CORPORATE RESTRUCTURING IN THE LIGHT OF THE WORLD'S FINANCIAL CRISES

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By Chris Iacovides

In volatile economic conditions there are always going to be businesses that suffer from a downturn. This does not necessarily indicate a failing in the strategy of the business but may be due to factors outside of the directors' control. However, the defining factor in the medium to long term is how the situation is managed.

In this article, Chris Iacovides, examines, how the UK, thought it's Insolvency Act 1986, as amended by the Enterprise Act 2002 and the US, through their Chapter 11 regime, embrace the rescue culture thus enabling turnaround professionals to restructure, renew and rescue insolvent companies, thereby enabling them to continue to trade, often debt free.

Until recently, the concept of restructuring or insolvency meant vastly different things in different parts of the world. But since the start of the new millennium, legal reform and the spread of debt trading across the globe have resulted in a convergence toward more universal restructuring practices.

Restructuring markets could be classified into creditor-friendly, debtor-friendly or a balance between the two.

In the Far East, the business culture emphasizes strategic relationships, a long-term perspective, and concern for the collective good over individual pursuits. As a result, Asian restructuring practices have emphasized the continuity of an enterprise and stable employment rather than the enforcement of creditor rights. In Japan and Korea, for example, government ministries have traditionally pressured banks and other creditors to extend liquidity to troubled companies continuously. Consequently, divestitures, layoffs, plant closures, and insolvency proceedings have been exceptionally rare although in recent days there has been an increase in corporate failures.

In contrast, European and Latin American business cultures are creditor-friendly. Restructuring laws and practices on these continents have mirrored culture by historically emphasizing the protection of contractual rights and the preservation of social contracts between workers and employers.

A third alternative is the U.S. restructuring system, which attempts to balance the creditor and debtor interests that divide Asian, European, and Latin American systems.

In this article, Chris Iacovides, examines, how the UK, thought it's Insolvency Act 1986, as amended by the Enterprise Act 2002 and the US, through their Chapter 11 regime, embrace the rescue culture thus enabling turnaround professionals to restructure, renew and rescue insolvent companies, thereby enabling them to continue to trade, often debt free.

In Cyprus, Cap 113 of the Laws of Cyprus, mirrors the English Companies Act 1948, this legislation has been complimented by the European Union Regulation on Insolvency Proceedings, following Cyprus's accession to EU. Although the Island is in need of modern Insolvency legislation turnaround and restructuring professionals can always turn to the UK regime for guidance when at attempting to restructure and rescue a company.

UNITED KINGDOM

Administration, as a legal concept, is a procedure under the insolvency laws of a number of common law jurisdictions. It functions as a rescue mechanism for insolvent companies and allows them to carry on running their business.

In United Kingdom law, the administration regime is governed by the Insolvency Act 1986 ("IA"), as amended by the Enterprise Act 2002 ("EA"). An administrator can be appointed without petitioning the court by the holder of a floating charge (created since 15 September 2003), by the company or by its directors or even by creditors, less common.

Other creditors must petition the court to appoint an administrator. The administrator, even when appointed out of court, enjoys the same privileges and protection afforded to him as if he had been appointed under an order of the court.

The EA 2002 amended the Insolvency Act 1986 to provide an out of Court process to appoint an administrator to the holder of a floating charge or the company or its directors. This is considerably cheaper and simpler than the previous mechanism, which involved an application to Court and a very lengthy and costly report.

The statutory purpose of an Administration consists of a single three-tiered purpose.

(i) The first objective is to rescue the Company as a going concern which involves rescuing the Company with all or most of its business intact.

(ii) The second objective (to be considered only if the first objective is not reasonably practical or would clearly be better for creditors as a whole) is to achieve a better result for the creditors than would be obtained through an immediate winding up of the Company.

iii) The third objective is realising property in order to make a distribution to one or more secured or preferential creditors.

The administrator is an officer of the court and an agent of the company. She or he is not personally liable for any contracts she or he makes on behalf of the company. She or he has the power to do anything necessary or expedient for the management of the affairs, business and property of the company.

An administrator must act in the interests of all the creditors and attempt to rescue the company as a going concern.

Administration is analogous to going into "Chapter 11" in the United States, although there are certain key differences, mainly stemming from the fact that English law does not include the Debtor in possession concept. During the reorganisation period, as a result, the administrator usually runs the business rather than the directors, and any additional liquidity requirements effectively have to be met by funds provided by existing creditors.

The new administration regime introduced by the EA 2002 replaces the previous situation where administrative receivership was available as an alternative to administration, which has traditionally been a more rescue-oriented insolvency regime. This regime allowed the holder of a floating charge to appoint an administrative receiver to realise assets in his favour, and also to block an Administration Order sough by a borrower. This was felt to be too favourable to the floating charge holder at the expense of other creditors. Holders of a floating charge created prior to 15 September 2003 retain their right to appoint an administrative receiver, but all purported rights to do so created after that date will be construed as rights to appoint an administrator.

Prior to the appointment of an administrator by the company or its directors, a five day notice must be served to the holder of a floating charge pursuant to the provisions of paragraph 26 of the EA 2002. The idea is to allow secure creditors, if they so wish, to appoint an administrator of their own choice, as opposed to the one nominated by the directors. Following the issuing of such notice, Rule 2.20 of the IR1986 provides that no hostile action of any kind can be pursued, against the company, without the court's permission.

Following the adoption of the EA 2002, Administration has become the gateway to corporate insolvency in the UK. When a business needs to be rescued there are often genuine worries about maintaining value, both for existing creditors and for prospective purchasers trying to restart the business. Continuity of supply is usually essential to keeping customers happy; key employees need to be retained; and current contracts need support to avoid potential claims for breach.

As a result, the practice of 'pre-packaging' the administration process has developed. In a Pre-pack, a company is placed into Administration and the business is sold shortly after the appointment of the administrator. Often, the insolvency practitioner, the directors and the bank will have obtained valuations, agreed a sales price and drafted contracts to enable the business to be sold immediately after appointment.

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Nevertheless, creditors are sometimes less understanding. Their perception is that assets may have been sold at an undervalued price or that goodwill has not been fully valued because of the speed of the sale. What critics often forget are the statutory and practical limitations under which the Administrator has to act.

Unlike Chapter 11 in the US, the Enterprise Act did not provide for super priority funding to enable the Administrator to raise funds for continuing trading while restructuring is planned and implemented. There is also an extensive list of other aspects to be considered: priority expenses during the administration, such as rent and rates; adoption of employee contracts; retention of title clauses on stock; the risk of trading losses; and the prospect of expensive marketing and lengthy – often contentious – sales processes. These factors have resulted in Pre-packs gaining increasing favour among turnaround specialists, directors and banks which, even with security and personal guarantees, still have capital at risk.

In September 2007 a Judge in the High Court ruled in favour of using a Pre-pack to save a business and jobs, even though it meant going against the wishes of the major creditor. The judge rejected a claim by HMRC against the sale of a firm of solicitors to allow an immediate sale of the business to another firm of solicitors.

The Judge claimed to be particularly influenced by the fact that the proposed sale appeared to be the only way of saving the jobs of the 50-plus employees of the partnership. The proposed sale was also likely to result in minimum disruption of the affairs of the firm's clients.

In a pre-pack administration the previous management often own the new company, hiving off the profitable parts of the company while the creditors are often left with nothing. The administrators also benefit from a pre-pack administration. Another consequence of a pre-pack administration is that employees may lose wages, pensions and redundancy pay. While a pre-pack administration is legal at 2009, many people question its morality. While the employees of the company that goes into pre-pack administration do not necessarily lose their jobs as the new company is debt-free, the debt that is dumped on the former creditor companies can be large enough to cause serious hardship and creditor layoffs. Pre-pack administration has increased since the credit crunch.

From my own experience, despite the adverse criticism and negative perception Pre-packs have significant advantages, providing there is careful management of expectations among those affected.

UNITED STATES

Chapter 11 Bankruptcy affords the debtor in possession a number of mechanisms to restructure its business. A debtor in possession can acquire financing and loans on favourable terms by giving new lenders first priority on the business' earnings. The court may also permit the debtor in possession to reject and cancel contracts. Debtors are also protected from other litigation against the business through the imposition of an automatic stay. While the automatic stay is in place, most litigation against the debtor is stayed, or put on hold, until it can be resolved in bankruptcy court, or resumed in its original venue.

If the business's debts exceed its assets, the bankruptcy restructuring results in the company's owners being left with nothing; instead, the owners' rights and interests are ended and the company's creditors are left with ownership of the newly reorganized company.

All creditors are entitled to be heard by the court. The court is ultimately responsible for determining whether the proposed plan of reorganization complies with the bankruptcy law.

Chapter 11 is reorganization, as opposed to liquidation. Debtors may "emerge" from a Chapter 11 bankruptcy within a few months or within several years, depending on the size and complexity of the bankruptcy. The Bankruptcy Code accomplishes this objective through the use of a bankruptcy plan. With some exceptions, the plan may be proposed by any party in interest. Interested creditors then vote for a plan. Upon its confirmation, the plan becomes binding and identifies the treatment of debts and operations of the business for the duration of the plan.

Debtors in Chapter 11 have the exclusive right to propose a plan of reorganization for a period of time (in most cases 120 days). After that time has elapsed, creditors may also propose plans. Plans must satisfy a number of criteria in order to be "confirmed" by the bankruptcy court. Among other things, creditors must vote to approve the plan of reorganization. If a plan cannot be confirmed, the court may either convert the case to liquidation under Chapter 7 or, if in the best interests of the creditors and the estate, the case may be dismissed resulting in a return to the status quo before bankruptcy. If the case is dismissed, creditors will look to no bankruptcy law in order to satisfy their claims.

As with other forms of bankruptcy, petitions filed under Chapter 11 invoke the automatic stay. The automatic stay requires all creditors to cease collection attempts, and makes post-petition debt collection void. Under some circumstances, creditors or the United States Trustee can ask the court to convert the case to liquidation under Chapter 7, or to appoint a trustee to manage the debtor's business. The court will grant a motion to convert to Chapter 7 or appoint a trustee if either of these actions is in the best interest of all creditors. Sometimes a company will liquidate under Chapter 11, in which the pre-existing management may be able to help get a higher price for divisions or other assets than a Chapter 7 liquidation would be likely to achieve. Appointment of a trustee requires some wrongdoing or gross mismanagement on the part of existing management, and is relatively rare.

CYPRUS

Cyprus has not adopted the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvencies but it has embraced the European Union Regulation on Insolvency Proceedings, following accession to EU.

The law in Cyprus is creditor friendly and although the rescue mechanisms are provided in the legislation the rescue culture is at its embryonic stage. This however does not prevent a turnaround expert to fully restructure the affairs of a company through a combination of hiving down assets into subsidiaries and swapping debts into equity and compromising liabilities via corporate voluntary arrangements.

There is nothing preventing restructuring professionals to look at the English and American models for guidance when looking to restructure a company's business, its assets and liabilities. I think all professionals know from experience that insolvent liquidations result in almost every case in no dividend being paid to the unsecured creditors. Consequently, I trust that both, professional advisors and directors would agree with me that there is a need to find ways to rescue companies as opposed to leave them in the fate of their creditors who are quite often aggressive and ruthless.

CAP 113 may be old and out of date but the mechanism for reconstructions is found in section 198. Although in need of modernisation, this section is wide enough to enable a restructuring expert to put together a Corporate Voluntary Arrangement ("CVA") that will be acceptable not only to secured creditors but also to preferential and unsecured creditors.

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The main objective of a Voluntary Arrangement is to place creditors in a more favourable position than they would have otherwise been had the company been wound up or placed into liquidation.

It has to be remembered that a proposal for a CVA is made to the company not by it.

A proposal cannot be approved if it contains a provision which affects the rights of a secured creditor to enforce their security, or one under which, inter alia, any preferential creditor is to be paid otherwise than in priority to non-preferential claims or less than other preferential creditors.

One must not forget that the holder of security, usually the banks, have the right to appoint a receiver and manager, so before any rescue schemes are attempted one will have to discuss them in detailed with the holders of security and canvass their support before a rescue plan is attempted.

With this in mind, I believe a turnaround expert can be the architect of proactive schemes of arrangements designed to save public and private companies from collapse. In my experience, providing creditors with pertinent information from the outset regarding a company's financial position is paramount to the success of any re-organization plan.

Chris is licensed to act as an insolvency practitioner in England and Romania with over 25 years experience in cross border insolvency and corporate restructuring. He is a member of the Insolvency Practitioners Association, the Association of Business Recovery Professionals and the Turnaround Management Association in the UK, as well as the Association of Restructuring Advisors in the US.

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