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Mr Nick Howard  
Director of Policy, Development, Review and International Issues  
The Insolvency Service  
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13 June 2008

Dear Mr Howard,

Thank you for your letter dated 8 May in regard to our proposals for a formal legal proceeding for large company rescue.

You have raised many interesting questions which we have taken the liberty of copying (and occasionally paraphrasing) for ease of presentation of our responses in a Q&A format in the attached annex.

We'd like to begin by dispelling any misunderstanding that may have developed that we seek to displace administration. Our proposed framework is an alternative to administration, not a replacement for it. We agree that administration will likely prove the fair and efficient insolvency regime for the substantial majority of small and medium sized companies. Large companies with complex capital structures, however, stand on a decidedly different footing.

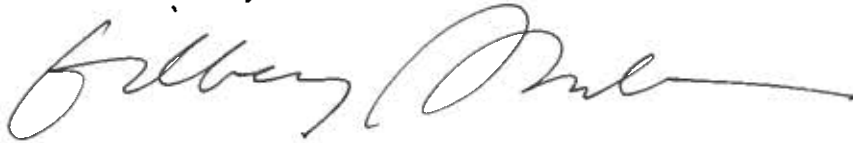
There is little practical disagreement that administration is ill-suited to large company rescue and that the Enterprise Act 2002 failed to alter this perception. Large companies continue to view administration as value destructive and resort to it only when there is no alternative. Under current law, the sole alternative is an informal, out-of-court restructuring. This process is widely regarded by companies, practitioners, and creditors alike as expensive and inefficient. The causes of this inefficiency (and expense) are grounded in a framework that lacks established rules, procedures, or precedent. Absent unanimous stakeholder agreement, the process grinds to a halt. Because there is no agreed, objective methodology to value an individual economic interest, the process creates opportunities for arbitrage, often at the expense of an efficient, cost-effective restructuring.

This is more than a theoretical concern or an academic debate. Market conditions have been in decline for nearly a year and show little sign of recovery. The downturn has now spread to the larger economy and insolvencies will shortly follow. The prime candidates for the first wave of insolvencies are the highly-leveraged companies that rest on the type of complex, cross-border capital structures that became more common after the

last economic downturn. The complexity of these structures – featuring a heterogeneous array of instruments, economic interests, and stakeholders – renders these potential insolvencies particularly vulnerable to the problems described above. These cases require a rational, ordered, and impartial process. This process is what our proposals aim to put in place.

We hope that this clarifies our position and that you agree with us that the situation requires the urgent and collaborative attention of industry professionals dedicated to addressing a problem that threatens the stability of the UK financial markets. We would appreciate the opportunity to meet with yourself and Stephen Leinster, and officials from Treasury, to formulate a solution that brings our collective experience and judgment to bear.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Gilbey Strub', with a long horizontal flourish extending to the right.

**GILBEY STRUB**  
Managing Director  
European High Yield Association

cc: Stephen Leinster, Director of Policy - Technical,  
Legislative and Professional Regulation  
Dan Hamilton, Co-Chair, EHYA European Insolvency Reform Committee  
Andrew Wilkinson, Co-Chair, EHYA European Insolvency Reform Committee

## ANNEX

### Insolvency Service Letter – Questions and Responses

#### 1. New Procedure - General

- 1.1. Who decides a 'distressed company is worth saving' -- creditors/shareholders/directors?

**It is the directors of the company who would usually decide whether the company is capable of being rehabilitated (just as they would make decisions as to the appropriateness of any other insolvency proceeding). However, for a restructuring to proceed, there must be a high degree of support from creditors.**

- 1.2. Would 'existing management stay in place' in all cases? What if there had been mismanagement/fraud committed by the existing management?

**Existing management would stay in place, on a case by case basis and subject to negotiation with shareholders and creditors, just as they currently do in an informal, out of court restructuring.**

**Where there is fraud, mismanagement, or simply a lack of skills necessary to turn the company around, the lenders would require managers to be replaced or additional managers appointed, just as they currently would in an informal, out of court restructuring.**

- 1.3. If the company were insolvent, who would pay the management fees?

**The company would pay management's salaries, just as it does in an informal, out of court restructuring. A company with insufficient cash flow to pay its management is unsuited for this procedure, which is really aimed at companies in need of adjustment to their capital structures, that is, companies with 'good businesses, but bad balance sheets.'**

- 1.4. To 'cancel or vary the rights of existing shareholders' could result in challenges from shareholders, with possible human rights consequences, or in delays in a restructuring, with a limbo situation during any legal wrangles. How would you address these situations?

**Shareholders' rights are protected by virtue of their opportunity to challenge the company's valuation in court. Where the court determines that the shareholders' interest in the company no longer has any value, there can be no misappropriation. This is a greater**

**protection than provided in administration or liquidation where underlying assets are liquidated, so destroying any hope of value for shareholders in the long term.**

1.5. Have you considered the rights of employees?

**In a rescue, employees are more protected because the company continues to trade as a going concern. Should the [rehabilitation procedure] fail, employees are protected by the protections and entitlements inherent in administration or liquidation.**

**In either case, any redundancies will have to be made following proper procedures, and redundant employees will receive their full contractual and statutory entitlement, not just their redundancy fund payment. This also, of course, reduces the strain on the public purse.**

1.6. How exactly would the EHYA scheme apply to schemes of arrangement or CVAs proposed by an administrator or liquidator? Which parts of the proposals would be applicable?

**The EHYA proposal for a stay would not apply to schemes or CVA's implemented by an administrator; the rehabilitation procedure is intended to provide an alternative to administration and to occur outside of and apart from administration. The valuation provisions and the cramdown, however, would apply. Many insolvency practitioners whom we've consulted believe a stay on creditors terminating contracts would greatly benefit the administration stay.**

1.7. Have you considered set off both in terms of an insolvency and non-insolvency situation?

**The area of set off, particularly as it relates to swaps, hedges, netting arrangements and other features of financial contracts is particularly technical and we would propose establishing a joint working group of experts to address it. Outside the financial markets issue, we envisage that set off rights would not be triggered by the stay, since it is not a liquidation procedure. Set off could be dealt with in any scheme or CVA just as it is now.**

1.8. Please provide evidence/examples of how it would work in practice, perhaps with detailed scenarios?

**The EHYA 'rehabilitation procedure' would work largely as an out of court restructuring works with the exception that it would work more quickly, efficiently and fairly: a stay would allow the company breathing space to restructure without the interference of contractual parties demanding modification or termination of their contracts; out of the money stakeholders would be unable to act as 'hold outs,' and the**

**company would be able to obtain additional financing in a more efficient manner.**

## **2. Stay of Enforcement**

- 2.1. Who would “commence” the automatic stay, directors or shareholders?

**The directors, on behalf of the company, would apply for the stay. Absent reasoned objections from any creditor or shareholder, the court would grant the stay.**

- 2.2. The proposal is based on an existing insolvency trigger (unable to pay debts) – How is this different to administration?

**The test for insolvency is the same as for administration.**

- 2.3. Who would decide who a ‘non-financial’ creditor is?

**A non-financial creditor would be any party that is not a ‘financial creditor,’ ie suppliers and customers and the like, but could be the subject of a further definition by Parliament. Were a party to challenge their status as a non-financial creditor, it would be up to the court to interpret the meaning.**

- 2.4. Is three months for the stay long enough? Three months for administration was rejected in the Enterprise Act 2002.

**A restructuring should be a swifter process than an administration. The stay could also be extended in the court’s discretion for a further three months. The initial three month period is meant to focus the parties on resolving the company’s capital structure, its short duration being a quid pro quo of the stay.**

- 2.5. How frequently this procedure will be available to companies? Could there be abuse of process?

**There are a number of ways to address this issue, for example, the court could deny the stay if any party challenged it on the basis of abuse of process, or there could be a limit on the number of stays or a period of time lapsing since the grant of the last stay.**

### 3. Funding

- 3.1. Would the decision to obtain funding be the directors or shareholders?

**The directors would have the power to authorize the company to obtain funding, as in all companies.**

- 3.2. An 'override of a negative pledge' could result in a challenge by existing charge holders with possible human rights consequences.

**The override of a negative pledge is only available by court order. The human rights of affected creditors would be protected by creditors' ability to challenge the override in court by showing prejudice arising from it.**

- 3.3. The EHYA scheme could skew commercial relationships beyond an insolvency scenario; ie result in more fixed charges and / or higher interest rates with shorter call periods; this could drive investment away from the UK.

**There is no suggestion that raising debt finance in the US is hampered by Chapter 11, which goes much farther than an override to actually allowing a super priority. A rescue oriented regime tends to lead to greater certainty that lenders will recover their investment, and so leads to a greater willingness to lend.**

- 3.4. If the company is struggling or insolvent, over what assets could the security be granted in order to borrow more funds?

**The company would not apply for the override unless it had unsecured assets available.**

- 3.5. How will the court hearings be funded?

**The process is intended to help rescue large corporates with issues surrounding their financial structure. Such companies should have sufficient liquidity to pay legal and other fees for the process (fees which should be small compared to their overall assets and liabilities). A company which is so short of cash as to be unable to pay advisors is probably too far gone to rescue.**

- 3.6. After all the fees are paid and challenges dealt with, will there be any significant value left in a company that was insolvent in the first place?

**As mentioned, this process is aimed at large corporates. Fees should form only a small proportion of their available assets.**

**We believe that more value will be preserved than under the current system of consensual restructurings because of the provision of a forum for the swift resolution of disputes and the elimination of hold outs. The evolution of judicial precedent and the costs of challenging a valuation will significantly reduce spurious claims, thereby reducing the costs of the restructuring.**

- 3.7. There is already provision within the legislation that would effectively afford a super priority status to post administration lending, where it is an expense of the administration. Is there any reason why you think this provision is not adequate?

**This is an issue of deep debate in the UK legal community. Many practitioners believe it is highly doubtful whether an administrator has the authority to override a negative pledge and grant security in breach of a contract. Moreover, the administration priority still ranks only pari passu with other liabilities incurred as an expense of the administration.**

**The vast majority of post-administration lending is made to smaller companies by their existing lender who already has super priority status, and in this regard administration works well for smaller companies to buy time until their assets can be sold off in an orderly fashion. To have a truly vibrant rescue culture, large corporates must have the ability to raise new money from lenders outside their existing circle of lenders. In the US, this ability has fostered an efficient and competitive debtor-in-possession (DIP) finance market.**

#### **4. Use of the Stay in CVAs**

- 4.1. Within a CVA, a nominee (Insolvency Practitioner) will work up proposals with the directors. What do you envisage the role of the nominee to be in this new procedure?

**The Insolvency Act and Rules do not envisage the nominee becoming involved until a final proposal document is given to him or her. We would envisage that the role of the nominee will vary, as it does now, depending on the level of assistance required by the company, its board and other directors.**

- 4.2. How would this new procedure interact with the current Schedule A1, which already allows a moratorium for 'small' companies. You could have a situation where there are small companies within a group.

**The new procedure is intended for large groups of companies with significant levels of debt. Any scheme or CVA is likely to be proposed by a holding company or treasury vehicle. We do not see any interaction with Schedule A1.**

## 5. The Monitor

- 5.1. The monitor would not have the power to control the board of directors or to manage the company's affairs in any way, yet would have a duty to the court and not to the creditors or the company.

**That is correct. The monitor would perform a supervisory / reporting function. The company's obligation to report to the monitor is a trade off for receiving the protection of the stay and the monitor's duty to report to the court the company's progress toward a resolution acts as a check on potential abuse of the stay.**

- 5.2. Would this be akin to having responsibility but no power? The monitor should not be simply a figurehead.

**The monitor's duty to report the company's progress to the court acts as a check on the company.**

- 5.3. What if there were fundamental disagreements between the monitor and existing management?

**Fundamental disputes would not arise because the monitor would not have the power to make substantive decisions with regard to the company's affairs.**

- 5.4. What safeguards are there against any abuse by the monitor?

**Given the monitor's limited supervisory/reporting role, there is unlikely to be abuse. If there were abuse, the company could petition the court.**

- 5.5. Will there be any scrutiny of the directors?

**Directors will have a duty to report the company's progress to the monitor.**

- 5.6. What about any fraud/mismanagement conducted by the directors? How do you envisage this procedure interacting with the CDDA and the other criminal and civil provisions contained within the IA1986, such as wrongful trading?

**Wrongful trading will be irrelevant since the procedure is intended to rescue companies – an administrator also cannot bring wrongful trading proceedings. As with informal rescues, we believe that creditors and other stakeholders will not support the retention of incompetent or dishonest management.**

- 5.7. What about the rights of creditors under provisions such as s423 Insolvency Act 1986 and other 'claw back' provisions?

**Section 423 gives rights to affected creditors even in the absence of an insolvency procedure. If a successful rescue is proposed, there is no scope for clawback. Given the obligation of a CVA nominee to report potential claims such as this, creditors can always weigh up whether the claim will be a better option than a rescue.**

- 5.8. Who would be eligible to be a monitor? What are the criteria? Would it be restricted to Insolvency Practitioners/turnaround professionals or others?

**We envision that insolvency practitioners and registered Society of Turnaround Professionals could be monitors.**

- 5.9. Who would accredit them and how would the regulation of monitors work?

**These are matters which can easily be determined by Parliament. We would envisage that insolvency practitioners could take the role, and perhaps the Society of Turnaround Professionals could become an accrediting body.**

- 5.10. How would a monitor get paid? What ranking would the monitor have in any priority of payments?

**To use this procedure the company must be able to pay its non-financial creditors as they fall due during the course of the stay. 'Ranking' is not relevant as the proposed [EHYA rehabilitation procedure] is not a liquidation.**

## 6. Use of the Stay in Administration

- 6.1. Are your proposals significantly different to what is already currently available under administration?

**The restructuring procedure is different from administration insofar as:**

- **the stay prevents nonfinancial creditors from terminating contracts on the sole basis of insolvency, which is a key component to giving the company the necessary breathing room to effect a restructuring,**
- **the limited time period of the stay within which to effect the restructuring ensures swift resolution and preservation of value,**

- **there is legal certainty with regard to the ability of a company to borrow and secure debt notwithstanding a negative pledge,**
- **management, where appropriate, remains in place such that the company's affairs continue to be managed by those most familiar with the business, and**
- **the stigma of administration and the immediate erosion of value once administration is announced are avoided.**

6.2. **Would there be any scrutiny of the directors or their actions? There would be a need to be protection against any abuse.**

**Protection from abuse comes in the form of judicial oversight and the supervisory and reporting role of the monitor.**