



To: Eleanor Mack
Enterprise Team
HM Treasury
Area 3N/1
1 Horse Guards Road
London
SW1A 2HQ

22 February 2008

Re: EHYA Submission on Insolvency Law Reform

Dear Ms Mack,

In April last year we first raised with you our proposals for the reform of English insolvency law. The proposals were designed to ensure that major corporate entities would have available the appropriate legal tools to effect restructurings that preserve value for all stakeholders to the maximum extent possible. Since then we have continued to consult with professional bodies, trade associations, members of industry and public authorities to solicit their views. The nearly unanimous theme that emerged is that English insolvency law is unsuitable to manage the type of insolvency that will soon become common: highly-g geared, cross-border companies with complex capital structures for which major restructuring will be the only solution.

Unlike many other countries, the UK has no insolvency proceeding dedicated solely to restructuring financially distressed companies. Although the Enterprise Act 2002 was meant to increase the use of administration for company rescue, academic studies widely conclude it has failed to do so. Instead, nearly all large restructurings in the UK continue to be effected on an out-of-court, *ad hoc*, consensual basis, without a predictable legal framework or meaningful precedent to guide the process.

The resulting ability of out-of-the-money stakeholders to impede the process by withholding approval makes this approach, at best, expensive, ineffective, and inefficient. Out-of-court restructurings may have worked, albeit imperfectly, in the past, but are inadequate to address the challenges of the present. The advent of private equity has brought a sharp increase in leverage and intricate capital structures which will require a more robust framework.

Because the risk of widespread economic instability this vacuum creates is unwarranted and undesirable, we are renewing our call for a targeted reform of English insolvency law. We urge the government to act now. We attach a proposal that could be implemented by making relatively minor amendments to existing law. Taken together the amendments provide the appropriate tools to preserve value for all stakeholders of distressed companies to the maximum extent possible. The proposal incorporates features from insolvency regimes from other jurisdictions with a view that the new UK procedure could ostensibly serve as a template for pan-European harmonization in the future. We do not view the proposed procedure as prescriptive. We hope it will form the basis for a government-industry dialogue and we stand ready to begin that dialogue immediately.

This proposal is the work of the European Insolvency Reform Committee of the European High Yield Association (EHYA), co-chaired by Andrew Wilkinson of

Goldman Sachs and Dan Hamilton of White & Case. The EHYA is an affiliate of the Securities Industry and Financial Markets Association.

We look forward to hearing from you on how we might take this proposal forward.

Kind regards,

A handwritten signature in black ink, appearing to read "Gilbey Strub". The signature is fluid and cursive, with a long horizontal stroke at the end.

Gilbey Strub
Managing Director
European High Yield Association

cc: Samrita Sidhu, HM Treasury
Lee Hewlett, HM Treasury

1. Outline of New Procedure

The new procedure would allow larger corporates to obtain an automatic stay against enforcement by their financial creditors¹ for a limited period of time whilst the company negotiates a restructuring with its creditors. The automatic stay is a global injunction on creditors to refrain from any further effort to collect amounts that the debtor owes them. Distressed companies that are worth rescuing risk dismemberment unless the parties can call a truce and reach an orderly decision as to what should be done with the company's assets. The automatic stay provides the breathing space to accomplish this, and hence is the cornerstone of our proposals.

The restructuring could be effected by either a scheme of arrangement under the Companies Act 1985, or a company voluntary arrangement (CVA) under Part 1 Insolvency Act 1986. The company's existing management would stay in place, but with a court appointed monitor. The monitor's function would be to prevent any improper use of the stay and to report to the court on the progress of the restructuring. The law concerning schemes of arrangement and CVAs would be supplemented with provisions allowing the court to hear and adjudicate on issues of valuation in the context of the restructuring, hearing expert evidence from any interested party.

The new procedure would allow the company to increase its share capital and to cancel or vary the rights of existing shareholders without the consent of those shareholders if it is proved to the court that those shareholders no longer have equity value in the company. The court would have the power to override any negative pledge in favour of existing creditors or other parties so that the company was able to borrow funds and grant security during the period of the stay, and as a part of any scheme or CVA.

A number of these proposals could also apply to schemes or CVAs proposed by an administrator or liquidator.

The mechanics of the new procedure are described below.

2. Stay of Enforcement

The automatic stay would be commenced by a company applying to court and showing four criteria:

- its centre of main interests is in the UK;
- it is, or it believes there is a real prospect of it becoming, unable to pay its financial debts;

¹ "Financial creditors" would include lenders, bondholders, financial lease creditors, and any other holders of debt or debt-like instruments and would mirror the definition of holders of "financial indebtedness" in the Loan Market Association's standard form loan agreement. There would, however, need to be a carve-out for financial market instruments as there currently is with administration (see for example the Financial Collateral Arrangements (No. 2) Regulations 2003).

- it believes that there is a real prospect of it negotiating a restructuring with its financial creditors; and
- It will be able to pay its non-financial creditors as they fall due during the course of the stay.

Upon satisfaction of this test, the court would make an order for a stay, and for the appointment of a monitor.

The stay would last for a maximum of three months initially, but could be extended for a further period of up to three months at the company's request. The court would have the discretion to terminate the stay if the monitor informs the court that there is no reasonable prospect of the company reaching an agreement with creditors, or on the application of a creditor who is able to show that the stay is likely to cause that creditor serious and unfair prejudice.

The effect of the stay would be two-fold:

First, financial creditors would be prevented from taking any of the following actions against the company (or any member of its group):

- enforcing any security;
- commencing any insolvency proceedings;
- accelerating or terminating any facilities; or
- calling any guarantees.

Second, the stay would render unenforceable any contractual clause that gives a party the right to terminate or modify the terms of the contract solely on the grounds of the filing for the automatic stay. This would ensure that the company's suppliers and customers could not impose more onerous terms at a time when the company is at its most vulnerable. It would not prevent termination for contractual breaches other than the commencement of the stay, such as non-payment or non-performance. Lenders, however, would not be required to lend under committed facilities.

3. Funding

When applying for an automatic stay, a company would also be able to request the court to disapply any contractual negative pledge which prevented the company from borrowing funds to enable the company to obtain financing while it put together a plan for reorganisation. Disapplication would be in effect only during the period of the stay. Any objecting creditor benefitting from the negative pledge would be given the opportunity to be heard by the court at this time and to show undue prejudice resulting from disapplication.

4. Application for a Leave to Call Scheme Meetings / Posting CVA Documents

If a company proposes a scheme of arrangement, it would apply as usual for leave to call meetings of its creditors. At this point, it is proper practice to raise any issues on the make-up of the different classes of creditors. This should also be the point at

which valuation issues should be raised as the negotiations with creditors which will already have taken place will have provided adequate warning of any likely valuation issues among creditor classes. In order to ensure that creditors and the court are properly informed of valuation issues, the company would submit its own valuation evidence with the draft scheme documents to support any proposed cramdown, debt to equity swap or other division of the value of the company.

Whilst recognising that there are different valuation techniques that may be brought to bear it is proposed that the valuer (and the court) should have regard to the following broad criteria:

- The valuation should be calculated on a going concern basis on the assumption that the restructuring has completed successfully.
- Regard should be had to the extent to which the restructuring requires new financing (whether by way of loan or equity) which serves to dilute the present equity interests.
- The degree of uncertainty attaching to the business plan of the company post-restructuring.

In the event of any dispute as to the valuation, the court would give directions for the resolution of that dispute (including for the exchange of experts reports and cross-examination of the expert). The court would then make a judicial determination as to the appropriate value to be applied to the company assuming its restructuring was successful.

Having a court valuation determination would allow the scheme to bind any junior class of creditors or shareholders with no economic interest in the company's assets.²

The court, having determined valuation issues, or having given directions as to how to determine them, would then give leave to hold meetings of creditors and shareholders as usual. Upon securing the necessary majority votes in favour of the scheme, the company would then petition for the court's sanction. The sanction of the court would allow the company to alter its share capital, and/or to cancel existing shares, as required by the scheme, and notwithstanding a lack of shareholder approval, thereby implementing the restructuring plan.

The court would not hear further valuation claims at this point unless a creditor can show that it was given inadequate opportunity to raise its claim at the first hearing.

The stay would remain in place from the date of the second court hearing until the court sanction hearing (and could be extended at that point to allow the company to take any steps necessary to implement the scheme prior to filing the court order at Companies House).

5. Use of the Stay in CVAs

² Currently a scheme can be proposed which ignore such creditors, but it will not bind them unless they are themselves included in the scheme and vote in the necessary majority.

The new procedure could equally apply to a CVA. The criteria for obtaining a stay would remain the same, and the procedure would follow a similar route to that set out above, more precisely as follows:

- the company would apply to court for a stay and the appointment of a monitor;
- the stay would last for three months, with a right for the court to extend it for a further three months;
- before the end of the stay, the company would deliver its proposal to its nominee as any other CVA, and, assuming the nominee consents to act and gives the necessary approval, proceed to call creditors' meetings;
- the proposal should contain more detailed valuation advice than would normally be provided in a CVA, so that any cramdown of creditors or shareholders is clearly supported by external valuation; and
- assuming that the CVA is approved by the requisite majorities, any challenge to the valuation evidence could be brought by dissenting creditors or shareholders as a material irregularity or unfair prejudice claim under section 6 Insolvency Act 1986.³

6. The Monitor

The monitor would be appointed by the court contemporaneous with the grant of the automatic stay. The court would require the monitor to submit a report within 14 days (or such other period as the court could determine) certifying that the monitor considers that there is a reasonable prospect of the company reaching an agreement with its creditors. Upon reviewing the report the court may give such other directions to the monitor as it considers appropriate including a direction for further interim reports if appropriate. In practice, it is likely that the process will be truncated and the proposed monitor's report will be submitted contemporaneous with the application for the stay.

The monitor shall have a continuing obligation to monitor the restructuring and to report to the court if, in his/her opinion, the circumstances have changed (1) such that he/she no longer considers that there is a reasonable prospect of the company reaching an agreement with its creditors, or (2) some other event has occurred or circumstances developed which he/she believes ought to be brought to the attention of the court.

In order that the monitor is able to carry out his/her obligations the company shall be obliged to:

- provide to the monitor such information and/or documents as may relate to the company and/or the restructuring as the monitor may require;

³ i.e. after the creditors' meeting and within 28 days of the chairman's report being filed in court.

- permit the monitor to attend all board (or other management) meetings, shareholder meetings or meetings with the company's professional advisers as relate to the proposed restructuring.

The monitor shall be independent of the company and its professional advisers. The monitor would not have the power to control the board of directors or to manage the company's affairs in any way. The monitor's sole duty would be to the court and not to the company or its creditors.

In most cases one would expect the monitor to supervise with a "light touch". Provided that the company and its restructuring advisers keep the monitor apprised of developments one would expect the monitor to observe from afar and only to become more proactive if circumstances appear to be changing or the company seems likely to require an extension of the three month stay.

It is not anticipated that a monitor would necessarily hold an insolvency licence but the monitor would be expected to have considerable insolvency and restructuring experience. The "benchmark" of expertise will be for the court to determine but it may be that the court would over time maintain a data base of those individuals who have the requisite qualifications and experience in the same way as the court presently maintains with regard to those individuals eligible for appointment as costs assessors in respect of provisional liquidations.

7. Use of the Stay in Administration

It is possible that administration may be necessary if a company wishes to propose a scheme but does not have sufficient cash to meet its trade creditors as they fall due. It would prove useful in practice for an administrator to have an extended form of stay so that no action could be taken by creditors to terminate contracts during the stay. The corollary of this is that the administrator would have to pay for ongoing, but not historic, liabilities under those contracts, and would have to have an ability to disclaim any contract which was onerous or which was not required for ongoing trading of the company.