KIRKLAND & ELLIS

KIRKLAND **ALERT**

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New Horizons: Major UK Insolvency and Corporate Governance Reform Announced

AT A GLANCE

The U.K. Insolvency Service has launched reforms under five categories which Kirkland believes will improve the ability of companies to be efficiently restructured in times of distress, but sound caution for creditors seeking to employ hold-out strategies.

At a glance, the reforms seek to introduce a new flexible cross-class cram-down "restructuring plan" procedure, a new moratorium to help business rescue, measures to prevent suppliers from relying on termination clauses in contracts solely by reason of the counterparty's insolvency or financial condition, improvements to the insolvency framework in cases of major failure, and action to further strengthen the U.K.'s corporate governance framework.

Kirkland will issue a detailed update as the legislative process progresses. Timing of the introduction of the reforms is unknown.

The government has vowed to bring forward legislation to implement the measures as soon as parliamentary time permits.

The U.K. Government has announced major reforms, including:

1. A new flexible "restructuring plan" procedure, which includes the ability to bind dissenting classes of creditors who vote against it (i.e., cross-class cram-down);

2. A new moratorium to help business rescue;

3. Measures to prevent suppliers from relying on termination clauses in contracts solely by reason of the counterparty's insolvency or financial condition (so-called ipso facto clauses);

4. Action to improve the insolvency framework in cases of major failure; and

5. Action to further strengthen the U.K.'s corporate governance framework.

We welcome these reforms, which will help ensure the U.K.'s insolvency regime retains its world-leading position, including reinvigorating its rescue culture. The government has vowed to bring forward legislation to implement the measures as soon as parliamentary time permits. As always, the devil will be in the detail.

1. New "restructuring plan"

The new procedure is modelled on schemes of arrangement, but with the key addition of cross-class cram-down, drawing inspiration from U.S. Chapter 11 proceedings. It will sit alongside schemes and company voluntary arrangements as a new tool in the U.K.'s restructuring toolkit.

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- There will be no financial entry criteria.
- Stakeholders will vote on the company's proposed plan in separate classes; class constitution provisions will closely resemble those for schemes.
- Voting thresholds differ slightly: The plan will require approval of at least 75 percent in value, in each class, of those voting, and more than half the total value of unconnected creditors.
- As with a scheme, the court's involvement will safeguard stakeholders' rights.
- The court will have absolute discretion as to whether to confirm a plan.

Crucially, the plan may still be confirmed by the court even where one or more classes do not vote in favour (provided at least one class of impaired creditors votes in favour). Safeguards will provide that a dissenting class of creditors must be satisfied in full before a more junior class may receive any distribution or keep any interest under the restructuring plan, unless:

- Necessary to achieve the aims of the restructuring; and
- Just and equitable in the circumstances.

This is a modified version of the absolute priority rule in U.S. Chapter 11 proceedings.

Certain areas of uncertainty remain, including:

- Jurisdictional eligibility threshold;
- Whether the plan will necessarily involve all stakeholders;
- Uncertainties regarding timetable/process;
- Whether the requirement for >50 percent of unconnected creditors to approve the plan will operate within each creditor class, or only overall; and
- Third-party releases (including whether compromises effected pursuant to a plan will automatically compromise creditors' claims against third-party obligors).

Cross-border recognition of the plan may also be a major issue in practice.

2. New moratorium

Designed to help business rescue, a new moratorium will be available to companies which are not already insolvent, based on prospective insolvency.

- The initial moratorium period will be 28 days, subject to extensions.
- All creditors must receive notice of the moratorium.
- A licensed insolvency practitioner must serve as "monitor" during the moratorium, verifying that the company has sufficient funds to meet its obligations as they fall due, and that rescue is more likely than not.
- The moratorium will affect both secured and unsecured creditors, but will not affect the enforceability of financial collateral arrangements (such as security over shares).

Creditor protections include:

- A right to challenge the moratorium at any time;
- Safeguards derived from the monitor's role;
- A requirement for extensions beyond 56 days to be approved by creditors; and
- New sanctions to deter abuse of the moratorium by dishonest/reckless directors.

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3. Ipso facto clauses

New rules will prohibit the enforcement of termination clauses by suppliers in contracts for the supply of goods and services, where the clause allows a contract to be terminated on the basis that a party has entered formal insolvency proceedings, the new restructuring plan procedure or the new moratorium. "Financial hardship" protection for suppliers will offer a safeguard of last resort.

This echoes the U.S. approach to so-called "executory contracts" in Chapter 11 proceedings, and recent Australian reforms. Critically, however, the U.K. proposals cover only supplier arrangements, not general commercial contracts. This is a significant divergence from the U.S./Australian regimes, and appears to be policy-based.

The government's paper does not envisage protection for companies proposing a scheme of arrangement; we hope schemes will nonetheless be included in the draft legislation.

4. Action to improve the insolvency framework in cases of major failure

The government will:

- Take forward measures to ensure greater accountability of directors in group companies when selling subsidiaries in distress, but having regard to concerns that the new measures should not disincentivise rescues or unnecessarily hold directors liable for the conduct of others over which they have no control;
- Legislate to enhance existing recovery powers of insolvency practitioners in relation to value extraction schemes which have been designed to remove value from a firm at the expense of its creditors when a firm is in financial distress; and

- Give the Insolvency Service powers to investigate directors of dissolved companies where they are suspected of having acted in breach of their legal obligations.

The Insolvency Service will obtain powers to investigate directors of dissolved companies.

5. Action to further strengthen the U.K.'s corporate governance framework

The government intends to strengthen:

- Transparency requirements around group structures;
- Shareholder stewardship;
- The U.K.'s framework relating to dividend payments; and
- Directors' training and guidance.

These measures are subject to further exploration of options and consultation.

Read the government's paper.

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland author or your regular Kirkland contact.

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