

Corporate restructuring and insolvency: Redefined by today's credit crunch

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In recent years there has been a seismic shift away from formal insolvency, largely due to liquidity and a lack of deals in the market. The market was no longer driven by lenders but by unsecured creditors and shareholders, including bondholders, pension trustees, private equity and hedge funds. Until 2008, these stakeholders have had the power to drive restructurings. Today, the credit crunch and lack of liquidity may reverse this trend, and formal insolvencies may be on the increase again. However, a change in the stakeholder dynamic is here to stay.

Covenant lite facilities have been another influence on changes in the insolvency market. These facilities delay default, enforcement, and insolvency. Covenants traditionally play a role as an early warning system. They allow close monitoring of trading performance and risk management. However, the decline in their strength and usage has meant the early warning device has disappeared with no-one outside the business warning of impending crisis. There has been a breakdown in risk management and there are plenty of examples of lenders not verifying asset values or credit quality sufficiently. The trend towards 'getting in early' has been reversed. Collapses, therefore, come as a shock to financial creditors who do not have sufficient time to organise a rescue strategy. The collapse of the subprime market, forcing financial institutions to write back liabilities onto their balance sheets in order to write them off, casts real doubt on realism. How can meaningful advice be given in any restructuring when Alice in Wonderland is holding the cards?

Bear Stearns, Peloton, Carlyle, and Pentagon are recent victims of the current situation. Perhaps events of default are finally coming to the surface. The International Monetary Fund has announced 1.6% growth for the UK and a one-in-four chance of a global recession. The signs of downturn are obvious. With covenant lite facilities, changes to the complexity of stakeholders, and a loss of confidence in the market, insolvencies appear to be increasing.

As yet, the statistics do not reflect these changes, and it will be interesting to see the Insolvency Service figures for the first quarter 2008 in May. Total liquidations in 2007 showed a decrease of 5.4% on 2006. The numbers of administrative receiverships and administrations also came down. Added together, there were 2,806 in 2007, a fall from 4,148 in 2006 and similar to the 2005 total of 2,851. The number of Company Voluntary Arrangements ('CVAs') has also

been falling from a peak in 2003 of 726. By contrast, in 2007 there were 399 against 534 in 2006 and 604 in 2005.

Restructuring

Many times in the last year, lawyers and accountants were retained by a company in distress, but just prior to a formal process, the bank was taken out by a distressed debt trader or private equity fund. It will be interesting to see whether this dynamic can continue and whether restructurings are successful without any use of the formal process. Whatever the approach taken, the valuation of assets will be crucial and open to challenge.

UK insolvencies have historically been more creditor-driven. Creditors approve CVA and administrators' proposals, and sanction appointments of liquidators. However, unlike the US, unsecured creditors do not have enormous influence, without joining forces or court intervention, on the actual outcome. US equity and debt players are now removing the traditional creditor role and apathy. These new players will be the drivers for restructuring, the preservation of value, and possibly the influence of change in relation to the statutory procedures of the formal process. Given the position taken in the capital structure of financial institutions by the new players, no sector is likely to be untouched.

History shows there has been a banking crisis in the UK every 10 years since the 1970s: Natwest in the 1970s; Johnson Matthey in the 1980s; BCCI and Barings in the 1990s. Some have said that the Northern Rock debacle was therefore expected and overdue. The use of nationalism and the application of insolvency legislation within the Banking (Special Provisions) Act 2008 marks an interesting development. The role of government and the regulators will create more regulatory intervention which will affect the dynamics of restructuring.

An area that has come under close regulatory scrutiny is the hedge fund and the Structured Investment Vehicle ('SIV'). There has been a steady stream of attempts to restructure SIVs led by sponsoring banks which are also taking their SIV assets back on balance sheet. In mid-December, Citigroup, the world's largest sponsor of SIVs, followed the example of HSBC and Soc Gen.

SIVs, bankruptcy-remote entities established by sponsoring banks, issue short-term, low-yielding debt (commercial paper) and invest the proceeds in longer-term high-yielding debt. Because their assets mature later than their liabilities, SIVs continue rolling over their commercial paper or they obtain leverage for liquidity.

HSBC recently announced its plan to restructure its US\$26bn SIV, Cullinan Finance Ltd. This involves replacing Cullinan with two new HSBC-backed conduits that will issue new notes to replace the Cullinan notes. This plan, approved by Cullinan investors, was no doubt crafted with a careful eye towards the tension that exists between SIV investors and the sponsoring bank's shareholders.

In the equity arena, shareholders have been prepared to take out lenders to capture value that would otherwise be lost to them in formal insolvency. Expect to see distressed investors interested in impaired businesses looking to invest in both private and public companies. Real returns can be made taking public companies private and reorganising them. These equity players have the power to take large companies private and restructure them out of the public gaze, capturing serious value on exit. This will also have an impact on the markets.

Hedge funds are now aggressive investors in both debt and equity. It was previously claimed that hedge funds would make money in bull and bear markets, because of their ability to invest in a wide range of products (thereby hedging the market). The recent turmoil has shown that when the entire market is falling, even hedge funds can struggle and there may be more casualties soon. Any distressed investors should still be wary of acquiring a company with a Defined Benefit Pension Scheme ('DB Scheme'). DB Schemes continue to influence all restructurings. There have been many high profile cases since the introduction of the Pensions Act 2004. With increasing life expectancy and mortality assumptions, coupled with the credit crunch and the Pension Levy, the risks attached to any acquisition are here to stay.

There are now many creative approaches to the pension problem including: debt for equity swap; section 75 debt compromises; statutory release and the transfer of pension assets; and liabilities to pension acquirers such as Paternoster and Pension

Corporation. Restructurings have taken place both inside and outside formal processes, but given the teeth of the pensions regulator, and the influence of the Pension Protection Fund, the right strategy must be followed to avoid a Financial Support Direction ('FSD') or Contribution Notice.

In the 'Sea Containers' case, there was an unsuccessful challenge to the Pensions Regulator's (first) FSD against group companies. Pension Corporation has just had to provide an undertaking to the pension regulator that restricts its ability to appoint trustees or otherwise control the retirement scheme of Telent, which they acquired last year. Currently, there is a judgment reserved by David Richards J. in the case of 'T&N v PPF'. The T&N supervisors of a CVA argued that it was possible to reopen a s.75 certificate issued by the scheme actuary, because they did not agree with the mortality assumptions. This was despite the case of 'Cornwell' where Lewison J. decided that, absent fraud or collusion, certificates were sacrosanct. Many insolvency practitioners feel this conflicts with their duty to assess claims. With Sea Containers' bondholders queuing up to challenge the level of pension debt, this judgment may be timely. But what if the employers are in Chapter 11? Non-UK entities, unless wound up under Part V of the Act, will not qualify for entry to the Pension Protection Fund. There are quite clearly some knotty issues to overcome.

Corporate insolvencies

There has been an increased focus on receiverships, particularly in the SIV arena. Many of the debt securities purchased by SIVs are backed by subprime loans. As a result, commercial paper issuance has come to a virtual halt, and SIVs are unable to refinance their outstanding debt. Even SIV portfolios without exposure to the subprime market have been harmed, as market panic relating to the subprime crisis drives down the value of prime mortgage-backed securities and other asset-backed securities. Two early victims of the crisis were Cheyne Finance PLC and Whistlejacket Capital. In the Whistlejacket case¹, the Court held that creditors due to be paid on the day that the SIV declared insolvency should be paid in full, as the obligation to pay them occurred prior to the occurrence of the insolvency redemption event.

Cheyne Finance, a £3.3bn SIV, was put into receivership in September 2007 after a decline in the value of its assets triggered an enforcement event. Cheyne hoped to preserve enough cash to continue operating in the short term and to negotiate a recapitalisation with its investors to allow for an orderly wind-down over three years. Its receivers won

the backing of the court to continue to pay maturing paper. However, on a second application, the court determined that an insolvency event had occurred. The definition of an insolvency event in the Common Terms Agreement referred to the company being or about to become unable to pay its debts as they fall due and utilised the cash flow test in Section 123 (1) of the Insolvency Act 1986. The judge found that there was a requirement to look to the future and to consider all of the payments to be made. The court decided that as Cheyne was in runoff, all debts had to be considered, whenever falling due. It was therefore insolvent².

There has also been a large increase in the number of Law of Property Act ('LPA') receiverships. The recent surge in the numbers of small-to mid-sized property developers and of the buy-to-let market, fueled by easy credit, has brought this process as the market has turned, back into vogue. It will be interesting to see whether it spreads to the top end of the property market.

Finally, and following the introduction of the Enterprise Act 2002, administrative receiverships have all but disappeared. They can only apply to pre-2002 security or to a small group of exceptions, such as capital market arrangements, public/private partnerships or utilities.

Administration continues to be the preferred route for formal insolvency reorganisation, but at what cost both in terms of potential destruction of business value and the costs of a successful trading administration? There are very few companies that have successfully exited administration and have been returned to directors and shareholders. This flies in the face of the government's idea of the new administration process being corporate rescue and renewal.

Case law continues to develop, often impacting on the area of return to the Qualifying Floating Charge Holder and other creditors. Administration expenses were a hot topic this time last year ahead of 'Trident'.

Happily, after April 1, 2008, the liquidation empty rates regime applies to administrations too. However, there is another small cloud on the horizon. Some landlords are reportedly lining up an application to see whether rent should also be an expense. A careful reading of 'Toshoku' in the House of Lords should dampen their enthusiasm. In 'CAB Automotive Limited v Blake and others' (UKEAT0298/07), the EAT³ held that under TUPE⁴, (where an administrator dismisses employees to 'slim down' a business with a view to a sale), 'the reason or principal reason' for the dismissals could be the transfer of the business or a reason connected with it, even though the potential buyer/transferee is neither on the scene nor identified

at the date of the dismissals. This case raises the most debated question when acting for a purchaser of an insolvent business: to what extent is the purchaser exposed to liability for employees dismissed pre-transfer. Where 'the reason or principal reason' for a dismissal is the transfer or a reason connected with it (other than an ETO reason), that dismissal is automatically unfair and liability, since that unfair dismissal passes to the eventual transferee/buyer.

In the recent application of the administrators of Permacell Finesse Limited (in liquidation), the High Court decided that the proprietor of a floating charge could not participate in the 'prescribed part' in respect of a shortfall under its floating charge. This mirrors the decision in *Airbase*⁵. It has been suggested that lenders might choose not to secure part of their loans in future so as to partake in the prescribed part. There has been a renaissance of section 425 Companies Act 1985 Schemes of Arrangement ('Schemes') and the use of CVAs as restructuring tools, especially over the last five years. This has been dynamic and innovative, and the trend appears set to continue. Apart from functioning as a collective distribution regime, CVAs may serve as a powerful reorganisation tool. The complex restructuring of the TXU group was achieved via a series of interlocking CVAs⁶.

Another recent novel use of a CVA was seen in the restructuring of Dana. There, pension liabilities of certain UK companies were transferred to and assumed by an SPV, which then compromised those liabilities via a CVA, with the consent of the pensions regulator and the Pension Protection Fund. As a result, the UK companies were released from all pension liabilities.

The migration of distressed foreign companies to the UK with a view to using a CVA to achieve restructuring has also gained market attention. One recent successful attempt was Deutsche Nickel, a distressed German company, which became an English company in order to enter English administration and promote a CVA.

Cross-border issues are one of the most interesting areas of development. With the introduction of UNCITRAL, Chapter 15, the application of the EU Regulation, and section 426 Insolvency Act 1986 ('IA'), there has been much cross-border activity. Migration of the centre of main interest ('COMI') to utilise the preferred jurisdictional procedures continues to create debate and provide solutions to corporate rescue. This and the application of assistance by utilising s.426 IA could facilitate an increase in financial corporate structures seeking a safe haven in the UK (but obviously dependent on any tax implications).

In the Cayman Islands, the main insolvency procedures are liquidation and provisional liquidation,

Peloton being a recent Cayman liquidation. English insolvency law may provide for greater flexibility. In particular, administrations provide a wider-reaching and automatic moratorium on all creditor actions. Administrators can also continue to make trades so that the fund's risk remains appropriately hedged and the potential for a fire-sale is reduced. A further distinguishing feature is the ability of the majority creditors by value to choose the insolvency practitioner. In the Cayman Islands, a liquidator would be chosen by the company's management and would be hard to dislodge.

These distinctive features mean that insolvency proceedings in England could be attractive to creditors and create an element of forum shopping. We have seen the beginnings of hedge fund insolvencies and the migration of those insolvencies from the Caymans to other jurisdictions. Some have gone to the US (in the case of SphinX and the two Bear Stearns Funds) and others to England for recognition of primary proceedings, for example, part of the Alpha Basis Yield Fund.

Another important development is the House of Lords' decision of April 9, 2008 to overturn the 'HIH' decision of the Court of Appeal refusing the request of the Australian courts for the assets of HIH to be pooled. The court has allowed the Australian appeal, enabling us to understand how s.426 IA is to be interpreted. We now know how the English Court will deal with requests under the Cross-Border Insolvency Regulations and that, unless creditors demonstrate that distributing assets under another jurisdiction prejudices their rights, English assets can be remitted to foreign jurisdictions. Cross border insolvencies are becoming the norm, and there is a need to stay abreast of all developments.

It seems obvious, given the lack of confidence fueled by only having half the story on the subprime

fallout, that this is going to be an interesting year. The recent rate cut combined with the raft of new legal authority and statutory changes⁷ affecting restructuring and insolvencies in the UK will mean a busy time ahead. It seems likely that there will be some high-profile collapses, and inevitably insolvencies – both formal and informal – will rise.

Notes:

¹ Whistlejacket Capital Limited (in Receivership) [2007] EWHC 2402 (Ch)

² Re Cheyne Finance PLC (in Receivership) [2007] EWHC 2402 (Ch)

³ Employment Appeals Tribunal

⁴ The Transfer of Undertakings [Protection of Employees] Regulations

⁵ David Richard Thorniley & Another v HMRC & Another [2008] EWHC 124 (Ch)

⁶ (see also '*Sisu Capital Fund v Tucker*' [2005] EWHC 2170 (Ch); [2006] BPIR 154)

⁷ Insolvency Rules, modification and modernisation and The Companies Act 2006 the making of rates as an administration expense

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