Chapter II vs. UK insolvency laws

US INVESTORS HAVE BROUGHT THEIR OWN STYLE OF CONDUCTING RESTRUCTURINGS TO THE UK AND ARE HAVING A GROWING INFLUENCE. BY HENRY GIBBON.

Across Europe, bankruptcy laws vary greatly from country to country. Any restructuring has to be structured and operate within the framework of the bankruptcy laws applicable to the company concerned, so the laws need clearly to be identified up front.

In the UK, it is widely accepted that senior lenders with the benefit of floating charges are in a very strong position when it comes to a financial reconstruction of the company, particularly when there are other financial creditors involved.

As Bryant Edwards, a partner in the corporate department at law firm Latham & Watkins, said: "This is because senior lenders in those circumstances can block the company or any other creditor appointing an administrator to a company over which they have a floating charge."

In the UK, the administrator operates to try to turn the company around with the benefit of a stay of execution affecting all creditors. Lenders with a floating charge can instead appoint an administrative receiver, who is their appointee in running the company.

James Roome, a partner in Bingham McCutchen's London office and a member of the firm's financial restructuring group, said: "In the UK, the senior lenders have the strong hand. This is because if the other creditors threaten enforcement action, the senior banks always have the appointment process as a last resort."

In addition, in the UK it is relatively straightforward to take security over all the assets of a company, Latham & Watkins' Edwards added.

In recent years a large number of changes have been made to UK insolvency law. These include the implementation of the Insolvency Act 2000 and the changes that will be made by the implementation of the Enterprise Act 2002. Among other matters, the former introduces the small company moratorium and the latter restrictions on the rights of floating charge holders to appoint administrative receivers, as well as a new type of "out of court" administration procedure.

In contrast in the US, Chapter 11 of the Bankruptcy Code deals with restructuring. In many ways it is similar to administration under Part II of the Insolvency Act 1986, except that in most Chapter 11 cases the debtor remains in possession. This means that the debtor is authorised to continue its operations and the existing or new management remain in office, rather than a licensed insolvency practitioner being appointed to take over the management of the business, as is the case with an English administration.

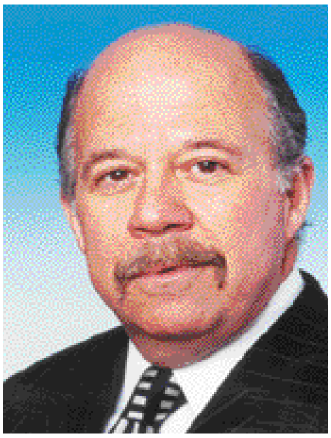
David Frauman, partner and head of the US law business restructuring group at law firm Allen & Overy said: "The US has a well developed restructuring process that creates a judicial environment, which assists in restructuring companies. For example, the automatic stay is accompanied by the ability to conclude debtor in possession financing, which is generally not practicable in the UK. Binding non-accepting creditors through the bankruptcy plan is also an advantageous feature of Chapter 11. Moreover, in Chapter 11, management remains in place."

The law of restructuring in the US is highly codified. American restructuring proceedings tend to favour granting a debtor the opportunity to reorganise, a predisposition often at odds with the interests of secured creditors. In addition, American reorganisation proceedings are, typically, litigious and protracted in nature.

Advantages of the Chapter 11 process:

- retention of management
- ability to conclude debtor in possession financing
- limits on enforcement by secured creditors
- ability to restructure all debt and bind non-accepting creditors (including classes of creditors that object to a plan)
- availability of asset sales free of third-party security can be concluded within Chapter 11
- availability of Chapter 11 for non-insolvent companies


Bryant Edwards


David Frauman


Chris Mallon


Lyndon Norley


James Roome

Colt Telecom

Mr Justice Jacob's decision on December 20 2002 denying the petition for administration against Colt Telecom highlights the difference between the US statute governing involuntary petitions in the US and the UK Insolvency Act 1986.

Christopher Mallon, head of the restructuring group at law firm Weil Gotshal & Manges, said: "Going concerns depend on continuing trade vendor credit, employee loyalty, customer support and sometimes bank support and equity market support. Once a company is publicly targeted for administration or bankruptcy, the withdrawal of support from one or more of these constituencies can quickly lead to a death-spiral, rendering the company unable to operate outside administration regardless of the merits of the petition for administration."

Mark Parkhouse, head of European insolvency in law firm Reed Smith's London Office, said: "In the Colt situation, the investor saw Colt sitting on immense cash reserves and the plan was very likely simply to figure out how to convince Colt to use some of the cash to repurchase the investor's bonds at a profit, or to force the company to agree to a solvent restructuring involving a debt-for-equity swap."

According to Judge Jacob's decision, the investor sent Colt's directors a letter (improperly in his view), not so subtly reminding the company of personal liability under certain circumstances. When that did not convince Colt to part with some of its cash to settle with the investor, the petition for administration followed.

Lyndon Norley, partner in the restructuring practice of Kirkland & Ellis's London office, explained that the investor's primary case, which was supported by an expert report issued by a partner at KPMG, was that it was inevitable that Colt was or would become insolvent (either on a cashflow or balance sheet basis.)

Bryant Edwards at Latham & Watkins, said: "Judge Jacob's decision has placed very considerable hurdles in the way of anyone now seeking to present an involuntary administration petition."

Kirkland & Ellis's Norley raises the issue of what the investor could have done better. "Because Colt inserted a no-action clause in its bond indenture, it is hard to quarrel with the notion that the 'deal' was that Colt would have several years to work without bondholder interference," Norley said.

As Mallon at Weil Gotshal & Manges argued: "If the no-action clause had been interpreted differently, petitions for administration could be filed against many start-ups on the day they issue debt, just by referring to the risk factors listed in their disclosure materials."

Cross-border restructuring

Although Chapter 11 is not recognised in the UK, protocols provide that if a US parent company files for Chapter 11, its UK subsidiary should petition for similar protective proceeding. Two cases in January 2003 highlight the current practice with respect to recognition between the US and the UK.

The first case involves a ferry company Cenargo, a UK company that filed for Chapter 11 protection without initiating any English procedures. One of Cenargo's creditors, Lombard, challenged this approach on the basis that an independent third party should be involved in administering the process and petitioned for Cenargo to be placed under provisional liquidation in the UK.

The second case involved Brac Rent-A-Car, a US company registered in Delaware. An administration order was made in the UK in respect of the Delaware company. This is important because it represents a significant expansion of jurisdictional reach.

Before this ruling, the position was that a UK court had no jurisdiction to make an administration order in respect of a foreign company except when the company was incorporated in one of several, principally Commonwealth, jurisdictions whose courts were accorded special rights under UK insolvency law. Companies incorporated anywhere else in the EU or in the US could not.

Correspondingly, US courts give recognition to certain restructuring proceedings in the UK, for example, a UK scheme of arrangement, formed under Section 425 of the Companies Act under which creditors can be given recognition in the US.

Norley at Kirkland & Ellis said: "In effect, this imposes a stay on creditors if the requisite threshold of consent has been achieved." AM