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KIRKLANDPEN
Private Equity Newsletter

October 10, 2018

Major U.K. Insolvency and Corporate Governance Reform Announced: What Private Equity Investors Need to Know

PENpoints

The U.K. government intends to adopt a highly controversial measure impacting holdco directors selling subsidiaries in financial distress by imposing a risk of disqualification and personal liability of directors on the sale of a distressed company.

The U.K. government has announced major reforms to the insolvency and corporate governance framework, including:

(1) insolvency reforms targeting sales of subsidiaries in distress without due consideration for other stakeholders and "value extraction schemes";

(2) potential corporate governance reforms, including changes to the dividend framework and new requirements to disclose capital allocation decisions and group structures; and

(3) restructuring reforms, including a new flexible "restructuring plan" procedure, a new restructuring moratorium and measures to prevent suppliers from relying on insolvency event termination clauses.

Timing is uncertain: The government intends to bring forward legislation to implement the insolvency measures as soon as parliamentary time permits. Given competing pressures such as Brexit, this may not be for some time.

1. Reform of the insolvency framework

Sales of businesses in distress: The government intends to adopt a highly controversial measure impacting holdco directors selling subsidiaries in financial distress by imposing a risk of disqualification and personal liability of directors on the sale of a distressed company.

Specifically, a director of a holdco who does not give "due consideration" to the interests of the stakeholders of a financially distressed subsidiary when it is sold may be subject to disqualification action, and possible personal liability under a compensation order[1], if that subsidiary enters insolvent liquidation or administration within 12 months of the sale. A director will not be exposed to liability if he or she had a "reasonable belief" that the sale would deliver no worse an outcome for stakeholders than if the subsidiary had entered formal insolvency proceedings.

The government has recognized market concerns that the new measures should not disincentivize rescues or unnecessarily hold directors liable for the conduct of others over which they have no control.[2] However, the new rules potentially expose sellers (and their directors) to greater risk than in, say, a pre-pack administration sale and could impact the prospects of rescuing businesses as a going concern.

It remains unclear how the proposed measures will work in the context of a multinational group where there is a non-U.K. holdco or a non-U.K. subsidiary.

Value extraction schemes: The government will legislate to enhance existing recovery powers of insolvency practitioners in relation to value extraction schemes designed to remove value from a financially distressed

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1 Under current legislation, individuals may be disqualified from acting as directors, based on their conduct; to avoid court action, directors may offer a disqualification undertaking instead. A disqualified director can potentially also be the subject of a compensation order, requiring them to pay compensation to the company's creditors. This possibility of personal liability will remain following these reforms, should the court find that a disqualified parent company director has caused loss to one or more creditors of the subsidiary.

2 The new measure is somewhat more limited than that originally proposed. For example: (a) the government will not take forward the proposed measure of enabling a liquidator or administrator to bring personal actions against holdco directors; (b) the original "look-back" period has been reduced from two years to 12 months; and (c) the measures will be limited to sales of large subsidiary companies (i.e. those which do not qualify as small- or medium-sized companies under the Companies Act 2006).

company at the expense of its creditors, particularly where other creditors are unfairly disadvantaged by credit transactions (such as "excessive" interest on loans from an investor). Reassuringly, the government acknowledges the need to have regard for the risk taken by the credit provider.

Dissolved companies: The government will give the Insolvency Service powers to investigate directors of dissolved companies where they are suspected of having acted in breach of their legal obligations. This responds to calls for the government to act against the practice of "phoenixing," where a company is dissolved and another is created soon after (usually with a similar but slightly different name); this practice is often used to avoid liabilities.

2. Potential corporate governance reforms

The government is considering the following corporate governance reforms, subject to further consultation and review of whether investor pressure and/or market changes are sufficient to deliver progress without the need for legislation.

Dividends: The government is considering the case for a comprehensive review of the U.K.'s dividend regime, including:

- requiring U.K. companies to disclose their distributable profits in their audited accounts;
- ways in which the definition of net assets (for U.K. public companies) might be tightened, such as a more critical look at the valuation of goodwill;
- whether there is a case for moving toward a solvency-based framework for the payment of dividends, as in the U.S. and Canada[3]; and
- the practice of some companies consistently paying interim dividends, rather than final dividends, so as to avoid the need for shareholder approval.

Capital allocation decisions: The government may legislate to require U.K. companies to disclose and explain their capital allocation decisions. There is a particular focus on dividend payments where the company has a pension scheme deficit.

Group structure transparency and streamlining: Proposed reforms would require U.K. companies of a significant size to publicly disclose their corporate governance arrangements and possibly group structure charts. It will also consider simplifying the process for dissolving redundant companies within a group.

Shareholder stewardship: The government intends to work with the investment community, regulators and other interested parties to discuss how investment mandates can make explicit reference to stewardship, and to provide a new mechanism through which institutional investors can escalate concerns about a company or its directors.

Board evaluations and guidance: The government has asked the Governance Institute to explore ways to improve the quality and effectiveness of independent board evaluations[4], including the development of a code of practice for external board evaluations. The government also aims to strengthen training and guidance for directors.

3. Restructuring reforms

Restructuring plan: The new "restructuring plan" procedure represents a potentially seismic change to the U.K.'s restructuring and insolvency framework and offers the possibility of a full financial and operational restructuring, akin to that possible within U.S. Chapter 11 proceedings. The possibility of cross-class cramdown sounds caution for stakeholders seeking to employ hold-out strategies.

New moratorium: A stand-alone moratorium will be available to "pre-insolvent" companies to encourage companies to engage with creditors early in cases of financial distress. The moratorium will affect both secured and unsecured creditors but — critically — will not affect the enforceability of financial collateral arrangements (which leaves open the possibility of enforcement of security over shares in an English company, for example). All creditors must receive notice of the moratorium, raising the prospect of negative publicity from a sponsor's perspective.

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3 Under such a system, dividends could be paid only where the board is satisfied (and makes a solvency statement to that effect) that, post-dividend, the company will still be able to pay its debts as they fall due. This is usually allied with a net asset test (requiring that, post-dividend, the company's assets will remain greater than its liabilities). This would constitute a shift away from the U.K.'s current "distributable profits" framework.

4 The U.K. Corporate Governance Code already requires a company within its scope (i.e. those with a premium listing on the LSE's Main Market, whether incorporated in the U.K. or elsewhere) to undertake an annual assessment of its board's effectiveness, and for an independent evaluation to be undertaken at least once every three years.

Insolvency event termination clauses: New rules will restrict the enforcement of insolvency event termination clauses in certain contracts for the supply of goods and services. The idea is that this will help stabilize distressed businesses to maximize value for stakeholders. However, suppliers will retain the right to terminate a contract on other grounds (such as non-payment or non-performance).

To learn more on the restructuring reforms, see our prior *Kirkland Alert* and the government's paper.

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

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PENbriefs

The Profits Interest Family Office Structure

High-net-worth individuals and families, hedge fund and private equity managers, technology entrepreneurs, real estate investors, and other private investors are increasingly creating and staffing "family offices" to invest and manage their family capital. While there is no one-size-fits-all approach, the profits interest family office structure is an increasingly attractive option for family offices and is best understood as a "model" structure that can be tailored to accommodate a family's unique needs and existing family office arrangement. To learn more, see our recent *Private Investment & Family Office Insights*.

SEC Settles with Investment Adviser over Cybersecurity Procedures

On September 26, 2018, the Securities and Exchange Commission (SEC) entered into a settlement order with a registered investment adviser and broker-dealer over alleged weaknesses in the adviser's cybersecurity procedures in violation of the Safeguards Rule and the Identity Theft Red Flags Rule. This is the first SEC enforcement action for violations of the Identity Theft Red Flags Rule, which requires a written identity theft prevention program designed to detect, prevent and mitigate identity theft in connection with covered accounts. To learn more, see our recent *KirklandAIM*.

Restructuring and Insolvency Dealmakers Face Uncertainty Ahead of Possible "Hard Brexit"

The U.K. is scheduled to leave the E.U. on March 29, 2019, and it is yet to be determined what kind of deal or transition arrangements — if any — will be reached. The U.K. government has issued guidance on the prospect of a "no deal" Brexit, including the possible future of the cross-border European restructuring and insolvency landscape. A "no deal" Brexit would negatively impact the U.K.'s restructuring and insolvency framework, the force of which depends, in part, on its pan-European reach. To learn more, see our recent *Alert*.

The United States-Mexico-Canada Agreement is Announced to Replace NAFTA

On September 30, 2018, Canada joined the U.S. and Mexico in agreeing to the renegotiated terms of the North American Free Trade Agreement (NAFTA), now called the United States-Mexico-Canada Agreement (USMCA). The USMCA is the product of a year-long and often contentious tri-party negotiation over this $1.2 trillion free trade agreement, and looks to achieve incremental market access and other gains for U.S. industry over time. However, whether the USMCA in its current form becomes law depends on required U.S. legislative review, which will not occur until after the midterm elections may have changed the make-up of Congress. To learn more, see our recent *Alert*.

New Jersey Opens Bidding on Nation's Largest Offshore Wind Project to Date

On September 17, 2018, the New Jersey Board of Public Utilities approved an order opening an application window for bid solicitations for 1,100 megawatts of offshore wind projects. The window began on September 20, 2018, and will end on December 28, 2018. Offshore wind is a growing industry in the U.S., and the New Jersey offshore wind solicitation looks to establish the state as an emerging leader in the space. To learn more, see our recent *Alert*.

Legal Privilege in Internal Investigations and the SFO's Compulsory Powers of Production

On September 5, 2018, the U.K. Court of Appeal handed down judgment in the highly anticipated case *SFO v. ENRC*. One day later, the High Court delivered a ruling in *R (KBR Inc.) v. SFO*. While *SFO v. ENRC* limited the U.K. Serious Fraud Office's (SFO) ability to compel the production of internal investigation documents, *R (KBR Inc.) v. SFO* saw the SFO's fortunes reversed as the High Court confirmed that the SFO can, without using Mutual Legal Assistance procedures, compel the production of documents located overseas, including from entirely foreign companies. To learn more, see our recent *Alert*.

PENnotes

Kirkland PENews Healthcare Market Update Call

Kirkland recently hosted a PENews call, "Healthcare Market Update," focusing on the current healthcare market and what to expect in the coming year. Discussion topics included the healthcare fraud and abuse regulatory landscape, current market drivers, and trends in representation and warranty insurance. Listen to an audio recording of the call.

Kirkland Registered Adviser Seminar & CCO Summit
San Francisco, CA, October 18, 2018
Los Angeles, CA, November 13, 2018

Designed specifically for private fund manager CCOs, general counsel and other senior executives, this annual event enables firms to navigate the evolving regulatory landscape and get timely updates about SEC policy and enforcement developments affecting private fund managers. Click here for more information.

NAIC Private Equity & Hedge Fund Conference
Chicago, IL, October 24–25, 2018

Kirkland sponsors this annual event, where institutional investors, CIOs, investment managers, consultants and others in the private equity and hedge fund industry discuss current investment strategies and research, and explore collaborative deals. The theme of this year's conference is "The Crossroads of Commerce and Capital." Click here for more information.

Women's Alternative Investment Summit
New York, NY, November 8–9, 2018

Kirkland is a sponsor of this annual event, which will bring together more than 400 senior-level women across the broad spectrum of alternatives to network and discuss alternative investments in an emerging new world. Kirkland partners Jennifer Perkins, Stephanie Berdik, Erica Berthou and Linda Myers will participate in the event. Click here for more information.

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Kirkland & Ellis' nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and fund formations on behalf of more than 450 private equity firms and hedge funds around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in each of the last seven years by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. U.S. News Media Group and Best Lawyers have ranked Kirkland as a Tier 1 law firm for Leveraged Buyouts and Private Equity Law for seven consecutive years and as a top-tier firm for Private Funds/Hedge Funds Law since 2012. The Firm was recognized as the #1 law firm for private equity in the 2018 Vault 100 rankings, and, in 2016, Private Equity International named the Firm "Law Firm of the Year in North America: Fund Formation" for the third year in a row.

In 2012-2017, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011-2017*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite," having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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