Interview with Dan Hamilton

Dan Hamilton, co-chair of the EHYA European Insolvency Reform Committee, explains that the EHYA proposals do not seek to introduce Chapter 11 to the UK: they are aimed at financial creditors only and at restructurings where there is over £200m of debt.

What are the EHYA proposals?

The proposals create a new law for restructuring large companies in financial difficulties in the UK. This is not intended in any way to change our existing insolvency laws. It would be an additional procedure. The key features would be that large companies that propose to restructure, perhaps through a CVA or a scheme of arrangement, can apply to the court for a stay of enforcement from action by their financial creditors. The companies will have access to enough money to carry on their ordinary trading operations while they go through the restructuring procedure. They would apply to the court with a statement that they are unable or likely to become unable to pay their financial debts. They would have the bones of a scheme, and they would have a document from someone we are calling a monitor who will be an insolvency practitioner or maybe an experienced turnaround person, telling the court that the company has a reasonable prospect of achieving a restructuring. The role of the monitor is not to run the company and they are not there to negotiate the restructuring. They are there really to report to the court if they think there is any sort of abuse of the process or if they think it is unlikely restructuring will ever be achieved, just to make sure companies do not abuse the process and don't obtain a moratorium for ulterior purposes.

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So effectively the monitor's role is reasonably similar to that of a nominee's in a CVA.

There are some similarities but if there is a CVA to be proposed the monitor will not be the same person as the nominee or as the supervisor of the voluntary arrangement. It is key that their duty is to the court and that they don't owe a duty to the company in the way a nominee or supervisor might do.

And why is that?

The whole idea was that the monitor would not have any economic interest or any other interest in seeing the restructuring go through. They are meant to be someone who is overseeing the initial procedure, ensuring it is used properly and reporting to the court. We didn't want this procedure to become a new insolvency procedure displacing the directors, but we felt some protection would be needed for the creditors to be sure it wasn't abused and that it wasn't sought when there wasn't a real prospect of a rescue.

Is what we are talking about here just a pre-CVA, pre-scheme framework allowing greater predictability?

Yes, we suspect it will usually require a CVA or scheme.

What do you propose?

The second limb of our proposal is providing a better means for judicial resolution of valuation disputes in restructuring. There are two parts to this. One is that we would hope that by giving some guidelines in the legislation, the courts develop a new jurisprudence on valuation in restructuring. There is a tendency in the restructuring world to view valuation where restructuring is going ahead purely on the basis of what the business is worth in an immediate sale. While in some cases that may well be fair, in other cases that is going to mean junior creditors or shareholders will lose out on the future value of the business if it is successfully turned around. It is also there, however, to make sure that junior creditors cannot use the threat of a valuation dispute in order to disrupt a restructuring and perhaps get something that they are not entitled to. The company proposing the scheme or CVA would put in some valuation evidence when it files the scheme documents and if there was a valuation dispute the court could quickly give directions. Objecting creditors would either have to go to court, put their evidence of why the valuation is wrong and challenge at that point or risk the court blessing the transaction and so removing the possibility of later arguments about valuation. We have all seen the situation where a small class of creditors who are completely out of the money managed to get themselves some part in a restructuring just through the threats of suing various parties for carrying out the transactions at the wrong values.

Once the company is insolvent, even just in terms of not being able to pay its financial creditors, why should 'out-of-the-money' junior creditors, or shareholders, share in post-turnaround future value?

There are many degrees of insolvency. Why should a temporary period of cash flow difficulty lead to whole tranches of a company's capital structure being disenfranchised? Our proposals are aimed at ensuring that a restructuring accurately reflects the real value of a business, and

properly values and recognises each stakeholder's share. The aim is that junior creditors should not be able to get something for nothing as hold-outs, but equally should not be deprived of an interest by means of a valuation based on a narrow, snapshot liquidation valuation.

What else needs to be done to deal with 'out-of-the-money' stakeholders?

Schemes and CVAs will be able to cram down classes of creditor or shareholder where they genuinely have no economic interest in the matter. Although schemes of arrangement are a wonderfully flexible tool and you can carry out schemes of certain groups of creditors, ignoring a junior group of creditors and shareholders, the effect of that is merely that the scheme does not bind that group, it doesn't actually cram them down. We would suggest that if you get a proper valuation, you can have a proper cram down and continue to keep your corporate structures in place. This is the best way of ensuring that parties get what they are entitled to and hopefully reduce the culture of liquidations and pre-packs and allow more restructurings, which have been a very useful but sometimes rather crude tool.

Why does the corporate structure need to stay in place?

Our proposals will not necessarily mean that the exact corporate structure has to stay in place. What we are keen to see is that as much of the capital structure as is appropriate should continue to have a stake in the enterprise in question.

What else is central to the proposal?

Funding. What we have suggested is that in the appropriate circumstances a court should be able to remove a negative pledge or a restriction by junior creditors on further borrowing so that a company can borrow money as it goes through a restructuring. This is particularly important where you have a multi-layered financing with junior creditors who may be completely out of the money but have contractual rights to block the money going in at higher levels. The final little tweak is that we would add to the stay a provision that other commercial creditors could not terminate their contracts solely on the grounds that the company has applied for a stay. Obviously, if the company isn't paying its debts as they fall due or if there are other breaches the stay wouldn't prevent termination, but it would prevent the sort of blackmail where a supplier terminates the contract and demands double the fees solely on the ground of the stay. I have heard some insolvency practitioners suggest they would rather like such a change to the administration stay as well.

How relevant are your proposals given the financial crisis?

I think the proposals are hugely relevant and we all feel a little bit like Cassandra. Nearly two years ago our committee came forward with this proposal and the reaction we had from many was that we don't need this, it is not relevant, the economy is doing wonderfully thank you very much.

> "Monitors… are there really to report to the court if they think there is any sort of abuse of the process or if they think it is unlikely restructuring will ever be achieved."

We were hoping to anticipate the problems this time round rather than have all the pain that leads to the reform.

So this will be a contribution to the reaction to the current recession?

No, we hope that this can still be brought in in short order. Given that now the market seems to think we are potentially facing a worldwide recession that may be quite long, we feel it would make sense to be ready with a rescue procedure to deal with this over the next few years, not wait until we have gone through it.

What about liquidity? These proposals are not designed for where there is a shortage of liquidity but for where there is balance sheet insolvency, and today's problems are largely credit driven.

The amount of liquidity you need for a period while you restructure is proportionately rather smaller than the amount of liquidity needed completely to refinance a company. If we are looking at a long-term recession, restructuring doesn't just help the junior creditors and make sure that they maintain some stake in the business, it also preserves jobs and peoples' pension funds.

One of the issues about the proposals is that they were presented as insolvency law reform but what we've talked about so far is a precursor to any form of insolvency?

I think we initially called this insolvency law reform because part of what is in our Insolvency Act is expressed to be rescue procedures and legislation. However, in practice that is not how it is being used and I think it has been very difficult for people to get away from the insolvency taint of administration. You and I know that administration in theory can be used and in a few successful cases has been used very well as a rescue tool, but they are very much the minority of cases and it is difficult for this not to be seen as a failure and as a liquidation process. I am not one of those people who criticises the use of pre-pack administrations, but their predominance has tended to reinforce that it is in effect a liquidation procedure.

What makes you say that pre-pack makes administration a liquidation procedure?

Because you have liquidated the assets of the company and you are left with a shell, which means that a large number of the stakeholders have lost out.

In the restructuring scenario, aren't you saying something pretty similar, but just doing it through a different mechanism? You are saying that there is going to be a valuation and the people above the break can participate and those below it can't. Isn't that exactly the same thing?

I see a pre-pack as liquidation because it does simply leave behind the contractual rights and proprietary rights of creditors and stakeholders in an old company and because it can be driven by one class of creditors and takes value away from others. Sometimes administration can be used as a useful restructuring tool but it is rarely used as a tool for a conceptual restructuring where genuinely all of the classes have a right to participate. Also, current jurisprudence is that when an administrator sells an asset, his duty is only to achieve the price he can obtain for the business in the market at the time. It is not genuinely taking into account the long-term interests of the restructured business and potentially the rights of those subordinated creditors who are always investing for a long-term view rather than to get the immediate value of the business.

> "Our proposals are aimed at ensuring that a restructuring accurately reflects the real value of a business, and properly values and recognises each stakeholder's share."

Are you arguing for something that protects against a dominance by the secured lenders in formal insolvency situations?

No, I think that is a whole different issue. What we are suggesting is that where there is a proposal for the business to be kept whole with some of the stakeholders remaining in the deal, it should be treated as a rescue and not as simply a liquidation. There will be cases where administration and a sale of a business is the only option and in many cases a pre-packaged administration is going to be the best way of getting value out of that. I am not sure it is always the best tool for a restructuring >>

within a group, and where it is used as a rather blunt instrument to exclude difficult junior creditors I am not sure it achieves equity or is the best way of protecting the interests of everybody.

Are you saying that this isn't really insolvency reform?

Exactly. I actually think the UK has some of the best insolvency laws in the world. I just don't think we have a useful procedure for restructuring and I don't think administration has been used in the way that it was intended to be used following the Enterprise Act reforms as a rescue for companies.

What size companies would the proposals apply to?

We are looking at companies at the larger end of the market who probably have multiple tiers of debt probably in excess of £200 million.

Are you intending to restrict it to companies with debt in excess of a particular amount or are you saying it is going to be generally available but that it is designed really only to apply to those high-end companies?

We think it is something that is lacking for larger, more complicated restructurings and initially we are proposing it just for them.

We have already got one of the most complex restructuring and insolvency landscapes in terms of the tools we apply. Now you are adding another one?

Really what we are seeking to do is to make slightly more formal the existing system of informal restructuring. We are really not changing the current way that they are done, except to make them more expedient and faster, and to remove the shareholder hold-out factor. We had the London approach and the INSOL rules on guidelines on restructuring but they are largely gone because the participants in the debt markets have changed so radically. We have managed in large restructurings, not because we have wonderful legal tools but because we have a very inventive and resourceful insolvency profession and restructuring advisory profession who have patched together restructurings with what tools are available. The use of schemes of arrangement has been very inventive, as has the use of CVAs. Both have gone beyond what they were originally intended and designed for, but it has worked. It is not necessarily a good thing from the point of view of selling the UK as an investment base that restructuring gets done because people are able to be inventive with the limited tools they have. It is much better to give them the better tool that means there is a degree of certainty in the outcome.

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Is it correct to say that your proposal is not connected with ordinary insolvency, it is just connected with the huge multi-party restructurings that have proved very difficult without a formalised framework?

Correct. Restructurings that have proved difficult and which we think are going to be much more difficult given that the financial structures have become more complex. The financial markets have become a much broader church so we're not just dealing with a group of bankers who to a large degree know each other. We now frequently have transactions where you will have senior secured debt, second lien debt, mezzanine and high yield bonds and potentially some sort of PIK instrument at the bottom. Each of those held by potentially a different class of people. In the large transactions as well as possibly the presence of credit default swap holders, a huge amount of the funds are no longer held by the banks that originated the deals, they are held by either distressed secondary investors or CDO and CLO funds who have very limited resources to engage in heavy restructuring.

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This summer, the Conservative party started talking about insolvency law reform and a lot of what they were saying seemed to echo parts of your proposal. Did you like what they said?

We would welcome in-depth discussion with the Conservative party on how their proposals would fit in with ours. We have only got an outline from them so far and I think they were referring on a number of occasions to Chapter 11 in the US. Our committee is not proposing a wholesale introduction of Chapter 11. It is hoping our proposal will bring the best from various parts of the world's restructuring laws in order to make something that is an excellent English restructuring law.

Where can a copy of the EHYA proposals be found?

www.EHYA.com □

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