OnAir with Akin Gump

Akin Gump
STRAUSS HAUER & FELD LLP

Ep. 32: UK Financial Restructuring During COVID-19

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Jose Garriga: Jose Garriga: Hello, and welcome to *OnAir with Akin Gump*. I'm your host, Jose Garriga.

Beyond the tragic toll it has taken in human lives, COVID-19 is wreaking havoc in almost every aspect of financial life in markets around the world. Businesses are experiencing significant liquidity issues, workplace disruptions, workforce reductions, increased costs, and fundamental uncertainty as to the future and the possibilities for recovery. As a result, insolvency and restructuring proceedings have, perhaps unsurprisingly, increased in many sectors of the global economy.

In this episode, Akin Gump London-based financial restructuring partners Liz Osborne and Emma Simmonds will be discussing trends in the way the pandemic is driving restructurings, as well as ongoing and proposed reforms to the insolvency regime that the U.K. government is undertaking.

Welcome to the podcast.

Liz, Emma, thank you both for appearing on the show today. Over to you.

Liz Osborne: Thank you very much. Hello everyone, I hope you are keeping safe and sane in these very strange times.

We thought it probably made sense to spend a few minutes at the start of this podcast just reflecting on some of the trends that we have seen over the last four or five weeks, since life became really very different to what we have all been used to. And particularly in the restructuring market, we moved very, very quickly from a period of quite flat activity in the distressed investing world, a lot of A&Es [*amend and extend proceedings*] but not a great deal of balance sheet restructuring activity, to, almost overnight, a very significant uptick in restructuring work and, clearly, a very significant amount of volatility in the markets.

So, initially, when the COVID-19 pandemic really reached crisis levels, as I said, four or five weeks ago, there was an initial flurry of activity at the debtor level, generally around immediate liquidity concerns because it became apparent that, really, globally, fundamentally businesses were going to be locked down for an unknown period of time, and that was going to have a very significant impact on cash coming into the business. There was also quite a lot of initial opportunistic trading activity, which funds were able to take advantage of, given the extreme markets volatility and the opportunity to acquire fundamental value at improved pricing levels.

We also saw a number of restructurings that we thought might be coming down the line several months from now actually coming in on an accelerated basis, principally in the oil and gas sector, given what we have seen with oil prices over the last few weeks. We also saw a huge uptick in the number of distressed investors contacting us to help with their debt review work, where they had done the underlying credit analysis on otherwise-sound businesses and wanted our views on the debt documentation relating to that particular piece of debt. But it seems to us, at least at the moment, that the distressed investors are not currently ready to invest significantly in the debt markets, I think, principally, because of concerns about, really, how long this pandemic is going to last for, and what the world is going to look like at the end of it. There's clearly a huge amount of uncertainty, and, therefore, making significant investment decisions at this point in the cycle is quite challenging.

But where we have seen restructurings actually starting to take shape is where we have been representing original par investors. Emma, I know that this is something that has been keeping you busy in recent weeks, so why don't you let our listeners know the sorts of things that you've been looking at?

Emma Simmonds: Thanks, Liz. Yes, that's right, I think the issues which businesses are facing at the moment as a result of the pandemic has led to a number of requests from borrowers and issuers for release. I mean, that takes a number of forms, so, in a number of cases, we're seeing requests for release from covenant testing. We obviously, though, have been operating in a pretty covenant light environment recently, so that means covenant release is not going to extend to all situations, but there have been a number where, immediately, borrowers and issuers are asking for release from financial covenants and in addition to that, really, for deferrals and publication of financial results, and so on.

What we're also seeing as a result of the liquidity issues which you talked about, requests for payment holidays. I think the lack of revenue which businesses are receiving are alluding to the fact that they're not all going to be able to make the payments which are due on their debts, so that's taking the form of requests for interest relief, in some cases moving to “pay if you can” for quite extended periods, and also, in some cases, principal deferrals. I think it's becoming quite difficult, actually, for businesses to predict how long they are going to need that relief for and when they are likely to be able to come back into compliance with their payment obligations and covenants.

I think the other thing that we're obviously seeing as a result of the liquidity issues are companies looking to get access to cash as quickly as they can. So, in a number of cases, borrowers have been drawing down very rapidly on the RCS lines that they have available to them, really with a view to trying to stockpile cash very quickly and have that available to them.

We're obviously seeing as well quite a few companies looking to access the government funding schemes which have been put out, and I think we're waiting, really, at the moment to see how much success companies have in accessing those. But inevitably, there are going to be requests for further new money coming to existing stakeholders, and I think one of the questions there will be whether it will be, say, the lenders and or the equity who puts in the new money. Certainly, we are looking to the sponsors and the equity to say that they expect them to make some sort of contribution during these periods.

But, as a general matter, I would say that we are seeing creditors being supportive towards the businesses that they're invested in. I think there's probably a couple of reasons for that. One is that there is a recognition, generally, that there are a lot of very good businesses which have been significantly impacted by the crisis and were previously very sound. And, so, I think creditors are looking to support them where they can through this crisis and hoping that they can emerge from the end of it intact. But probably there's one other point to note there is that I think many creditors are mindful of guidance which has come out from the PRA [*Prudential Regulation Authority*] and the FCA [*Financial Conduct Authority*] which is really encouraging lenders to support businesses through this time, and I think there is now, really, a regulatory onus on creditors to do that.

So, Liz, that's the backdrop of what we're seeing at the moment, as this moves quite quickly. Interested, really, to hear your thoughts on how we might see it playing out in the coming months?

Liz Osborne: Yeah, thanks Emma. Look, it's difficult to predict with any certainty how this might play out. Certainly, what we saw in the '08 and beginning of '09 crisis that, actually, there were initial casualties that came through pretty quickly. But then, it wasn't until another six or so months down the line that we saw that big wave of restructurings. I think it's not unlikely that that similar pattern is going to be the case here as well.

I think once the initial lockdown measures begin to ease up, and we are allowed to venture forth into the world again, then the businesses that are currently being mothballed need to get going. You can see that there is going to be quite a significant new money need at that point in time, which will only exacerbate the current liquidity issues, as these businesses gear up to take themselves out of mothballs and start work again. I think that lack of liquidity, restocking costs and the lack of receivable inventory is going to be a big problem when the lockdown begins to ease, and that new money providers are going to be in short supply, potentially, at that point or heavily in demand, at least, at that point in time.

I think that as the full recessionary impact of the current crisis does begin to really hit in six or so months' time, I think we should expect to see a very significant wave of larger restructurings coming through. I think it's potentially interesting to just note that, probably, by that point in time, a lot of the debt will have traded out from the original par investors into the hands of the secondary investors. I think, bearing that in mind, we can probably expect to see some much larger balance sheet restructurings at that point in time, rather than the amend & extends that we have got rather used to seeing in recent years.

Okay, so we've talked a little bit about some of the trends that we have seen over the last four or five weeks. Clearly, we are in a state of fairly unprecedented crisis at the moment. Emma, what do you think companies, investors should be thinking about at the

moment in terms of how the existing insolvency framework can be used by companies at this particular point in time?

Emma Simmonds: Well, I think, within the U.K., there are obviously very good insolvency mechanisms and restructuring mechanisms that are available as a statutory matter. It's become, really, the destination of choice for European restructurings. But there are, I suppose, some areas where the existing regime is not completely equipped to deal with the current crisis, and I think, as a result of that, we are going to see some changes.

I suppose, touching on the most immediate change that we've seen already, the U.K. government announced at the end of March that it was going to introduce a three-month suspension on the wrongful trading legislation within the U.K.. That suspension is actually going to be retroactive to the first of March this year, so, while the legislation hasn't been brought in yet, I think directors are operating on the basis that that change is coming. The reason the government has done that really is to remove the threat of personal liability for directors, really in an attempt to give previously sound businesses just a bit more breathing space during the COVID-19 crisis.

Just by way, I suppose, of reminder: The wrongful trading insolvency provisions apply to people who are directors, or shadow directors, and where a company of which they are a director subsequently goes into administration or liquidation, the director can be found guilty of wrongful trading if they, first, knew or ought to have concluded that there was really no reasonable prospect of avoiding insolvent outcome. Then, secondly, that they failed to take every step to minimize loss to creditors. Under those tests, there's no requirement for any sort of fraudulent or dishonest intent.

But having said that, liability only arises if, in the end, the company was worse off as a result of the continuation of trading. If that does happen, the directors themselves can be required to make a contribution to the company itself to make good that loss. Potentially, that can be quite a significant liability. I think the reason the government has looked to suspend that legislation is, really, because they're conscious that it can be quite difficult at the moment for directors to make an assessment as to whether an administration or liquidation can really be avoided. That is going to be quite dependent on how long the COVID-19 crisis continues and how significantly it impacts businesses.

The government wants to avoid a situation where directors are just making preemptive filings for insolvency now to ensure that they avoid liability for wrongful trading. So, they're trying to discourage too many filings happening simply as a result of the pandemic. Just, I suppose, to add to that, the existing laws on the fraudulent trading will continue, though, through the period. They actually require some level of intention to defraud creditors, so the test there is quite high; it's a significant hurdle, really, to be found guilty of fraudulent trading. But that will continue. And the general duties on directors remain unchanged. They will still be required in the zone of insolvency to act in the best interests of creditors, so, much of the regime remains the same, even with the suspension on wrongful trading.

I think, just one point, really, to add on that, is that notwithstanding the suspension on wrongful trading, at the end of the day if a company is running out of money, the directors are still going to need to file because there just won't be cash available to meet the liabilities. So, while this wrongful trading suspension may be significant in some cases, it is not going to prevent filing in situations where there are severe liquidity shortfalls.

I think, just moving on from that, really, the other immediate change that we've seen isn't really legislative, but, rather, that there is an emerging practice now of using administration as more of a rescue regime than has perhaps been the case previously. I think, generally, administration has been seen as signifying a collapse, which necessitates the replacement of management because there's been some level of mismanagement within the company. But I think, within the insolvency community at the moment, a new practice is emerging of using administration to really provide breathing space to businesses through the crisis. So, while it's true that the administrator would usually displace the management team, that isn't a necessity; it is possible for the management to retain their powers with the consent of the administrator and remain in place.

But if that happens, the company is going to obtain a number of the benefits that administration provides. Probably the first and most important of this is the statutory moratorium, which will prevent action being taken against the company by unsecured creditors. In addition to that, in administration, where the administrators borrow new money, that new money liability is automatically given priority status. It's often the case in restructurings that we spend a lot of time as advisors, putting in place contractual mechanisms to give new money super-priority status, but in an administration, that can, really, just be done as a matter of statute. I think that would be something that we will see administration, potentially, being used for. Administration also gives quite a lot of flexibility in terms of allowing the administrators to decide which payments they want to make, which contracts they want to take on.

So, I think we have, in fact, already seen a number of cases where companies have filed for administration just to get access to these protective measures through the pandemic period. I think we'll really have to see how effective that is in the long term; there are a still number of issues associated with an administration filing. For instance, it could trigger termination rights in key contracts, which may make it harder to use as a short-term rescue tool. In addition to that, there probably is still a public perception that administration is a terminal insolvency proceeding.

I would just add that we should all be mindful that where we see companies file for administration at the moment, that may not actually be indicative of a collapse. It may, instead, be a case where the company is looking to use that process for protection as a rescue mechanism.

I think those are the two immediate changes that we are seeing. But Liz, I think there are a number of changes which the government is looking to bring in on a more long-term basis, so it would be helpful if you could talk to those.

Liz Osborne: Sure. Thanks, Emma. Our insolvency laws have actually not changed much for nearly 20 years, so we are probably overdue for some legislative reform in this area. The government is keen to address some of the perceived failings in our existing regime and, as a result of that, undertook a fairly large consultation exercise in 2016 and 2018. The result of that, certain key themes came out of it. Legislation to enact the findings of that consultation has been quite slow coming through and has been rather on the back burner not least because of Brexit and other things. But, it does seem now to have been elevated to the forefront of the legislative minds as a result of COVID and in an effort to try and best equip our insolvency and restructuring landscape to let us deal with what we expect to be a very busy time in the restructuring market.

It's worth saying there is still some uncertainty as to what shape these legislative changes are going to take. There are a number of points of detail that will need to be worked out as the legislation is drafted. But there are three main areas for reform.

Firstly, it is supposed that there will be a new moratorium proceeding, whereby a company can try and get the benefit of a 28-day moratorium, which will prevent creditors from taking action during that period, and that can be extended for a further 28 days. Indeed, in fact, it can be extended beyond that period with creditor or court approval. During that moratorium period, the directors will remain in control, but an authorized monitor will be appointed during that period, and that monitor will be a licensed insolvency practitioner.

The moratorium is designed to be used by companies who are not currently insolvent, but which would become insolvent if proactive action is not taken. That's really the qualifying condition, if you like, in order for a company to be able to avail itself of the moratorium. Really, in effect, the moratorium is there to give the company breathing space and to allow companies to be more proactive in managing their financial difficulties before they get too far down the line, and an insolvency is, perhaps, inevitable.

The second key area for change is in relation to ipso facto provisions. For those of you who are not familiar with those, those are provisions which allow a counterparty to terminate a contract simply because the other party entered an insolvency proceeding. It is supposed that a legislation will be enacted to prohibit enforcement of those types of termination provisions in contracts for the supply of goods and services. Again, the overarching principle here is to provide a framework which allows a business to continue to trade, but, clearly, termination due to nonpayment will still be permitted. So, suppliers will need to be kept whole and are not expected to continue to supply goods and services if they're not being paid for them.

Then, the third main area for reform, which is quite an interesting one, is the introduction of a new restructuring plan. I think most listeners will be familiar with the English law scheme of arrangement, which has become, really, the restructuring tool of choice across Europe in the last decade or so. It's quite common for schemes to be used for non-English companies, where you have English debt which you're wanting to compromise, and there's a huge body of case law which is now built up in English courts. While schemes are very prevalent, and, I think, are a very good tool for restructurings, there are some shortcomings. The government is seeking to address those perceived shortcomings in this restructuring plan. This is one area where, as I say, the points of detail really do need to be worked out, and it is not entirely clear exactly what the restructuring plan is going to look like.

But I think we can expect it to have the following main themes, if you like. Firstly, I think it will be very similar to a scheme, but, importantly, it will include a cross-class cramdown mechanism. That, I think, is really one of its main features, because the scheme at the moment does not have that ability to cram down junior holders in other classes. But it is proposed that the restructuring plan will have that capability.

The cross-class cramdown will broadly follow the absolute priority rule, which for those of you who are familiar with U.S. Chapter 11, you will know that the absolute priority rule can sometimes be quite difficult to stick to, particularly if you have a restructuring where you want equity to retain some value, but that would offend the absolute priority rule. That can be quite difficult to bring about in a Chapter 11. So, what is proposed in our

new restructuring plan is that we will follow the absolute priority rule, but there will be some flexibility for the court to confirm a plan where noncompliance with that rule is necessary to achieve the aims of the restructuring, or it is just inequitable in the circumstances.

Again, it is expected that the restructuring plan will be available to both solvent and insolvent companies. The question of jurisdictional threshold is still being considered, and, clearly, that is important because, as I said, one of the reasons why schemes have been used so frequently is because it is possible to establish jurisdiction, really quite easily, and you do not have to be an English company in order to use a scheme. I think, in terms of the consent thresholds for the new restructuring plan, again, we would expect that to be similar to a scheme with 75 percent in value and 50 percent by number.

So, that is a quick canter through the proposed solvency reforms. Timewise, we don't really know when they will find their way onto the legislative books. As I said, we expect that to be at the forefront of people's minds when Parliament reconvenes. But, in practice, given the points of detail that do need still to be worked through, it seems to me somewhat unlikely that they will be in force before the end of this year, at least, but I could be proved wrong on that.

I think, in short, these reforms are a welcome addition to the restructuring toolkit in the U.K., and, given that we expect to be very busy in the restructuring market for several years to come, I suspect that they will be useful in a number of restructurings once they are implemented.

Emma, I don't know whether or not there was anything else you wanted to add, in terms of the expected insolvency reforms?

Emma Simmonds: I think what will just be interesting to see with it really is what the landscape is when those reforms come in, so I think we'll be in quite a different environment there in terms of companies, as you said, needing access to new money quite quickly, probably the debt, at that point, having traded into the hands of secondary investors. I think it'll be interesting to see, really, how that cross-class cramdown, if available, affects the way in which restructuring is negotiated and run. We're quite used to seeing creditors taking holdout positions in situations, particular creditors to whom the debt is traded, but, in all likelihood, that may be less easy to do when the cross-class cramdown is available, and the company has a way of forcing through a deal with the consent of, really, just one class.

So, I think that is really likely to change the way in which restructurings develop and are negotiated over time. It's something to look forward to in the future.

Liz Osborne: Yes, indeed, another element of uncertainty to add to the current very uncertain world. Thank you.

Emma Simmonds: Yes.

Jose Garriga: Thank you. Listeners, you've been listening to Akin Gump financial restructuring partners Liz Osborne and Emma Simmonds. Thanks to you both for appearing on the show today to discuss a topic that's top of mind for many in the business community.

And thank you, listeners, as always, for your time and attention. Please make sure to subscribe to *OnAir with Akin Gump* at your favorite podcast provider to ensure you do not miss an episode. We're on, among others, iTunes, SoundCloud and Spotify.

To learn more about Akin Gump, and the firm's work in and thinking on insolvency and related matters, look for “financial restructuring” under practices at akingump.com, and take a moment to read Liz and Emma's bios on the site as well.

Until next time.

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