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Twists and turns on the road to a real rescue culture

BY DAVID BRYAN, ALLAN TILLEY AND MATT QUADE

Business failures are an emotional subject. Inevitably, stakeholders lose out, some more than others. Insolvency laws change in response to perceived problems and the mantra is to improve the prospects of business rescue. With further legal changes lined up in many countries, it is worth reflecting on the history of reforms and how practical implementation differs from theoretical intentions and hence consider whether currently-proposed reforms might actually work. We will focus on the UK but will also consider trends in other countries.

During the 1960s and 1970s, the insolvency of a company normally led to the appointment, by a secured creditor, of a firm of accountants with the task of realising value for assets through receivership, a procedure created in the 18th century and based on an old equitable remedy in real property law. It was a liquidation process with no concern for the survival of the business. There were also worries about 'cowboy' liquidators who would take hold of small businesses and enrich themselves by selling the assets of the company in return for commission. Some liquidators even stalked companies they knew were struggling, offering a contrived liquidation which enriched themselves at the expense of creditors with the funds released from asset sales.

The Cork Report of 1982 proposed major changes, including the establishment of licensed and regulated insolvency practitioners (IPs) and the establishment of administration and company voluntary arrangements (CVAs) as recovery procedures. These were legislated for in the Insolvency Act 1986. In practice, the new laws were beset by perceived conflicts between the rights of different classes of creditors and a lack of clarity in objectives. Secured creditors often acted at the first sign of trouble, preferring the control of a receivership process and, as a result, administration was rarely used, unless there was a no debenture-holding creditor. Companies in receivership were, however, often traded by the appointed IPs for many months while stabilising performance and conducting a sale process for the benefit of the secured creditor which sometimes saw the business survive in some form. There were at least some trading skills and experience in the IP profession.

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Criticism of the continued use of receivership to protect a bank's position at the expense of other creditors, and its aggressive use at the first sign of distress, led to several consultations and, eventually, the Enterprise Act 2002. Minor modifications were made to the CVA process and receiverships were phased out. New priorities were introduced for administrators which were hierarchical, giving rescue of the company theoretical priority.

Again, the practical effects of this have not been as anticipated. The lack of control by the bank makes it less likely to support a period of trading the business, while potential personal liability of IPs in an administration and spiralling professional costs have led to the rise of the pre-pack. This is a process where the distressed business undergoes limited marketing, and a sale is agreed, often with existing ownership or management. An administrator is appointed, and the sale of the desirable business and assets completed immediately. The rump of the company is then liquidated along with the liabilities. The argument is that this enables a business to be sold quickly before its value falls and it loses key assets, including people, as a result of insolvency. However, many argue that despite the introduction of required standards in Statement of Insolvency Practice 16 (SIP16), the marketing is insufficient and the first that unsecured creditors know about it is when it is announced as a done deal. It is often said to have been inspired by the US Section 363 process. However, the US procedure involves an initial 'stalking horse' bid that sets a floor price, followed by an open auction process. It is not as quick as a UK pre-pack, but it is more transparent. Currently, the pre-pack process is being criticised for being abused as a means to purely shed liabilities without the intention of achieving one of the statutory aims.

The CVA process has remained relatively little used. It has procedural problems that have not made it popular until recently when it has found a specific use for retail businesses restructuring property estates and leases. The record of CVAs is also poor, with a recent survey suggesting as many as 75 percent subsequently fail.

Schemes of arrangement, a Companies Act procedure rather than insolvency law, have also emerged as a means of cramming down a minority of dissenting creditors in consensual restructuring deals. This process has been very successful for large cross-border cases where sufficient connections to English law can be demonstrated, but it is expensive and not generally used in smaller UK businesses.

The current position remains sub-optimal, and much value is destroyed. The practical reality is that current insolvency processes in the UK do little more than recycle assets. The approach is primarily a transactional one which is easy for the IPs, keeps their personal risk at a minimum and pays lip service to a true rescue culture. Rarely is any effort made to address the underlying business problems of the distressed business.

IPs offering assistance to distressed businesses ahead of insolvency offer refinancing or accelerated sale processes, which, again, are transaction and balance-sheet based. Publicity says "x hundred jobs have been saved", but says nothing about the number of jobs lost, the effect on pensions, that the unsecured creditors will get virtually nothing or the effect of the process on the supply chain. It is estimated that around a third of insolvencies are caused by the insolvency of a key customer.

We believe the quest to implement a real rescue culture has largely failed. However well motivated the legal changes have been, the practical effect has been very different. It has been a similar story in many other countries. Most European countries had a liquidation approach to insolvency and have been trying to change and create a true rescue culture. Success has been mixed, but most have not found the formula they were hoping for.

In the US, the Chapter 11 process was a way to address underlying business problems and agree a turnaround and restructuring with creditors while the company's management remained in control. However, the right of all creditor classes to appoint advisers at the company's expense, and the increased attempts by groups buying into the capital structure to seek leverage, have made the process so expensive that its use as a turnaround process has dropped markedly in favour of Section 363 auctions. The US is now looking at how to change the process as again it has become very transactionally focused.

In 2014, the EU proposed major new legislation drawing on Chapter 11. It recognised that too many companies entered insolvency without any attempt at a rescue and intended to give troubled companies a chance of a turnaround. It proposed a moratorium preventing

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creditors from taking action against the company, provisions to prevent suppliers terminating contracts or holding a business to ransom, the ability to cram down a minority of dissenting creditors and ideas to encourage rescue financing. This is progressing, and EU countries have either recently introduced or will introduce legislation in the next few years. The UK consulted on its own proposals before the Brexit vote and has said it will still introduce new legislation along such lines as soon as parliamentary time permits.

Generally, the UK and EU proposals are a step in the right direction, but that could be said of most legislative changes that come up short of expectations in implementation. At present, those that operate as turnaround professionals outside of insolvency have to try to address a business' operational problems and negotiate with creditors outside of any legal framework. Just one creditor can enforce and the whole consensual approach will fail. The moratorium process is, therefore, to be welcomed. The UK is proposing only 28 days duration (extendable to 56) whereas the EU proposed four months. Arguably, however, 28 days is too short, with insufficient time to review the business, prepare plans and negotiate with creditors.

The proposals around essential suppliers from critical vendors may prove difficult in practice, but the cram down mechanism is based on the tried and tested scheme of arrangement, so should work. The UK has, however, dropped the idea of super-priority funding in a turnaround, as the view is that funding is readily available for well-constructed restructuring plans.

The UK originally proposed a suitably qualified 'monitor' to approve a company satisfying the conditions to enter a moratorium and ensure continuing satisfaction of those conditions. The latest government responses to consultations are that a monitor will have to be an IP. This is likely a mistake. The very word 'insolvency' signals distress and erodes value. Many IPs today have not traded a company in years and are not best placed to do an operational and financial turnaround. The government has left the door open for other professionals to be allowed at a later date. We expect that IPs and turnaround professionals outside the large multi-disciplinary firms will have to work together to deliver the required results.

A big challenge for government will be to change the perception of financial distress. In the UK and most of Europe there is a stigma and management leave it too late to seek help. The new proposals for moratoriums will only apply to companies that seek help early. The message needs to spread to the business community that seeking help is not an admission of failure, but is the first step to an improved outcome. It has been interesting to follow recent similar changes in Australia. It has allowed suitably qualified turnaround professionals to run the rescue process, not just IPs. It has also adopted a 'carrot' rather than 'stick' approach to management conduct by giving a safe harbour to management who act honestly and take decisions that are 'reasonably likely to lead to a better outcome'. It is hoped this will lead management to seek advice earlier and avoid companies being put into insolvency processes as a safe option, rather than risk wrongful trading. This is a positive approach. We await the new laws in the UK and the rest of Europe in hope. ■

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