afme/

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By e-mail: policy.unit@insolvency.gsi.gov.uk
Mr Muhunthan Vaithianathar
Policy Directorate
The Insolvency Service
Zone B, 3rd Floor
21 Bloomsbury Street
London
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RE: Proposals for a Restructuring Moratorium

Dear Mr. Vaithianathar,

On behalf of the Association for Financial Markets in Europe (AFME), we are pleased to provide industry feedback to The Insolvency Service's Consultation on Proposals for a Restructuring Moratorium.

We believe the moratorium could be quite useful to restructurings, particularly for large companies with complex capital structures involving multiple classes of creditors, which would otherwise be likely to enter into contractual standstill agreement.

We think the tests of showing a "reasonable prospect for reaching agreement with creditors" and that the company possesses "sufficient funds" to operate during the moratorium are the right tests. However, the criteria for satisfying these tests are what will determine whether the moratorium is actually useful. We suggest an approach that is transparent and easy to implement and that protects the interests of creditors, but yet doesn't put such a burden on the company to show a level of creditor support that will require an actual restructuring proposal to have already been put forth. A test like this would undermine the purpose of the moratorium to give the company breathing room to develop such a proposal.

We attach hereto at Annex 1 our response to each of the consultation questions. Q3 in particular contains our ideas for how to frame the test, and Annex 1A is an example of what the application for the moratorium could actually look like. We are happy to meet with you to discuss the contents of this submission in more detail with you.

Yours sincerely,

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ANNEX A: AFME Response to the Insolvency Service Moratorium Proposal

Q1: Do you agree with the expected costs and benefits of the proposals, as set out in the Impact Assessment? Are there other benefits or costs that you believe should also be considered?

We believe that the introduction of the moratorium could lead to significant cost savings.

However, we would note the following:

- It is inherently difficult to predict the costs associated with any restructuring and a fundamental factor in the cost saving afforded by the moratorium will be the stage at which the moratorium is applied for. For example, if this is at an early stage in the restructuring process and avoids the necessity of negotiating and agreeing a contractual standstill agreement, there could be significant savings. However, the later in the process the application is made, the greater the erosion of any cost saving.

- The costs involved in applying for a moratorium will be directly linked to what is required to satisfy the two limb test for securing the moratorium. For example, if the "reasonable prospect" limb of the test requires showing a particular level of (concrete) creditor support, it is likely that a standstill will already have had to be entered into and a restructuring proposal will need to have been developed for creditors to be able to indicate their support, which in turn will involve a substantial amount of costs for the parties.

- One of the key benefits of a moratorium from a financial creditor point of view would be as a negotiating tool / "plan B" in respect of hold-out minority creditors, but this benefit is difficult to quantify in a financial sense.

- Some form of cap on the costs of the insolvency practitioner in preparing the court application and the on going costs of the Monitor may impact the cost saving achieved. However, any such cap may also disincentivise any putative insolvency practitioner from acting as Monitor.

- We note that the Impact Assessment does not address the negative impact on costs where a company applies for a moratorium but is subsequently no longer eligible and the moratorium is withdrawn. In this instance any cost saving might be eroded (and, indeed, overall costs may even increase for the company).

Q2: Do you agree that in order to help safeguard creditors' rights, a company should not be eligible for a moratorium if there is an outstanding petition for winding-up unless it has a statutory compromise proposal (a scheme of arrangement or CVA) that it is ready to put to creditors?

We agree in principle and note that the existence of an outstanding winding-up petition can be a serious issue for creditors. There is, however, the risk that a dissenting creditor could use this eligibility exception to its own advantage in order to attempt to frustrate the moratorium. We suggest that, in line with the LMA leveraged facilities agreement insolvency event of default, the court could override this eligibility provision at the application stage if it considered the petition to be frivolous or vexatious i.e. at the application stage for the moratorium, the court could also deal with the winding up petition and determine whether there are sufficient grounds for such to be dismissed in accordance with S126 Insolvency Act 1986. If there were not sufficient grounds to dismiss the petition, the application for the moratorium could not then proceed. In other words, the court could be directed to handle the winding up petition and moratorium application in the same way it handles a winding up petition and application for administration that are before the court at the same time.

Q3: At the pre-proposal stage, do you agree that the two proposed qualifying conditions provide the right balance in ensuring that a moratorium is only available to companies where the core business is viable but there is nevertheless a need to restructure their debts?

We agree in principle with the qualifying conditions of showing 1) a reasonable prospect of reaching agreement among the creditors, and 2) that the company has sufficient funds to carry on its business during the moratorium. Indeed, these conditions are generally the factors that the parties to a major corporate restructuring consider in undertaking the entering into of a contractual standstill agreement.

It is the actual criteria required to satisfy these tests that will determine how useful the moratorium is, however; so it is important that the right balance is struck. If the criteria are too lax, the moratorium will be subject to abuse. If they are too stringent, the work required to establish the "reasonable prospect" and "sufficient funds" tests will be as extensive as if the parties were to negotiate a contractual standstill (or even the restructuring agreement), which will render the moratorium redundant.

We suggest an approach that gives the court wide discretion to determine, based on the facts and circumstances of the particular application, whether the tests have been met, counter balanced by the creditors having a right to notice of the application and a chance to register their objection at the application hearing.

This will afford the court the opportunity to consider all of the relevant issues in the case at hand. To satisfy the test, we would suggest that:

- The monitor could be able to rely on a report by the company's financial advisor that in the advisor's professional opinion, the company has satisfied the qualifying conditions, together with their reasons. The contents of any particular report would not be legislatively prescribed but left to the professional judgment of the advisor.

- The financial advisor's report could be similar to the Para 2.2 Report for administrations prior to the Enterprise Act 2002 and include (at a minimum) the information relating to the company's financial position set out in the sample application report as set out at <u>Annex 1A</u> hereto.

- We recommend against any requirement of soliciting feedback from creditors to show whether the "reasonable prospect" test has been met, for several reasons:

    - First, a creditor, in deciding whether to indicate support for a restructuring is likely to want to see a formal restructuring proposal. This requires that a proposal has been developed (and, quite likely, that a contractual standstill has been entered into). A creditor is likely to be inclined to use its feedback of any such proposal as leverage for exacting conditions. This would ultimately defeat the purpose of the moratorium, as set out in paragraph 3.7 of consultation, *"to provide a protected breathing space for companies in which a restructuring or compromise can be negotiated and agreed with creditors."*

    - Second, creditor feedback could be problematic to achieve in respect of bondholder creditors because of securities laws governing solicitation and prohibiting selective disclosure of material non-public information, and

    - Finally, requiring particular creditor feedback raises difficult issues of the format of support required that could further beg the question of the moratorium- an agreement in principle? In writing? What are the contractual consequences of such expression of support? Again this will cause creditors to request that an actual proposal be put forth before they commit to support the moratorium. With respect to whether the consent of any qualifying floating charge holder will be required, please see our comments at Other issues – 5 (*Interrelationship between qualifying floating charge holders and the moratorium*).

Please also refer to Question 7 – Rights of Creditors

Please also refer to Question 7 - Obligations on directors

Q4: Where a company has a proposal for a CVA or Scheme of Arrangement and wishes to apply for a moratorium (or extend the existing moratorium), do you agree that provided the existing statutory conditions are met the only additional qualifying condition that should apply is that the company is likely to have sufficient funds to carry on its business?

We agree in principle with this although as a practical matter, it is somewhat late in the process of either a CVA or Scheme of Arrangement as a contractual standstill is likely to have been agreed by this stage. But a moratorium may assist in those negotiations or any extension discussions or where a creditor may be coming to the end of a contractually imposed standstill period. Please note therefore our comments at Question 1 regarding the cost/benefit analysis for applications made late in the restructuring process.

Q5: Do you agree that any extension of the moratorium during the period when a compromise proposal is still being negotiated should require a further court hearing?

We note that the proposed moratorium of 3 months is backdated to run from the date the directors gave notice of their intention to apply for the moratorium.

As is the case in *Sauveguarde* proceedings, we believe that it is important that the court is aware how the restructuring is progressing. We agree that any extension to the initial 3 month period should require a further court hearing, although some latitude could be granted if a more formal creditor approval process were already in place at such time, for example, the time period required to implement a scheme of arrangement.

Q6: We would welcome views on whether an additional court hearing should be required for the extension of a moratorium to cover the formal approval of a CVA proposal.

We believe that a consistent approach across applications is desirable and (although it is slightly anomalous to have a court hearing imposed for a CVA, hitherto an out of court process), hence, we suggest all extension requests be treated similarly whether it is in conjunction with a scheme, a CVA or otherwise.

Q7: Do you agree that the proposed role of the Monitor, together with the rights of creditors and the obligations on the directors, strikes the right balance in safeguarding the interests of creditors and deterring abuse,

without imposing disproportionate costs or impeding the objectives of the moratorium?

(i) Role of the Monitor

The role of the Monitor requires further clarification.

- We do not believe that it would be acceptable or prudent for the Monitor to be the company's financial advisor or any other person involved in the satisfaction of the qualifying conditions including the person making the application statement referred to at paragraph 4.11 of the proposals.

- We believe that it is of key importance to the protection of creditors, and to ensure that the restructuring proposals are achieved, that the court exercises its discretion to determine whether the proposed Monitor has the requisite depth of experience as set out in paragraph 4.13 of the proposals.

- The proposal states that the Monitor will be an insolvency practitioner and officer of the court. We agree with this approach and believe that, in order to provide some guidance and checks on its roles and duties, the Monitor should be bound by the regulatory and statutory rules applicable to insolvency practitioners in carrying out the role. We recommend that to avoid confusion between the Monitor's role and the company's role or its financial advisor's, it be clear that the Monitor's role be merely a liaison role between the court and the company and creditors where it is responsible for objectively reporting the progress of the restructuring to the court.

- The Monitor will need to be satisfied on an ongoing basis that the qualifying conditions are met which will require an assessment of (a) whether or not there remains a reasonable prospect of the company reaching agreement with its creditors and (b) the companies financial position. To fulfil this role it will be necessary for the Monitor to be fully appraised of developments in the restructuring process and to have access to such information as is necessary.

- We note that Monitors will be accountable for their actions. What does this mean? Will there be any financial liability or can their actions simply be challenged by interested parties? If they can be challenged, the criteria of, and the procedure for, such challenge must be set out. If there is any financial liability, Monitors may refuse to act without factoring this risk into the fees charged with a detrimental effect on the cost/benefit analysis or first obtaining an indemnity for any loss from the company (but note that the company is, by definition, in financial difficulties). What priority should any such indemnity have in a subsequent distribution?

- Monitors should be entitled to statutory protection as long as they act in good faith. Creditors should be deterred from suing monitors and in the event that an action is brought Monitors should be entitled to have their reasonable costs and expenses incurred in defending such action paid as a priority claim.

We note that there is little detail as to how the Monitor will supervise the directors to ensure that the creditors are protected. We suggest that the views of some of the larger practitioners are sought on the practicalities of this role and what information they would require from the directors to enable this role to be properly performed.

(ii) Obligations on directors

We suggest that there should be an initial and ongoing obligation on the directors to deliver financial information to allow the Monitor to assess whether the second qualifying condition has been, and continues to be, complied with. This could mirror any obligations to deliver financial information in the facilities agreement or other relevant financing document. There should be a sanction for fraudulent or misleading information delivered.

We would welcome clarification on the extent of the criminal sanctions that could be imposed on the directors and confirmation that these would not extend to any shadow directors or other similar officers.

(iii) Rights of creditors

We believe that one of the key creditor protections is the requirement on the Monitor to advise the court, and withdraw the application bringing the moratorium to an end, if and when the creditors are no longer in support of the restructuring process. This will involve the Monitor being fully appraised of developments in the restructuring process.

It is also imperative, particularly if the requirements to satisfy the first condition are relatively low and non prescriptive (see Question 3), that creditors are given notice of the application for the moratorium and an opportunity to raise concerns and / or additional requirements at the hearing. There should be further guidance on the grounds for objection and the extent to which creditors can be prescriptive i.e., the extent to which they could require the company to take additional steps as part of the restructuring proposal; their support of the proposal being conditional on such steps being effected.

A creditor may raise objections at the court hearing. It is not clear whether the company or other creditors would receive prior notice of any such objections to allow them to put forward alternative arguments or how the court would proceed in these circumstances. Would the application simply be dismissed or will there be objective criteria for the court to apply in this instance?

Creditors have the additional right to challenge in court the actions of an officer of the company where the creditor's interests have been unfairly prejudiced. We are unclear as to when or how this creditor action could be taken.

Q8: Do you agree with the proposals for treatment of moratorium debts in a subsequent CVA, and in any distribution undertaken in an administration or liquidation that immediately follows a moratorium?

This question raises two different issues, namely the incurrence of "new" trade credit and the possibility of the relevant company incurring debtor in possession style priority funding.

Taking these in turn:

(i) DIP Financing

This issue has split members of the AFME with possibly the majority being against or indifferent to the introduction of debtor in possession financing.

We note that the proposals are silent as to whether it is intended that the ability to incur debts during the moratorium would override any contractual prohibition on the company doing so and whether any debt so incurred would rank in priority to any existing security granted (whether by way of fixed or floating charge) and we would welcome clarification in this regard.

Whether such a proposal is viable here remains a topic of hot debate and there are obvious concerns that any such financing could detrimentally dilute the position of secured creditors. It is difficult to see how debtor in possession financing equivalent to that seen in the USA is viable in the UK without significant and effective creditor protections being agreed, such as the respecting of existing contractual, security and priority rights and restrictions (with any model based on US concept of "adequate protection" of secured creditor possibly being viewed as insufficient in a UK context).

(ii) Trade Credit

Again this is an issue that has divided members and we suggest that the Insolvency Service monitors this area going forward.

There is a concern about the incurrence of large amounts of trade credit during the moratorium, which would enjoy super priority status, to the detriment of secured creditors. This may be exacerbated further by trade creditor insurers withdrawing coverage and overdraft facilities being withdrawn. This could be addressed, to some extent, by extending the moratorium to cover *ipso facto* clauses and in this regard please see our comments at Other issues – 2 (*Ipso facto clauses)* below or perhaps by some form of cap being imposed on the amount of new trade debt that can be incurred during the moratorium.

In addition, we would welcome clarification as to how the ability to raise trade debt during the moratorium interacts with the on going compliance with the second qualifying condition and how the global search to make sure always capitalised is intended to supervise this. We see this as a key protection for creditors. Please refer to Question 7 above.

(iii) General

Clarification is required as regards the treatment of any intercompany liabilities arising during the moratorium and the status afforded to such.

We note that the proposals specifically exclude the possibility of debts incurred during the moratorium being compromised by a subsequent CVA. Is the proposal that such debts could be compromised in a subsequent scheme of arrangement?

There is a further concern that revolving credit facilities (and any ancillary facilities) that are drawn, repaid and redrawn during the moratorium might achieve super priority status with respect to the 'new' debt pursuant to the rule in *Devaynes v Noble* (1816) 1 MER S72 (Claytons Case) whereby payments are presumed to be appropriated to debts in the order in which the debts are incurred. Clarification is required in this regard.

Other issues

1. Extraterritorial recognition

To what extent is it intended that the proposals have extraterritorial recognition? Most leveraged buyouts involve cross border groups of companies, commonly with holding companies in tax friendly jurisdictions such as the Netherlands and Luxembourg. Perhaps the moratorium should be added to the list of Insolvency Proceedings set out in Annex A of the European Insolvency Regulation.

2. Ipso Facto Clauses

Unlike in a USA Chapter 11 filing, the proposals do not extend the moratorium to cover set-off rights or *ipso facto* clauses. This is of key concern to secured lenders. At the very time that the company stabilises its financial creditors with the moratorium, and in doing so prevents its secured lenders from taking action to accelerate their debt or enforce their security, it destabilises its business creditors by subjecting the company to the risk that contracts will be terminated, which may render the company unable to operate.

Clarification is required as to when set-off will be effected – upon an application or on the granting of the moratorium.

3. Capital Markets exemption

The exception for capital markets should be based on the broader UK Banking Act exceptions for set-off and netting, capital markets arrangements and financial markets set out in the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009.

Clarification should be given as to whether the exemption is intended to apply to structured capital markets transactions only or issuer vehicles in general.

4. Public nature may destabilise customer and supplier relations

For non-publicly traded companies (with no public reporting obligations), the public nature of the moratorium could have a detrimental effect on the customer and supplier base.

5. Interrelationship between qualifying floating charge holders and the moratorium

Whilst we appreciate that in most situations it is normal for the company to work alongside and in conjunction with the secured lenders, it is not inconceivable that, in some situations, there may be a tension between the secured lender holding a 'qualifying floating charge' and the company's ability to seek a moratorium which may ultimately lead to a premature 'race to court'. Care needs to be taken to ensure that any proposed moratorium does not prejudice the rights of existing secured lenders so as to minimise this risk and prevent the potential destruction of value that may result.

6. Non UK companies

We note that the moratorium is available to companies that could be subject to a CVA or scheme of arrangement which might include companies incorporated outside the UK. Clarification of interaction of local jurisdictional issues, such as directors' duties, is required.

7. Group companies

Clarification is required in the group company context. For example, how will intercompany debts be dealt with, and can group applications be made or will separate applications be required for each group member. Clearly this would affect the cost/benefit analysis.

8. Antecedent transactions

Would the application for, or granting of, the moratorium be deemed to be the "relevant time" for purposes of antecedent transactions?

ANNEX 1A

APPLICATION REPORT

Contents of Moratorium application

(1) The application shall contain a statement of the applicant's belief , and reasons therefore, that the company has met the tests for the moratorium that:

  (a) There is a reasonal prospect of reaching an agreement or compromise by the creditors, and

  (b) That the company has sufficient funds to operate during the moratorium.

(2) There shall be attached to the application an affidavit in support which shall contain –

  (a) a statement of the company's financial position, specifying (to the best of the applicant's knowledge and belief)

    (i) the company's assets and liabilities, including contingent and prospective liabilities; and

    (ii) a cashflow statement showing that the company is likely to have sufficient funds to carry on its business during the moratorium.

  (b) details of any security known or believed to be held by creditors of the company, and whether in any case the security is such as to confer power on the holder to appoint an administrative receiver or to appoint an administrator under paragraph 14.

  (c) details of any insolvency proceedings in relation to the company including any petition that has been presented for the winding up of the company so far as within the immediate knowledge of the applicant and, in the case of a petition for the winding up such evidence as is necessary for the court to make a determination in relation to such pursuant to S126 Insolvency Act 1986.

  (d) any other matters which, in the opinion of those intending to make the application for the moratorium, will assist the court in deciding whether to make such an order, so far as lying within the knowledge or belief of the applicant.

(3) The affidavit shall state whether, in the opinion of the person making the application, the EC Regulation will apply.