from a behavioural shift by shoppers from stores to online; likewise, casual dining and the wider leisure industry have had to adapt to more discerning consumer habits; while other highly leveraged sectors such as care homes, student accommodation and logistics may also be vulnerable to changes in demand and/or regulation – not least as a result of Brexit.

There have been some notable developments and reactions to these dynamics. For example, there has been a significant uptick in the use of company voluntary arrangements (CVAs), through which businesses can

1 This trend is explained in the chapter on debt finance.

address and rationalise their leasehold portfolios. Pre-packaged administration sales continue to be the procedure of choice for distressed mergers and acquisitions.

Both the circumstances causing insolvencies and the insolvency procedures that are used have been scrutinised in the press and in government. High-profile failures such as BHS, Carillion and, recently, Thomas Cook have placed a focus on professionals, especially auditors. Importantly, there is an increasing political focus on the conduct of directors and shareholders. There is every indication that more legislation will be introduced to sanction actions and behaviours that are perceived to have contributed to insolvencies. On a similar note, the Pensions Regulator has an expanding role. Proposed regulations will mean that pension trustees and the regulator are likely to take a more active role in restructurings of businesses with defined benefit schemes.

2. The restructuring toolkit

Generally, a restructuring will be needed where the existing equity and debt capital structure is broken. The operating business is also likely to be underperforming and in need of an operational turnaround. The business may need fresh capital, as well as some relief in respect of its current debt burden. Without remedial action, the business may be facing insolvency.

Ideally, a solution will be agreed and implemented consensually. However, this may not be practical, especially if there are multiple stakeholders with competing interests and differing agendas.

English law provides a number of tools which can be used (or which can credibly be threatened) to enable a restructuring to be achieved. They are:

- amendment mechanisms in existing finance documents;
- release mechanisms in intercreditor documentation;
- administration (including pre-packaged disposals of businesses, assets or shares);
- schemes of arrangement; and
- CVAs.

The key point to note is that there is no 'one size fits all' solution – a restructuring could include one or more (conceivably all) of such techniques. It is also vital to understand that the restructuring tools mentioned above are methods of implementing a commercial deal; they are not an end in themselves. Moreover, some of these processes can be cumbersome and expensive, and their suitability should be assessed on a case-by-case basis.

3. Key concepts and issues

One of the first steps in any proposed restructuring, from a legal perspective, is to understand the existing capital structure – in particular, which entities within a group of companies owe liabilities and to whom – as well as understanding which companies own key assets and how the various liabilities rank, contractually and/or structurally.

As a general rule, there is a presumption that, given the potential damage to the business and the possible termination of key contracts or licences, operating companies should be kept out of any formal restructuring process and that any necessary surgery should take place only at the holding company level.

When considering the options of stakeholders in the context of a restructuring, the following key concepts should be kept in mind:

- subordination/ranking;
- 'value break';
- moratorium;
- the role of the security agent; and
- directors' duties and antecedent transactions

4. Subordination/ranking

An understanding of the current ranking of creditor claims is vital in designing a restructuring.

Broadly speaking, secured claims will rank ahead of unsecured claims in the event of insolvency or enforcement of security, when it comes to the distribution of proceeds of realisation of secured assets (subject to certain preferred claims and expenses where the security is not 'fixed' security).

In addition, transactions which include secured debt will typically be governed by an intercreditor agreement pursuant to which the various classes of secured creditors (including senior lenders and hedge counterparties) and core unsecured creditors (eg, intra-group lenders, investors and, possibly, bondholders) agree contractually on the ranking of payments and on rules for the enforcement of security. Where debt is owed to shareholders, this may also need to be contractually subordinated as there is no legislation in England which subordinates debt owed to shareholders. Intercreditor agreements now commonly follow the form of templates published by the Loan Market Association (LMA), first published in 2009.

In addition or as an alternative to contractual subordination, a creditor's claim may be 'structurally subordinated'. This applies, for example, where the claim is owed by a holding company of an operating subsidiary. In that case the creditor's claim is structurally subordinated to the claims of the subsidiary's direct creditors, unless the subsidiary has given the creditor of the holding company a guarantee.

5. Where does the value 'break'?

At the outset of any restructuring, lenders and other stakeholders will analyse the outstanding debt alongside the value remaining in the business, to determine where the value 'breaks', taking into account the rankings of the respective liabilities. Valuations will help to determine the amount of debt that can realistically be repaid. There are often disputes as to the most appropriate valuation methodology. In practice, there might well be a marketing process in parallel with restructuring discussions, which will inform value.

In a simple debt structure comprising a senior and a junior tranche, the value might 'break' in the junior tranche. In such case the restructuring might be centred on a compromise of the junior debt, with the senior debt remaining largely untouched. If, however, the company's problems are very serious, such that the value 'breaks' in the senior debt, the holders of the junior debt are likely to have no economic interest in the outcome and the restructuring will be centred on a compromise of the senior debt, with the junior debt either eliminated or made redundant as a result of changes to the structure.

Some deals will comprise multiple layers of debt instruments or tranches, ranking one after the other. In such cases, the issue is which tranche the restructuring should be centred on, with successive classes of debt jostling for position. Assuming that the equity owner(s) are no longer in a position to support the business, it would be open to the most junior debt tranche to make a proposal to the more senior debt tranches to refinance them and provide fresh capital to the company (effectively purchasing the company for the total of the full value of the more senior tranches, plus the amount of new capital to be injected). In the absence of such a proposal, the restructuring would centre on the next most senior creditor. The business would effectively be up for sale; it would come down to the creditor class which is prepared to pay the most for the company. Alternatively, the business may be sold to a third party following a sales process, which could offer creditors better returns than following a restructuring.

6. Moratorium

Stability during the course of negotiations is key to achieving a successful restructuring. Of the English law restructuring tools available, currently only administration provides a legal moratorium against creditor action,[2] although the court may agree to stay particular proceedings while a scheme of arrangement is promoted.[3] A moratorium may also be available while a CVA is promoted, but only in relation to 'small' companies. This means that, in practice, in order to avoid legal or insolvency proceedings, ordinary unsecured creditors of the operating companies will need to be paid in full while restructuring negotiations continue, and funding must be made available to allow for that.

Stability can also be maintained, at least for a period, at the holding

2 However, see section 15 in relation to proposed reforms and the introduction of a new moratorium.
3 *Bluecrest Mercantile BV v Vietnam Shipbuilding Industry Group* [2013].

company level through the way the finance documents usually work. Acceleration and enforcement of security in respect of senior debt in a multi-lender situation in the leveraged loan market usually require action by a facility agent and security agent, acting on the instructions of the 'majority lenders', typically being more than 66.66% of the lenders by value, where there is a continuing event of default.[4] As such, lenders holding at least one-third of the senior debt by value can block any proposed acceleration or security enforcement, although care needs to be taken to avoid a non-payment event of default, because this would, subject to any restrictions under the related intercreditor provisions, allow insolvency proceedings to be initiated by any single senior lender, based on its own unpaid debt.

The general position regarding creditor action may also be extended in practice by means of deal specific forbearance or standstill agreements. There will often be a need for waivers of defaults while restructuring negotiations continue. Even if a majority lender instruction to accelerate appears unlikely, the existence of a default may need to be waived in order to avoid causing a 'cross-default' under other finance documents or trading agreements.

7. Role of the security agent

While guarantees and borrowing obligations are usually owed or given directly to the lenders, security is often granted in favour of a security agent (or security trustee), to be held on trust for the financial creditors (eg, the senior creditors and hedge counterparties). As we shall see below, in order to give effect to a restructuring, the security agent may be instructed to enforce such security and/or use its powers under the intercreditor agreement to release parts of the group from certain liabilities in connection with the enforcement of security or a 'distressed disposal'. The security agent will be concerned to ensure that it does not incur liability by doing so and will want to minimise the extent to which it may have to exercise any discretion (which might be open to challenge). Intercreditor agreements will usually contain extensive exclusions of liability and indemnities in favour of the security agent. But, as a practical matter, it will be important to ensure at an early stage that the security agent will cooperate with the restructuring process.

8. Directors' duties

In addition, consideration should be given to some of the legal risks to avoid, which could otherwise result in criminal and civil liability for key individuals and may also result in the subsequent invalidity of core elements of the restructuring transaction:

4 In the high yield bond market the thresholds are usually lower for acceleration (25%) and enforcement (50.1%).

8.1 Directors' general duties

The directors of an English company are subject to a number of statutory duties, codified in Sections 171 to 177 of the Companies Act 2006. The Companies Act duties include the requirement for a director to act within his or her powers, to promote the success of the company and to avoid conflicts of interest. However, additional duties and responsibilities apply to the directors of a company in financial difficulties.

8.2 Duty to creditors

Section 172 of the Companies Act states that the duty to promote the success of the company has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company. When a company becomes insolvent, the primary duty of its directors changes so that they must act in the best interests of the company's creditors, rather than its shareholders. This shift in fiduciary duties to creditors occurs when the directors know or should know that the company is more likely than not to become insolvent. This perspective shift is critically important. Unless directors appreciate this point and act accordingly, there is a risk of breaching the duties that apply to them in these situations.

8.3 Who is a 'director'?

These legal duties apply to all directors of the distressed company. This means:

- formally appointed directors (including non-executive directors);
- '*de facto* directors' – that is, anyone who claims to be a director, acts as a director and is held out by the company as being a director, notwithstanding that he or she has not been formally appointed; and
- 'shadow' directors – that is, anyone in accordance with whose directions or instructions the directors of the company are accustomed to act.

However, if advice is given to the directors by an adviser in a professional capacity, that alone will not make the adviser a shadow director. The shadow director concept extends the wrongful trading and disqualification provisions (discussed below) to those who 'pull the strings' of a company's board.

8.4 Investor directors

Directors appointed by investors, sponsors or other stakeholders are subject to specific considerations in a distressed restructuring. For example, it is generally advisable to limit such appointments to the non-trading holding companies and to ensure that investor directors do not dictate the decisions of the operating company boards. This should avoid those directors from being characterised as shadow or *de facto* directors of the operating companies and thereby becoming exposed to claims relating to the trading of those entities, such as breach of duty or wrongful trading (see below). Shadow directorship can, for example, arise where an individual or a parent company dominates and directs the operations of a subsidiary which regularly carries out those requirements. Alternatively, where an investor (either directly or through a representative who does not sit on that company's board) directs what actions the investee company's board should take, and the board complies on a regular basis, that investor and/or the individual is likely to be a shadow director.

An investor director should ensure that he or she does not act or exercise his or her vote in a way that conflicts with the interests of the investee company. In most circumstances, it is reasonable for the investor director to represent the interests and express the views of the investor. However, as explained in section 8.2, when the company is more likely than not to become insolvent, all of its directors have a duty to act in the best interests of the company's creditors, rather than its shareholders. This may place an investor director in a difficult position if his or her interests as an investor representative might take precedence over the duties he or she owes to the investee company. In such cases, that investor director should take independent advice on how to avoid that situation, which may involve him or her being recused from various decisions or result in him or her resigning from the board.

In many cases an investor director may be privy to confidential investor information. To the extent that this information is relevant to the investee company, that investor has a duty to share that with the investee company board. An investor director will be in a position of conflict if, for example, the information relates to, or potentially reveals, whether the investor intended to continue funding its investment and the investor did not wish for its position to be disclosed at that time. An investor director should consider, at an early stage of a restructuring, whether such conflicts might arise. In order to mitigate that risk, a director might recuse himself or herself from investor meetings or investment committees where the investee company is under consideration.

8.5 Misfeasance and breach of duty

Section 212 of the Insolvency Act 1986 provides that the court may make a compensation order against an officer of a company or anyone else who has been involved in the promotion, formation or management of the company if that person has misapplied any money or property of the company or has been guilty of misfeasance or breach of any fiduciary or other duty to the company. Matters which could be treated as breach of duty are therefore very wide and include breaches of a director's statutory duties to the company and negligence,[5] as well as specific instances of wrongdoing, such as the misappropriation of company funds or assets. A director's involvement in a company granting a

5 *Re D'Jan of London Ltd* [1993].

preference or entering into a transaction at an undervalue (see below) may also be evidence of misfeasance.

8.6 Wrongful trading

Under Sections 214 and 246ZB of the Insolvency Act, the court may make an order in relation to wrongful trading, so that a director or former director of a company in insolvent liquidation or insolvent administration is liable to make such contributions as the court thinks proper to the company's assets. Before any order is made, the court must be satisfied that the director knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid going into insolvent liquidation or insolvent administration, that is, resulting in the company's assets being insufficient for the payment of its debts – in other words, it is balance-sheet insolvent. Cash-flow insolvency does not of itself mean that a company is wrongfully trading. It may, however, call into question whether the company has a reasonable prospect of ultimately avoiding a balance-sheet insolvent liquidation or insolvent administration. From the point in time that a director knows, or should know, that the company cannot avoid insolvent liquidation or administration, he or she must take "every step with a view to minimising the potential loss to the company's creditors".[6] These tests apply both objective and subjective criteria. Therefore, as well as being tested by reference to the standards of a 'reasonable' director, he or she will be subject to his or her own knowledge and skills. So, for example, executive directors may be held to higher standards than non-executive or part-time directors.[7]

8.7 Fraudulent trading

If any business of the company is carried on with intent to defraud creditors or for any fraudulent purpose, a director (or any other person party to that fraud) commits the criminal offence of fraudulent trading (Section 213 of the Insolvency Act). It is relevant to a restructuring that fraudulent trading can arise when directors of a company incur credit when they know there is no good reason for thinking that funds will be available to repay the debt when it becomes due or shortly thereafter.

The offence applies whether or not the company is being wound up. The sanction is imprisonment or a fine, or both. In addition, if the company enters into liquidation or administration, any party to fraudulent trading can be made personally liable to make such contributions to the company's assets as the court thinks proper.[8]

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6 Section 214(3) of the Insolvency Act 1986.

7 *Re Continental Assurance Co of London plc* [2001].

8 Claims against directors are brought relatively infrequently – largely because they are very fact-specific and require significant amounts of evidence. They are often settled out of court. The reported cases tend to be limited to circumstances where there is significant mismanagement or fraud (eg, the *BCCI* case).

8.8 Other considerations

Pursuant to the Company Directors Disqualification Act 1986, a person may be disqualified from being a director of any company for up to 15 years.[9] When assessing conduct, the court is entitled to bring into consideration a wide range of factors and to judge a director unfit on the strength of his or her conduct regarding:

- the insolvent company, alone or taken together with the director's conduct as director of any other company or companies (including overseas companies); and
- matters connected with or arising out of the insolvency of any such company (including an overseas company).

Therefore, if a director is found liable for breach of duty, wrongful trading or fraudulent trading, or causes the company to enter into a voidable antecedent transaction (see section 9), this will generally establish unfitness for the purposes of the Company Directors Disqualification Act.

8.9 Implications for a restructuring

In the light of these duties, the directors should, in principle, support and seek to assist attempts by the company's stakeholders to progress any restructuring proposal which would enhance the company's prospects of avoiding an insolvent liquidation or administration or, failing which, would minimise the potential loss to the company's creditors.

An important protection for the directors is to ensure that proper advice is obtained and all options are considered and minuted at board meetings. Equally, stakeholders should be conscious that aggressive or ill-thought-out action on the part of the stakeholders could put the directors in a difficult position and jeopardise their ability to safely continue to progress a restructuring outside of an insolvency process.

9. Avoidance of antecedent transactions

Certain transactions may be set aside by a liquidator or administrator. Therefore, care should be taken when negotiating a restructuring to avoid or minimise the risk of challenge to transactions intended to implement the restructuring.

9.1 Transaction at an undervalue

A 'transaction at an undervalue' is any transaction (eg, the grant of security or a guarantee) for no consideration or for consideration that is significantly less than

9 High-profile disqualification cases include those brought against Dominic Chappell, the former BHS owner; Craig Whyte, the ex-owner of Rangers FC; and the MG Rover 'phoenix four'.

would ensure equality of exchange of consideration. Under Section 238 of the Insolvency Act, a liquidator or administrator can apply to the court for an order restoring the position to that which it would have been in the absence of such a transaction. It is a defence if the company entered into the transaction in good faith for the purpose of carrying on the business of the company and there were reasonable grounds for believing that the transaction would benefit the company.

9.2 Preference

A company grants a 'preference' (under Section 239 of the Insolvency Act) where it puts a creditor in a better position than it would have been in if the company went into insolvent liquidation. This could be the case if a company granted security for an existing debt. However, the court will only make an order restoring the position if the company was influenced by a desire to prefer the other person. This desire to prefer is presumed where the parties are 'connected' (as defined in the Insolvency Act).

9.3 Floating charges

In addition, certain floating charges will be invalid under Section 245 of the Insolvency Act, except to the extent of any valuable consideration (ie, money, goods or services supplied; or a discharge or reduction of any debt or interest). No application to court is required.

9.4 Hardening periods and connected persons

A transaction will not be voidable as a transaction at an undervalue, preference or invalid floating charge unless, at the time of the transaction, the company was unable to pay its debts or became unable to pay its debts as a consequence of the transaction (except in the case of a floating charge made with a connected person). Inability to pay debts is presumed in the case of a transaction at an undervalue in favour of a connected party.

There are time limits on the availability of these remedies. The relevant 'hardening periods' prior to the onset of administration or liquidation for the above heads of challenge vary depending on whether the counterparty is 'connected', as follows.

Insolvency Act	Section 238 undervalue	Section 239 preference	Section 245 floating charges
Connected person	2 years	2 years	2 years
Not connected	2 years	6 months	1 year

9.5 Extortionate credit transactions

Within three years of the transaction, the court may set aside an extortionate credit transaction, meaning a transaction on terms requiring grossly exorbitant payments to be made in respect of the provision of credit or otherwise grossly contravening ordinary principles of fair dealing (Section 244 of the Insolvency Act).

9.6 Transactions defrauding creditors

A liquidator, administrator or 'victim' of the transaction may challenge any transaction that is entered into at an undervalue where the purpose of making the transaction was to put assets beyond the reach of a person who is making or may make a claim against the company (Section 423 of the Insolvency Act).

9.7 Financial collateral

In relation to security over financial instruments, shares, credit claims (including claims for repayment of money to and loans made by credit institutions) and cash, the Financial Collateral Arrangements (No 2) Regulations 2003 may, if the requirements are met, dis-apply certain insolvency challenge risks and the moratorium on enforcement of security in administration.

10. Restructuring options may be limited by the terms of the finance documents

A range of documentation points will dictate the feasibility of a restructuring. Some recent market developments merit further consideration as they are likely to impact on potential restructuring outcomes.

10.1 Non-amortising structures with limited financial covenants

Non-amortising structures (whether traditional bank-arranged term loan B or direct lender unitranche/stretched senior structures) are now the preferred tool for sponsor-backed deals. This allows cash flow to be invested in portfolio company growth, rather than servicing debt repayments. Hence, in most cases the financing model will assume that the principal will not be repaid until there is a wholesale refinancing, an initial public offering or a sale of the business. However, interest-only debt service payments can make borrowers more vulnerable to spikes in interest rates on unhedged debt. In this context, the forthcoming demise of the London Inter-Bank Offered Rate may add cash-flow uncertainty on deals documented without provisions for a successor rate.

When a borrower experiences financial difficulties, a breach of financial covenant ratios (tested quarterly in the case of 'maintenance' covenants) has, in previous downturns, served as a reliable early warning sign for lenders. This will trigger an event of default under loan documentation (unless the shareholders elect to 'equity cure' such a breach by injecting cash into the borrower group), giving the majority lenders the opportunity to vote to instruct the facility agent to accelerate the debt. In practice, it will usually result in a dialogue between borrower and lenders as to amendments required to the terms of the loan, with pricing reviewed to reflect increased risks. However, sponsors have recently eroded this protection on several fronts.

Most importantly, the vast majority of syndicated deals are now covenant-lite, with no maintenance financial covenants. Often, lenders benefit only from a springing leverage covenant, triggered when the revolving facility is drawn to a certain level. Financial covenant headroom (the cushion compared with the bank case model) has also increased, which magnifies the underperformance that needs to occur before a default arises in cases where a maintenance financial covenant applies. So-called 'deemed cure' provisions (where a covenant breach is disregarded if compliance is restored on the next test date and lenders have not called the breach) are also common. Sponsors have also succeeded in re-moulding the rules for calculating earnings before interest, tax, depreciation and amortisation (EBITDA) (a measure of core earnings and key component of covenant ratios) by introducing a range of subjective elements which make it easier to game covenants. EBITDA 'add-backs' allow a borrower to boost notional earnings. For instance, sponsors have for some time been able to include projected (but as yet unrealised) synergies, such as cost savings likely to result from an acquisition. The caps on such synergies have been progressively loosened recently, along with requirements for third-party verification. Add-backs for non-recurring costs on other events such as restructurings, reorganisations, start-up costs and business disruption events may now also be permitted. Consequently, a borrower may have considerable freedom to exercise subjective judgements to ensure that ratios are respected. This not only serves to ensure compliance with any quarterly maintenance financial covenants; EBITDA is also a key ingredient in incurrence covenants which might, for instance, allow a borrower to incur additional debt. Other baskets may also be affected.

The standards applicable to equity cures have also been loosened. Traditionally, borrowers have had the opportunity to cure a ratio breach – usually by equity investors injecting more capital, with the cure amount used to notionally reduce total net debt. A stronger position increasingly obtained by borrowers is for the cure amount to be added to EBITDA for the purposes of covenant calculation, which is more flattering to the leverage ratio. Restrictions on the number of cures or the amount by which a breach can be cured have also been watered down.

We focus here on the terms of typical loan documentation, but the bond market has traditionally seen similarly loose terms in respect of financial covenant protection and the rights of bondholders to put a business into default and enforce their security. Indeed, a number of the relaxations to loan documentation in recent years have started life in bond documents.

Sponsor-friendly tweaks to security documents may also impact on restructuring options (see section 12.5).

10.2 Lender consent thresholds

Ideally, a restructuring can be agreed and implemented consensually by the parties amending existing documentation and/or entering into new documentation. In some cases, this will require unanimity; in others, majority (or possibly super-majority) approval will suffice.

Accordingly, early in the restructuring process, it will be important to review principal finance documents to determine the consent levels required for actions contemplated. Without the approval of lenders (which will usually be the main creditors of the company and have the benefit of security), restructuring will be impractical. Consent threshold requirements will depend on what types of changes need to be made.

A borrower will often seek to 'amend and extend' an existing facility agreement in order to avoid a forthcoming maturity of its debt, which would otherwise result in a more painful restructuring process. To achieve this, a borrower will typically seek to extend the maturity of some or all of its existing loans, coupled with additional concessions such as a change to the amortisation profile of the loans or more lenient financial covenant ratio tests. This essentially buys time for the company and makes it easier to service its debt in the short term. In a transaction where the existing facilities benefit from upstream and cross-stream guarantees and security from borrowers and guarantors (possibly incorporated in different jurisdictions, meaning that security is subject to a range of governing laws and rules relating to hardening periods), lenders may prefer to keep the existing facilities agreement in place, while amending or confirming the existing security and guarantee package with the aim of extending the security and guarantees to cover the amended loan. This may be preferable to taking new security in the context of a wholesale refinancing.

In exchange for agreeing to amend the loan documentation, lenders will wish to see improved terms, additional fees and an increased interest margin. Consent solicitations will be necessary in order to implement such changes.

LMA-style facilities will envisage different consent thresholds, depending on the nature of the waivers and amendments requested. The default position will be that finance documents may be amended or waived only with the consent of 'majority lenders' (typically, lenders whose commitments aggregate more than 66.6% of the total commitments). However, some matters will require the consent of all lenders (eg, items such as extension to a payment date, reduction of the margin or a change in currency of payment) or of a super-majority such as 85% or 90% (eg, the release of guarantees and security outside agreed parameters).[10]

10 In the high yield market, decisions other than modification of key commercial terms will often require a 50.1% majority, with all remaining decisions – for example, to extend maturity or to write off part of a debt – often requiring a 90% majority.

If the requisite lender consent threshold is not practical, such changes may be implemented through a scheme of arrangement or (if the debt is unsecured) a CVA (see sections 13 and 14). A credible threat to achieve the amendments through a scheme or CVA may be sufficient to persuade minority lenders to agree to support the changes.

Target voting thresholds may be complicated by provisions in an intercreditor agreement requiring all creditors to cast their votes in any proposal in accordance with the instructions of an instructing group. This potentially allows a group (eg, majority senior lenders) to force through a restructuring procedure which might otherwise appear to require a higher consent threshold.

10.3 Structural adjustment

Increasingly, a 'structural adjustment' clause will allow changes to the structure and size of the loan facilities which would otherwise require all lender consent to be made instead with the consent of all the 'affected' lenders plus a specified majority (sometimes a super-majority of, say, 85%) of all the lenders. The LMA structural adjustment clause contains three categories of structural adjustment, allowing the commercial parties to specify different consent thresholds for each category:

- major structural adjustment – an alteration to the facilities, or the insertion of a new facility, where the size of the facilities is increased (subject to an optional cap) or where the currency of a facility or of an amount payable is changed;
- minor structural adjustment – an alteration to the facilities, or insertion of a new facility, which does not result in an increase in the size of the facilities or a change in currency of a facility or of an amount payable; and
- payables reduction – an amendment which results in the extension of a payment date or a reduction in any amount payable.

Structural adjustment provisions can be particularly relevant if a syndicate contains a significant number of lenders which are collateralised loan obligations (CLOs) – debt securities in the form of bonds or notes which are funded by and secured over a portfolio of loans. CLOs will often be constrained by their constitutions from investing 'new money' after the end of their investment periods. It may thus only be possible for a CLO to participate in an amendment to an existing facility (via a 'cashless roll'), rather than in a new facility.

Where it is not possible to achieve the consent of all relevant lenders, sometimes lead banks will purchase and resell loan positions to front the necessary consents to be given.

10.4 Snooze and lose

A syndicate may comprise many lenders by the time a restructuring is contemplated, which can result in logistical challenges in the handling of consent solicitations. A 'snooze and lose' clause in a loan agreement provides that if a lender fails to respond to a request for a consent, waiver or amendment within a specified timeframe, it will not be taken into account in calculating whether the requisite consent level has been reached. Lenders actively involved in the voting process are thus not unduly affected by the inaction of passive investors.

10.5 Yank the bank

Another commonly used provision (often referred to as 'yank the bank') comes into play when a high consent threshold is required. For instance, where unanimous lender consent is required for an amendment, if a high level of consent (typically 85% or 90% of the total commitments) has been achieved, but unanimous lender consent has not, this clause permits the borrower to replace a dissenting lender. This provision may make it easier for a borrower to meet the necessary lender consent thresholds. However, yank the bank clauses typically only allow the borrower to force a transfer to a replacement lender at par value. This may be unrealistic in a distressed scenario, when the debt is likely to be trading in the secondary market at substantially below par.

10.6 Debt trading and borrower restrictions on transferees

It is a regular feature of a debt restructuring that debt held by creditors, in all parts of the capital structure, will be sold to incoming debt investors, which may wish either to further trade the debt at a profit as events unfold, or to build up a strategic stake which might be used to influence the terms of a restructuring and, possibly, be converted into an ownership interest. The ability to trade can provide an exit for an unwilling existing lender and an investment opportunity for another investor. Debt trading does, however, affect the dynamics of any proposed restructuring, as the composition of the creditor constituencies fluctuates from time to time. In particular, a par lender may be concerned primarily with trying to recover its loan in full, whereas a sub-par lender will have bought into the capital structure with a view to making more money.

In previous downturns, lenders faced few documentary restrictions on transfers. Increasingly, however, lenders are being restricted from transferring their loans. Borrower consent is typically required, except in the case of transfers:

- to whitelist lenders;
- to an affiliate/related fund of existing lender; or
- if a key event of default is continuing (eg, insolvency, covenant breach or non-payment events of default).

Increasingly, documentation may also feature a long blacklist, naming prohibited transferees. It is also common to limit the ability of lenders to transfer debt to a range of transferee entity types perceived as likely to employ aggressive tactics in response to future requests for consents or amendments, such as:

- competitors of the borrower;
- suppliers and sub-contractors;
- private equity sponsors; and
- certain categories of distressed debt investor (eg, 'loan to own' investors).

Depending on how these categories are defined in the facilities agreement (often hotly negotiated at the outset), this may prove to be too broad a restriction, impractical to enforce and restricting the liquidity of the debt. If wide terms are used, it may be difficult for an exiting lender to assess with any certainty the extent to which the proposed transferee falls within such categories. The lack of deemed consent provisions is another factor which may prevent a timely transfer of participations while a company's health is deteriorating.

It is also common for transfer restrictions to purport to affect synthetic transfers of debt – most commonly, sub-participations. If such provisions are widely worded, they may have the potential to restrict a lender's ability to pursue risk mitigants such as credit default swaps or credit insurance; at best, the consequences of synthetic transfers may be rendered ambiguous.

While it is easy to understand the motivations for a sponsor to obtain restrictions on transfers, there is a risk that overzealous policing of transferability could prove counterproductive. The initial lender group may include entities without the appetite or resources for a full-blown restructuring and lenders with little opportunity to sell down their positions may feel compelled to pursue shorter-term (or harsher) options.

During the global financial crisis, many stressed credits had debt documentation which either did not expressly prohibit debt buy-backs or were ambiguous as to whether it was possible for a borrower to buy back debt without triggering mandatory pre-payment provisions. Many borrowers took advantage of this loophole to buy back debt at a significant discount to par value. This strategy was not without problems. These included adverse tax implications, an uncertain impact on financial covenants or an adverse insolvency analysis in some jurisdictions with doctrines of equitable subordination. Nevertheless, for a time some form of debt buy-back was a tool worthy of consideration and there was uncertainty as to the consequences. The LMA soon acted on this issue and most LMA-based documents now contain detailed provisions on the legality of buybacks (which are either prohibited or made subject to detailed procedures to ensure existing lenders are not disadvantaged). Whether or not sponsor affiliates are permitted to acquire debt, a common theme is to disenfranchise such transferees so that they do not have the ability to vote on subsequent lender decisions.

11. Intercreditor release mechanisms

11.1 Distressed disposals

In order to maximise returns for creditors, the security agent will be authorised to release transaction security and other claims against relevant entities in the borrower group when disposals are made in distressed circumstances (ie, in an enforcement scenario).

This guarantee and security release mechanism is one of the most important provisions for prior ranking creditors. The LMA precedent intercreditor agreement envisages various enforcement scenarios. Commonly, rather than selling individual assets, it will be more efficient (and value may be better preserved) if group companies are sold in their entirety, by way of share sale, free of liabilities under the finance documents. In order to achieve this, in the case of a distressed disposal of shares of a member of the borrower group, the security agent will have express powers to release the relevant entities and their subsidiaries from all borrowing liabilities, guarantees and security under the finance documents and from the claims of intra-group lenders and other subordinated creditors.

If subordinated creditors were to have continuing claims (eg, under guarantees) against group companies after a disposal of those companies to a third party, the value of the business on disposal would effectively be reduced by the amount of those subordinated claims, giving the subordinated creditors a *de facto* right of veto over any such disposal.

11.2 Fair value

All stakeholders will have an interest in ensuring that enforcement proceeds are maximised. The recoveries of subordinated creditors will be limited to any excess of the enforcement proceeds (if any) after satisfaction of prior ranking claims. Consequently, the subordinated creditors will often seek contractual protections to prevent the disposal of companies or other assets at too low a price. Under English law, secured creditors are under a duty to obtain the best price reasonably obtainable in the circumstances. However, many deals will involve assets in other jurisdictions which apply different tests relating to fair value. Furthermore, the applicable principles of law in any given scenario may only be determined at the time the security is being enforced. To achieve greater certainty for all parties, under the LMA precedent intercreditor agreement the security agent will also be subject to an express requirement to take care to obtain a fair market price (or value) in the prevailing market conditions when making a distressed disposal. This requirement may be satisfied, for instance, if:

- the disposal is made pursuant to a court-sanctioned process;
- the disposal is effected by (or at the instruction of) an insolvency officer;
- the disposal is made pursuant to an auction or similar competitive sales process; or
- a financial adviser delivers an opinion that the proceeds received in connection with the disposal are fair in the circumstances.

The LMA intercreditor agreement states that this obligation does not oblige the senior creditor or security agent to postpone the disposal in order to achieve a higher price (or value).

11.3 Cash and non-cash consideration

In adverse market conditions, making a prompt disposal for cash consideration may be impractical or may not represent the best long-term value for secured creditors. Since 2012, the LMA intercreditor agreement template has provided a framework to enable the security agent to accept non-cash consideration for disposals of assets on enforcement – for example, shares or the benefit of claims. The valuation of any such non-cash consideration (and the level of liabilities discharged upon a distribution of non-cash consideration to creditors) is determined by an independent financial adviser. Usually, a specified majority of the then most senior ranking creditors will determine whether to instruct the security agent to accept non-cash consideration, whether to realise it for cash prior to distribution to creditors and, on the appointment of any financial adviser, to carry out such a valuation.

12. Pre-packaged administrations

12.1 Administration

Administration is a procedure under the Insolvency Act whereby a company may be reorganised or its assets realised under the protection of a statutory moratorium. A company may be put into administration by court order or by an out-of-court procedure available to the company itself, its directors or the holder of a qualifying floating charge. Broadly, the aim of administration is to facilitate the survival of companies which are in financial difficulties. It is also a method of enforcement by secured creditors.

There are a number of reasons why an administration may form part of a restructuring:

- The value 'breaks' in the senior debt and, for whatever reason, the junior debt owed by the company which owns the assets cannot be eliminated or compromised, at all or on acceptable terms. As such, those assets may need to be transferred to a new company which might be owned by some or all of the senior creditors, or by a third party (or a combination).

Administration is a very effective means to deliver such change of ownership;

- A sale by an administrator will insulate the directors and the purchaser against the deal being subsequently challenged as a transaction at an undervalue (see section 9.1), because the 'relevant time' for the review of such transactions ends upon appointment of the administrator;
- The mechanism in the intercreditor agreement for the release of borrowing, guarantee and other liabilities normally applies only where there is a 'distressed disposal' (see section 11.1), which could include a sale by a company in an administration. Moreover, under usual intercreditor documentation, a sale at the instruction of an insolvency officer would satisfy the 'fair value' requirement of the release mechanics;
- An administrator has certain powers to sell assets free of existing security (see section 12.3), which may be useful if for any reason it is not possible or practicable for the security agent to release such security; and
- The appointment of an administrator may facilitate the obtaining of recognition in certain jurisdictions of an English scheme of arrangement.

12.2 Pre-pack sales

A 'pre-pack' is an expedited sale process whereby an administrator in waiting negotiates with potential buyers and agrees a sale prior to the company going into administration. Once the company goes into administration, the sale assets are purchased by the buyer immediately thereafter. Marketing and selling a business is rarely quick or straightforward. A pre-pack offers a viable option where no funding is available for a conventional trading administration process. A pre-pack offers an efficient transfer of business without an erosion in confidence caused by a lengthy insolvency process and, as such, is likely to preserve a company's goodwill.

Sometimes a pre-pack will involve a sale of part only of the assets of the company. However, sale of the business and assets of the company as a going concern will, where it is possible, tend to fetch a higher price than the sale of assets on a break-up basis. A pre-pack sale can be structured so that nominal value is attributed to the assets of the company, but the purchaser agrees to assume certain liabilities going forward (eg, employee liabilities and specific continuing contractual obligations).

12.3 Administrators' ability to sell free of security

An administrator has the ability to sell the assets of a company subject to a floating charge free of security and without the chargeholder's consent (Paragraph 70(1), Schedule B1 of the Insolvency Act). The court may authorise the administrator to dispose of fixed charge property (Paragraph 71(1)) if it would benefit the administration. These provisions can be used to force through a sale of charged property in appropriate circumstances.

12.4 Criticisms of pre-packs

Despite their advantages, there can be suspicion around pre-packs, due to a perceived lack of transparency and accountability. Unsecured creditors may have always been 'out of the money', but often feel prejudiced by a pre-pack because they do not have the opportunity to protect their interests – unlike secured creditors, which will be aware of the administrator's appointment and whose consent (without the need for a court application) is required for the transfer of assets subject to fixed security. Case law has confirmed that the administrator may dispose of the business and assets of the company in advance of the first creditors' meeting and without the need for direction from the court.[11]

A pre-pack would be less effective if it became public knowledge that the business was on the brink of insolvency and up for sale (as this would be detrimental to goodwill). However, the speed of the process does limit the time for marketing and creditors may question whether the best price has been obtained.

In response to these criticisms, the Insolvency Service issued guidance called Statement of Insolvency Practice (SIP) 16. SIP 16 is not legally binding, but failure to comply may lead to disciplinary action against an insolvency practitioner. Administrators are now obliged to justify and provide a detailed explanation of why a pre-pack is effected and the attempts at marketing made before pursuing the pre-pack strategy. A failure to obtain proper valuation advice and to have regard to the matters in SIP 16 may provide grounds for a potential claim. The Insolvency Service commissioned an independent review of pre-packs in 2013 (the Graham review), as a result of which an amended SIP 16 took effect in 2015. A revised SIP 16 introduced a new option for connected parties considering a pre-pack purchase to approach a pool of experts with a view to seeking an independent opinion on the proposed sale, thereby enhancing stakeholder confidence in the transaction.[12]

Pre-packs are often confused with liquidation restarts, where a business is purchased out a formal insolvency process (often by the existing directors) – a trend often referred to as 'phoenixing'. Essentially, this is where directors start a new 'phoenix company' after the old company has gone into liquidation and

11 See *Re Transbus International Limited* [2004] EWHC 932 (Ch); *DKLL Solicitors v Revenue and Customs* [2007] EWHC 2067 (Ch))

12 The pre-pack pool has not been heavily used. According to Insolvency Service figures, in 2018 there were 241 confirmed pre-pack sales to connected parties and only 18 referrals to the pre-pack pool (down from 23 referrals in 2017).

use the new entity to buy core assets such as stock and websites. Such restarts are subject to strict controls. For instance, there are restrictions on the name of the 'newco' and the role of certain directors, and assets must be sold at a fair price. Otherwise, directors could face investigation by the Insolvency Service, including potential director disqualification.

12.5 Security enforcement

As an alternative to administration, the security agent may itself enforce security – for example, by appointing an administrator or receiver to sell assets, or by appropriating shares pursuant to share charges or pledges. Historically, lenders would insist on and get a full share and asset security package over the borrower group. Sometimes there could be good reasons to exclude certain companies or assets – for example, where the law of the jurisdiction prohibits upstream guarantees or where taking and perfecting security is likely to be too onerous and expensive. However, more recently, borrowers have been in a position to demand more flexibility from lenders, so that their businesses can benefit from the operational advantages of having fewer encumbered assets. This shift in the balance of power has led to lenders agreeing to water down their security packages – for example, by limiting their asset security to material assets in the borrower group, or even forgoing asset security entirely and relying on share security. This has and will continue to reduce the security enforcement options available to lenders. For instance, it may call into question whether the lenders' English law security package comprises, in aggregate, charges over 'all or substantially all' of a company's property (a test which is the subject of some legal uncertainty). This is the key hurdle to ensure lenders have a qualifying floating charge, which gives them the ability to appoint an administrator out of court.

13. Schemes of arrangement

13.1 What is a scheme of arrangement?

A scheme of arrangement is a statutory procedure under Part 26 of the Companies Act which allows a company to reach an arrangement or compromise with its members and/or creditors (or any class or classes of them).[13] A scheme could be a compromise or arrangement about anything, subject to certain limits. Insolvency is not a prerequisite for a scheme. A scheme will bind each class of members and/or creditors irrespective of whether they voted in favour of the scheme, provided that the requisite majority of each class of members or creditors approves the scheme and the scheme is sanctioned by the court. A scheme is the only procedure available under English law that

13 Schemes are used commonly in practice company takeovers.

enables secured creditor claims to be compromised without their consent (ie, a cram-down). A scheme can be a 'member scheme' (affecting shareholders' interests) or a 'creditor scheme' (affecting creditors' interests), or a combination of the two (either in a consolidated scheme or by linked (and co-dependent) schemes). Not all creditors have to be made subject to the scheme. The court will sanction a scheme that excludes persons if it can be shown there were commercial reasons for doing so. For example, a company might wish to leave trade creditors' claims unvaried to provide continuity of operations and trading.

13.2 Uses of a scheme

A scheme of arrangement can be used, with or without other techniques, to implement a debt restructuring. But, most importantly, junior creditors or shareholders will not be bound by a scheme unless they agree or are in a class which has voted in favour of the scheme by the requisite majority. If they are not bound by the scheme, the senior creditors may consider it necessary to move the operating companies or their relevant holding companies out of the existing corporate structure and remove the junior creditors' claims, guarantees and security, using a security enforcement and intercreditor release (see above).

Some examples of the utility of a scheme in a debt restructuring include the ability to:

- release or compromise secured and unsecured debt or change its ranking;
- remove minority share interests;
- effect a debt for equity swap (as in the following schemes: *Seat*, *Le Seda de Barcelona* and *Global Investment House KSC*);
- introduce a new debt tranche or liquidity generally;
- transfer businesses and assets and/or shares to a new structure, which may be controlled by the existing lenders (a 'transfer scheme') (eg, the *IMO Car Wash* scheme – see footnote 10); or
- effect changes to finance documents.

13.3 Procedure

A scheme is usually proposed by the company itself. However, a scheme can be initiated by a creditor of the company, by any member of the company or, if the company is being wound up or is in administration, by the respective liquidator or administrator.

Once the person proposing the scheme has settled its terms, the next step is to obtain approval. In broad terms, the process is as follows:

- application to court for permission to convene meeting(s) of the relevant classes of creditors and/or members;
- approval by the required majorities of creditors and/or members. The scheme is subject to approval at the meeting(s) by each class of creditors and members (as relevant) by both a majority in number and a majority

representing 75% in value of the relevant class of persons present in person or by proxy; and

- application to court for sanction.

13.4 Commercial deal

A scheme is typically heavily 'front-loaded'. Before embarking on a scheme in earnest, the person(s) proposing it must, in consultation with the company's key stakeholders, finalise the scheme's terms, consider and determine the proper class composition, and produce draft documentation.

Those stakeholder(s) that hold security and/or have a priority on an enforcement (ie, those above the 'value break') are likely to lead negotiations. The question of the value of a business will, in all probability, be a contentious point and the value (or perceived value) of the business is in any event likely to move during negotiations as the business continues to trade. Creditors below the value break are not necessarily disenfranchised; hence, those that control the minority vote may be capable of blocking a scheme.

That said, there is the possibility of excluding creditors with 'no economic interest', provided that compelling evidence can be produced that those persons really are 'out of the money'. Any uncertainty could trigger challenges to the scheme, and so valuation is absolutely key.[14]

Valuation is usually on a 'forced sale' basis (this assumes that this is the only alternative to a scheme) so that members/creditors have a ready comparator. It is, however, usually advisable to have a second valuation prepared on a 'going concern' basis which would help to establish, beyond reasonable doubt, where the value break is and which stakeholders have an economic interest and can therefore vote in the scheme.

In the past, the court, when trying to ascertain value break, has looked at trading of the relevant debt in the secondary market. Where this is below par, this is indicative of actual value. The court might also infer, where an intercreditor agreement affords junior creditors the right to buy senior debt and the junior creditors choose not to exercise that option, that the senior debt must be impaired.

In practice, there may also be a market testing exercise in order to generate offers for the business, thereby establishing value.

13.5 Lock-up agreements and fees

A scheme can take months (or years) to formulate, launch and implement. A lock-up agreement can be used to effect a short-term waiver or forbearance of rights to give the company time to implement a scheme and could require the counterparties to support the scheme (assuming that there is no material

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14 See further *Re Bluebrook Ltd* [2009] (*IMO Car Wash*) and *MyTravel Group plc* [2004].

dilution in the commercial terms offered to them). A fee might be offered as part of a lock-up agreement to incentivise creditors to sign up. The court has thus far upheld the validity of such fees, and said that such fees did not create disparate classes on the basis that the fee had been paid to some and not others.[15] This also assumes that such fees are not a 'materially significant amount'.

13.6 Scheme of arrangement as 'Plan B'

As will be apparent from the above, promoting and implementing a scheme of arrangement can be cumbersome and expensive and (as a result of the sanction process) involves at least some execution risk. As such, it could make commercial sense, within reason, to 'sweeten' the economic terms of a restructuring to persuade stakeholders to agree to approve the implement the restructuring voluntarily. In a large or complex case this may simply not be practicable, however.

14. Company voluntary arrangements

14.1 What is a CVA?

A CVA is a procedure intended to assist a company in financial difficulties. It is a contract between a company and its creditors. A CVA allows a company to agree a 'compromise or arrangement' with its creditors in satisfaction of some or all of its debts. A CVA is implemented under Part 1 of the Insolvency Act and under the supervision of an insolvency practitioner, known as the 'nominee' before the CVA is approved and the 'supervisor' thereafter.

While the scope and potential utility of a CVA are narrower than those of a scheme (eg, unlike a scheme, a CVA cannot compromise secured claims without the secured creditors' consent), CVAs are very flexible procedures and can be used to compromise any unsecured debts of a company. That said, the market has seen a sharp increase in the number of 'landlord-only' CVAs. These are CVAs which compromise a company's leasehold liabilities to its landlords – for example, by allowing it to pay less rent or return unprofitable sites, while generally leaving other creditors' claims untouched. This type of CVA has been used by companies with large or burdensome property portfolios – typically in the retail, leisure and casual dining industries.[16]

The increase in landlord-only CVAs is probably due to a combination of factors. As widely reported, many companies have been struggling against inflationary pressures, such as increases in the costs of supplies and employment, while experiencing a sharp decline in customer footfall and spending habits.

15 *Primacom Holdings GmbH v Credit Agricole* [2011].

16 For example, Prezzo, Carpetright, Mothercare, House of Fraser, Homebase, Paperchase, Arcadia, Debenhams and Monsoon.

Those companies with significant leasehold portfolios must also contend with increases in business rates and high rents (exacerbated by a history of upwards-only rent reviews) under long-term leases. If those lease terms cannot be renegotiated consensually, many companies have resorted to proposing CVAs that rationalise their real estate portfolios in order to save their businesses.

A CVA is open to be voted on by all of the company's unsecured creditors. Once approved, the CVA will bind all of the company's unsecured creditors, irrespective of how or whether they voted.

14.2 Features of a CVA

As a general principle, and in order to satisfy the 'vertical comparator' test (see section 14.4), when promoting a CVA the company is subject to a 'burning platform'. In other words, its financial position must be so serious that if the CVA is not approved, the company will have to enter into liquidation or administration. Examples of a 'burning platform' include financial covenant breaches, accompanied by a standstill pending a restructuring through a CVA, with the secured creditors being in a position to enforce if the CVA is not approved.

As stated above, a CVA can be used flexibly – for example, in order to compromise all creditor claims in return for a dividend or to compromise one or more classes of creditor. Because landlord-only CVAs have been so prevalent (and at times controversial), the key features of such a CVA are summarised below:

- The company's leases are categorised based on an objective assessment of their actual and projected financial impact on the company. At its simplest, this usually results in a green category (ie, those leases that have market or below rents, are performing and will be retained); an amber category (ie, those leases that might become profitable if the rents are adjusted); and a red category (ie, those made up of underperforming stores that are over-rented and which the company proposes to vacate).
- Differing levels of rent and other compromises are proposed, depending upon lease categorisation, generally reducing rent payable across the compromised categories to reflect what is deemed to be market rent.
- All categories are shifted from quarterly to monthly rent payments.
- The company is given the option to vacate and terminate certain leases within the red and, usually, amber categories.
- Equally, the landlord will be given termination rights in respect of compromised leases.
- Because the implementation of a CVA does not result in a statutory moratorium,[17] the CVA proposal will impose a contractual stay,

17 However, it is possible for certain smaller companies to receive the benefit of a 28-day moratorium if they meet two or more of the following criteria: turnover no greater than £10.2 million; balance-sheet assets no greater than £5.1 million; or no more than 50 employees.

preventing landlords and other unsecured creditors from taking legal action as a result of the CVA.[18]

- Generally, 'ordinary' creditors, such as employees and suppliers, are kept whole. This is on the basis that compromising their claims would result in immediate and severe operational damage.
- The company will describe its future business plan and how it proposes to turn around its trading difficulties. A CVA is also likely to be one part of a larger restructuring. New funding may be provided and/or existing facilities retained, but conditional upon a restructuring of the business through a CVA. A landlord will be more inclined to vote in favour of a CVA if other stakeholders are 'sharing the pain'. The company will need to demonstrate to landlords – and indeed its other stakeholders – that it has a viable business plan going forward, and that it can comply with its revised leasehold and financial obligations during and following the CVA.
- Woven into this business plan will usually be some upside for the compromised landlords – that is, a fund out of which payments will be made when the business achieves certain performance metrics, or warrants might be issued by which compromised creditors can share in any equity upside.

14.3 Procedure

The company, with its advisers, will prepare a CVA proposal. A well-planned CVA process will then include a period of consultation with key stakeholders: lenders, major landlords (and commonly their trade body – the British Property Federation) and, if there is a defined benefit pension scheme, the scheme trustees and the Pension Protection Fund. If the company is confident of obtaining sufficient support for the CVA, it will then appoint nominees (ie, insolvency practitioners). The duty of the nominees is to scrutinise the CVA proposal and, if appropriate, file a report at court confirming the viability of the CVA and that the proposal should be considered by the company's creditors and members. The nominees will then circulate a copy of the CVA proposal to all known creditors and shareholders, and will usually convene creditors' and shareholders' meetings on 14 days' notice.

The creditors and the shareholders of the company will vote at their respective meetings and decide whether to approve the proposal, with or without modifications. To be effective, a CVA requires the approval of the requisite majorities of the creditors and shareholders:

18 A recent High Court judgment regarding Debenhams held that landlord forfeiture rights constitute property rights and cannot therefore be validly altered by a CVA. Accordingly, the court directed that the 'forfeiture restraint provisions' in the CVA be deleted (*Discovery (Northampton) Limited v Debenhams Retail Limited* [2019]).

- In the case of creditors, of those that vote on the CVA, 75% (in value) must vote in favour, which must include at least 50% (in value) of unconnected creditors; and
- In the case of shareholders, of those voting, more than 50% in value must vote in favour.

The CVA takes effect if approved at both the creditors' and the shareholders' meetings. If there is a difference of decision between the creditors and the shareholders, the decision of the creditors will prevail. Once the CVA is approved, it binds all unsecured creditors that were entitled to vote at the meeting (regardless of whether they voted).

14.4 Challenge

A CVA can be challenged within 28 days of the result of the meeting being filed at court on one or both of the following grounds:

- It unfairly prejudices the interests of a creditor. In assessing unfairness, a number of techniques are used, including the 'vertical' and 'horizontal' comparators. The vertical comparator is a comparison between the creditor's entitlement in the CVA and in a hypothetical administration or liquidation. The return in the CVA should exceed the return in that counterfactual. The horizontal comparator is a comparison between the position of the applicant and the other creditors. Different treatment between creditors or classes of creditors is a relevant factor, but will not necessarily render a CVA unfairly prejudicial. It may be possible to justify differential treatment; or
- There has been some material irregularity in the proposal or at the meeting, which may possibly have affected the outcome of the meeting.

A number of landlord-only CVAs have been challenged in the courts – namely House of Fraser, Supercuts and Debenhams. At the date of writing, only the Debenhams challenge has been heard at trial and adjudicated. As a result, potential points of issue may remain which have not yet been determined by the courts. At the Debenhams hearing, Justice Norris dismissed four of the applicants' five grounds of challenge, ordering that, save for the deletion of clauses preventing the landlords from exercising their rights of forfeiture, the CVA remained valid and enforceable as so modified.

There have been calls for legislative change. The insolvency and restructuring trade body R3 has also published research in support of reforms to improve the effectiveness of CVAs. Given the current pressures on parliamentary time, it seems unlikely that reform in this area will occur in the near future.

15. What the future holds

15.1 Government consultations

In August 2018 the government responded to two earlier consultations aimed at updating the UK restructuring framework.[19] The consultations sought views from stakeholders on new proposals aimed at improving the UK corporate governance and insolvency processes. The March 2018 consultation can be seen partly as a response to a number of high-profile business failures such as BHS and Carillion, but also as a means of reacting to EU proposals for a new European directive on preventative restructuring frameworks.

The proposals include:

- a moratorium to enable distressed but viable companies to consider their options;
- a new restructuring plan that, like a scheme, will permit cross-class cram-downs; and
- legislation preventing suppliers from relying on 'ipso facto' clauses (ie, clauses which entitle that supplier to terminate the contract on its customer's insolvency).

The government has indicated that legislation will be progressed when parliamentary time allows. In the meantime, it plans to consult on other areas – below – that should be of interest to sponsors in relation to future restructurings.

15.2 Sales of distressed businesses – director liability

The government has announced that a new measure will be introduced whereby a director of a holding company who does not give due consideration to the interests of the other stakeholders of a financially distressed subsidiary when it is sold may be subject to a disqualification action if that subsidiary enters into insolvent liquidation or administration within 12 months of the sale. Disqualification action can also include compensation orders.

There will be no liability if the directors of the holding company had a reasonable belief at the time of the sale that the sale would likely deliver no worse outcome for the stakeholders of the distressed subsidiary than placing it in formal insolvency (administration or liquidation). The government will develop guidance on the steps a director should take when considering the sale of a distressed subsidiary, but the 'reasonable' measures are likely to include professional advice and engagement with subsidiary stakeholders/creditors.

The measures will be limited to sales of large distressed subsidiary companies

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19 A consultation on Insolvency and Corporate Governance was issued in March 2018 and a Review of Corporate Insolvency Framework consultation was issued in 2016.

– that is, those which do not qualify as small or medium-sized companies under the Companies Act 2006. There is no guidance yet on what level of distress the relevant subsidiary will need to be in for the measures to bite. Clearly, this is intended to prevent the reoccurrence of situations such as the BHS failure. Concern has been expressed that such measures, if not carefully thought through, may hamper genuine M&A activity in the distressed market.

15.3 Value extraction schemes

On the same theme, the government says that it intends to work with stakeholders to consider whether any clarification of the existing regime of office-holder recovery powers is required and will undertake a more general review of antecedent recovery powers in the context of unfair value extraction. While there may be further legislation introduced on this subject, the government intends for any legislation to be "balanced and proportionate so as not to deter investment in the UK's sophisticated market for turnaround finance".

15.4 Declaration of dividends

The government has expressed concerns about companies in financial difficulties continuing to pay significant dividends. The government will look further into the merits of a comprehensive review of the UK dividend scheme, including requirements for the disclosure of audited figures for reserves and distributable profits and the alternative of a solvency-based system. Legislation may require companies to disclose and explain capital allocation decisions if investor pressure and the new company reporting regulations do not deliver sufficient progress.

The government is also concerned about the overuse of 'interim' (rather than final) dividends to avoid the need for shareholder approval, and has asked the Investment Association to assess the prevalence of the practice.

Further consideration will also be given to ways in which directors could provide stronger reassurances that proposed dividends will not undermine the affordability of any deficit reduction payments agreed with pension fund trustees. In parallel, at the time of writing, a Pension Schemes Bill with cross-party support is set to significantly boost the powers of the Pensions Regulator to intervene in a wide range of corporate transactions which could to have a negative impact on the ability of a company to service a defined benefit scheme.

15.5 Group structures and shareholder stewardship

The government will consider how transparency around group structures and corporate governance can be improved, although its proposals are currently at a nascent stage. Likewise, feedback will be sought on how best to encourage shareholders – in particular, institutional investors such as pension funds and asset managers – to exert influence calling for best practice from company boards. One suggestion has been that access to training and guidance should be improved for directors, with mandatory training being required for directors of larger companies.

15.6 HMRC preference

While not part of the consultations, it was announced in the 2018 budget that, with effect from 6 April 2020, certain claims by Her Majesty's Revenue and Customs (HMRC) in insolvency will have enhanced priority. HMRC will be a secondary preferential creditor in respect of taxes collected and held by businesses on behalf of other taxpayers (ie, value added tax, pay as you earn income tax, employee National Insurance contributions and Construction Industry Scheme deductions). These amounts will be paid to HMRC out of the 'prescribed part' of floating charge realisations in priority to floating charge holders and unsecured creditors. The ring-fenced 'prescribed part' amount is also set to be increased from £600,000 to approximately £800,000 to account for inflation. Thus, the impact of this change will depend on the size of the business, with a potentially significant impact on smaller deals.

These reforms are surprising, because HMRC priority was previously abolished by the Enterprise Act 2002 in order to encourage business rescue by disincentivising HMRC from taking enforcement action. This move could have a significant impact on floating charge and unsecured creditors, which would otherwise have had an entitlement to share in these funds. It may impact on lending practices, given that lenders will need to factor in a larger incursion into their floating charge security.

16. Brexit

The UK decision to leave the European Union has important consequences for cross-border insolvency proceedings. The recast EU Insolvency Regulation (1215/2012) ensures recognition, without further formality, of insolvency proceedings throughout the European Union (except Denmark), and determines the law applicable to such proceedings. Given that the regulation is based on reciprocity, the government has announced that it will cease to apply on 'exit day'. There is therefore no guarantee that, thereafter, UK insolvency proceedings will be respected elsewhere in Europe. The United Kingdom may be forced to rely on the vagaries of private international law in each remaining EU member state (rEU), which would increase the risk of competing insolvency proceedings between the United Kingdom and rEU, due to the removal of the rule requiring automatic recognition of insolvency proceedings. There could also be increased uncertainty for English insolvency practitioners seeking the assistance of courts in rEU. At the time of writing, the outcome of Brexit remains uncertain.

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