EHYA UCL Roundtable Discussion

Is now the time for the UK to adopt a formal proceeding for restructuring distressed companies?

Moderated by **Ian Fletcher**, Professor of International Commercial Law, Head of the Institute of Bankruptcy, Restructuring and Insolvency Law, **University College London**

4 March 2009, 15:00 – 18:00

UK Government
Steve Leinster, Director of Policy - Technical, Legislative & Professional Regulation, **The Insolvency Service**
Peter Brierley, Advisor, **Bank of England**
Joanna Perkins, Secretary, Financial Markets Law Committee, **Bank of England**
Stuart Willey, Chief Counsel, Wholesale Markets and Firms, **FSA**

Academics
Prof. John Armour, Lovells Professor of Law & Finance, Faculty of Law, **University of Oxford**
Dr Maria Carapeto, **Cass Business School**
Prof Julian Franks, Professor of Finance & Academic Director of the Corporate Governance Centre, **London Business School**
Dr Sandra Frisby, Baker & McKenzie Associate Professor and Reader in Corporate and Commercial Law, School of Law, **University of Nottingham**

Professional Bodies
Richard Heis, **R3**, Partner, KPMG
Angela Knight, Chief Executive, **British Bankers Association**
Robert O Sanderson, President, **INSOL International**
Geoffrey Yeowart, Partner, Lovells, **City of London Law Society**

Judiciary
Mr Justice Blackburne
Lord Neuberger

Practitioners
Neville Kahn, Partner, **Deloitte**
Nick Segal, Partner, **Freshfields Bruckhaus Deringer**
Richard Sheldon, QC, **3-4 South Square**

Company Directors
Tony Alvarez III, Managing Director, **Alvarez & Marsal**
Ken Maciver CBE, Chairman, **TMD Friction**
John Weston, Chairman, **Isoft Group**

Investors
Terry Hughes, Partner, **Silver Point Europe LLP**

EHYA
Mark Andrews, Partner, **Denton Wilde & Sapte**
Dan Hamilton, Partner, **White & Case and Co-Chair**, **EHYA Insolvency Reform Committee**
Gilbey Strub, Managing Director, **EHYA**
Andrew Wilkinson, Co-Head of Restructuring, **Goldman Sachs and Co-Chair**, **EHYA Insolvency Reform Committee**

Restructuring Procedure Reform – Timely Change For Britain's Economy

A Roundtable Discussion on EHYA (European High Yield Association) Reform Proposals with Government, Academia, Professional Bodies, Practitioners and the Judiciary.

Moderated by Ian Fletcher, Professor of International Commercial Law, UCL Institute of Bankruptcy, Restructuring and Insolvency Law

Wednesday 4th March 2009

Herewith are notes from the discussion. The roundtable discussion was conducted in an open and frank way where the views expressed by the panellists were in the main, their personal opinions and not necessarily of their organisations.

INTRODUCTION

The event started with a warm welcome from Gilbey Strub, Managing Director of EHYA and Professor Ian Fletcher of UCL welcoming everyone to the event and in particular thanking the participants in the roundtable discussion for giving their time and views to the issues at hand.

There followed a brief statement from Stephen Leinster of The Insolvency Service who gave a brief overview of their dealings with the EHYA, and the need for any insolvency regime to have a balanced approach, taking into account the views of all the different stakeholders. The UK insolvency system is generally acknowledged as being more creditor friendly and business is aware of this. Any change to this emphasis would have wider consequences in other parts of the economy. All these factors are highlighted to Ministers, who would need to be satisfied that the benefits outweigh the detriments of any new policy proposals. Today, the INSS has a listening brief.

Andrew Wilkinson of the EHYA then gave a summary of the EHYA proposals. He talked about the financial institutions that were in crisis and the different challenges that they face with the collapse of the shadow banking system. He said it was recognised that the insolvency system for financial institutions doesn't work, hence the new Banking Act, with specific rules on insolvency. If it has been recognised that the insolvency regime for financial institutions does not work, what about for corporates?

He then talked about the level of debt in Europe and falling asset prices. From research, it has been shown that following a large issuance of debt, default normally occurs after two to four years. In the current cycle, this could affect corporates around 2010/2011. With LBOs, there is around 140 billion euro debt in Europe, which could affect 6M employees. Therefore the time to act is now.

Future restructurings could involve organisations with 100 billion euros of debt, very large companies, which have previously been unseen in Europe before.

Restructurings can be quite long in Europe, taking at least 12 months to work out. Eurotunnel took three to four years.

Capital/Financing structures tend to be more complex, with multiple layers of financing (sometimes up to 12 different layers). Different lenders want different outcomes, and the groups are no longer

homogenous, and it is difficult to reach any agreement on a restructuring.

Need to decide on a method of valuation, with the crucial question of ‘Where does value break?’ There are no real laws on this in the UK, and therefore has to be agreed informally between the different parties. This isn’t an ideal situation.

Market value or liquidation value? – Is there an alternative, particularly in light of the fact that an asset is unlikely to be sold in a restructuring anyway. Therefore, why use the liquidation value?

Briefly went through the EHYA specific proposals of an extended Stay, Monitor, Funding, Implementation (schemes), and Valuation (Dispute Resolution).

SESSION 1: MANAGING THE DEBTOR DURING THE RESTRUCTURING PROCESS

1) Is there a need for reform? If so, what kind of approach is required?

What is your assessment of the effectiveness, and “fitness for purpose” of the procedures currently available in the UK for undertaking a restructuring of a large, multi-national corporate with multiple layers of debt? What do you perceive to be the wider consequences of any shortcomings you have identified?

Views were expressed by a current CEO/Chief Executive (John Weston, Isoft Group), who had experienced financial difficulties in some of the companies he was involved in. He talked about the need to balance the interests of the various stakeholders, e.g. shareholders, lenders, trade creditors, employees, customers, etc.

Problems can be exacerbated when stakeholders get news of difficulties. In one of his companies, short selling drove down the value of shares. Once in a downward spiral, the chance of a successful rights issue has effectively gone, so the business is in the hands of its lenders where the only card left to play is the threat of going into a formal insolvency procedure, such as administration. Why would suppliers continue to support a company if they might not get paid?

We need an alternative to these procedures to manage the cycle of the crisis in confidence and stigma associated with insolvency. This still occurs even if you have a strong company that is in temporary difficulty. Current options for banks are either to restructure or liquidate (cash in assets).

It would be much better if one could get a stay while matters are being resolved. Eventually they did sort out the business (restructure), but it was touch and go with the banks, and had to sell at a knock-down price.

However, we do not want a system that makes banks more risk-averse to lending or where poor performance occurs indefinitely. Therefore the right balance has to be struck, but it is clear that current UK and broader European regimes need improvement and could be better at protecting companies/industry.

Another CEO (Ken Maciver, TMD Friction) talked about the knock-on effect from large restructurings on smaller companies – the supply chain effect. These can be very competitive, good companies. In the example given, a business restructuring was completed in 2006 but finances were stretched and the capital structure needed to be addressed. The capital structure

was very complex with interconnected lending and fluctuating values. Concerned parties could not agree a restructuring even though it was necessary.

A drawn out ad hoc attempt at restructuring tends to destroy value both to financial stakeholders as well as to the host economy. Can only preserve value, if any valuation is based on an ongoing/going-concern basis. If customers get concerned and don't order, value is harmed, suppliers withdraw credit. Also you need employee security or they will go elsewhere, and good managers will find other jobs. Restructuring is also very distracting, and diverts attention away from running the business, which also destroys value.

It is important for the economy as a whole to keep good businesses going. In this example, the company was sold to a weaker competitor that ironically had spent a lot of time in Chapter 11, a solution enforced by a German administration procedure.

Views were then expressed from an Insolvency Practitioner (Neville Kahn) with a lot of experience of rescuing/dealing with companies of all sizes in financial difficulty. He experiences a lot of frustration with the current restructuring system. At the smaller end of the market, informal restructuring works well, normally because there are fewer parties involved and it is easier to get agreement on the way forward. When the companies end up in administration, normally the result is fire sales, as it is difficult to get funding and partly because of the culture of IP profession in seeking quick returns.

For large scale corporates, again informal workouts can work well. However under formal procedures, problems of complex financial structures, too many competing bodies, e.g. banks, hedge funds, other debt holders, etc. emerge, which often make reaching consensus very difficult. On the other hand in the US, banks strive towards a rescue.

The UK needs a system where you can have priority funding to ensure cash is available and also a cramdown feature, to force restructurings through, so you can maintain economic value.

Pan-European insolvencies a particular issue.

Are there any lessons to be drawn from recent, high-profile cases (e.g. Lehman; Federal Mogul) which indicate how value erosion could be reduced, and effective outcomes achieved, if there were additional tools in the locker?

An international restructuring expert (Tony Alvarez III, Alvarez & Marsal) gave his view that it was difficult to deal with the UK part of Lehman due to the lack of time to plan. Lehman was an integrated financial institution operating in a number of countries around the world and so was very complex. This resulted in a number of insolvencies around the world, with the main ones in the US, UK and Japan. He considers that $75B of asset value has been lost/destroyed due to the lack of time in which to prepare for the restructuring.

Alvarez feels US companies are advantaged by being able to wipe out debt, thus enabling them to buy assets in these current difficult times of poor liquidity. He gave an example of TMD Friction, which was in essence a better company than its purchaser, Federal Mogul, but FM had the benefit of already going through a restructuring in Chapter 11, wiping out its debt, and so was better placed to become the predator with TMD as the prey. Often the first companies in an industry to go through a restructuring of finances are often the best placed to take advantage of opportunities in the future.

A regulator (Stuart Willey, FSA) then gave his views. He concentrated on the restructuring of banks and financial institutions. The immediate cause of the failure of individual institutions was in most cases a collapse of market confidence, leading to withdrawal of funding and then a liquidity crisis within the institution. At the onset of the crisis in August 2007 it was apparent that the restructuring tools available to deal with failing banks were inadequate. Now following the implementation of the Banking Act 2009 a wider range of tools is available to deal effectively with the insolvency of financial institutions. What is important for the FSA and the tripartite authorities is the ability and competency to take pre-emptive action to stop confidence going in the first place by organising a private sector work out involving merger or reorganisation of the institution. In this respect, the EHYA proposals are relevant and analogous in providing more flexibility to enable a company to avoid failure.

With regards to Lehman, the cause of the failure of the UK companies was the withdrawal of funding from the parent and this caused the directors to apply for administration. However the timing was such that the administrators had no time to prepare, had had no experience of running a financial institution but were expected to take over the running of a highly complex international business. In US, the insolvency was delayed because the bank was supported through the provision of funding by the New York Fed. This allowed time for an initial orderly wind down and the broker dealer did not immediately file for insolvency. The funding in the US part of Lehman allowed a more orderly insolvency than in the UK.

What do empirical studies tell us about the relative efficiency of UK insolvency procedures, compared to those of other European countries or the USA? What do you consider to be the key elements in the other systems that are currently absent from that of the UK?

An academic (Professor Julian Franks) gave his views on this question. Not many comparative studies have been undertaken of insolvency procedures in different countries. What there is don't show the UK in too bad a light. In a study of 2300 companies in France, Germany and the UK, which looked at the level of liquidations vs going concerns, recovery rates, etc, the UK came out well. French procedures were not looked on favourably.

In a World Bank study of 88 countries, UK procedures also came out well. US style Chapter 7 and 11 procedures also fare well. Most companies in the US use Chapter 7 (liquidation); typically Chapter 11 is used by large companies.

There are few deviations in priority of payment – this may be due to moves in the last few years to curb abuses of process, resulting in less deviation from strict policy of priority for secured creditors.

There is intense judicial oversight in the US, with many judges making business decisions. This is a key question for the UK – Who will have oversight? If not the judiciary, then who might do this?

Any new system needs to be seen in the context of each country's law, and must have judicial buy-in.

What additional factors do you regard as adding weight to the case for introducing a formal restructuring procedure? Do you have any views about the relative merits of Chapter 11 versus Administration in terms of, e.g. direct costs, efficiency, fairness and transparency?

Another academic (Professor John Armour) gave his views. So far as direct costs are concerned, empirical studies of US and UK insolvencies appear to suggest costs are significantly higher in the UK. Bris, Welch and Zhu (2006) found that direct costs in Chapter 11 cases were around 9% of

gross realised asset values, probably about 11% of net assets realised. In the UK three studies — one by Franks and Sussman (2000), one by Citron, Wright, Rippington and Ball (2004) and a third by Armour, Hsu and Walters (2006) – report consistently that the costs of both receiverships and administrations are around 25-30% of net assets. However, to compare UK and US studies may be misleading owing to the different sizes of the typical firm going into insolvency — being much larger in the US. There is a scale effect in insolvency costs — that is, there are economies of scale — so that larger cases tend to incur costs which are a smaller proportion of the assets. One conjecture, however, is that the difference in costs has something to do with the higher level of professional involvement in UK insolvency procedures, as compared with Chapter 11 where the firm continues to be run by existing management.

Out of court restructurings work effectively in the UK for smaller companies where there are relatively few significant lenders and parties can agree on the way forward without going into formal insolvency proceedings. However, the sort of complex financial structures typically found in large corporates make out of court restructuring difficult, as we have heard already. A Chapter 11 type mechanism can help to reduce the costs of consequent creditor failure to agree by permitting the firm to continue to operate and raise finance more easily. In particular, DIP lending reduces consequences in terms of costs where there is a lack of agreement between creditor groups.

A potential downside of DIP financing in Chapter 11 is that the ability to give super-priority to DIP lenders may be thought to give the debtor too much power. However the evidence from the US is that creditors are now controlling this process through the terms of the DIP financing agreement and have taken the driving seat in Chapter 11. A study by Ayotte and Morrison (2008) concludes that those providing DIP finance control outcomes. This results in creditors controlling the procedure, and has a lot of aspects which are comparable with the UK's more creditor friendly approach. In particular, the presence of 'oversecured' secured creditors seems to be associated with a greater likelihood of fire sales in Chapter 11, a finding that might be more expected in relation to the UK's more overtly creditor-oriented procedures.

Tony Alvarez noted Chapter 11 is not a panacea. It has its own strengths and weaknesses. You need to look at what you can take out of each procedure (US and UK) that is good/beneficial.

Less IP input in US leads to lower costs. It would be interesting to carry out a study of Lehman on both sides of the Atlantic and compare the costs when both cases are complete. In the UK, the restructuring is being carried out by 400 staff, while in the US, only 160 staff.

One big advantage in the US is that contracts are generally honoured. It would be very helpful to ensure that a counter-party to a contract must honour it as long as the company complies with its contractual terms. In Europe, even if the company (in an insolvency procedure) complies, counter-parties can renege due to the insolvency event. This has a big impact on value.

A bank advisor/specialist/regulator (Peter Brierley, Bank of England) explained the rationale of the London Approach. It was aimed at preventing the failure of viable companies as a consequence of short term problems/issues and was used quite successfully in the late 80's/early 90's recession. It is an informal out-of-court rescue/restructuring procedure.

The London Approach was subsequently globalised through the INSOL principles, which he feels are still relevant. Furthermore, all insolvency regimes should provide incentives for efficient private out-of-court mechanisms for rescuing and restructuring viable companies.

Could the London Approach work today with the different financing structures that currently exist?

Probably not in the previous format. A number of key issues would need to be addressed:

- The London Approach was based upon unanimity, and there would need to be a move away from this, and agreement on some degree of majority voting/cramdown. The requirement for majority decisions should be greater than in an insolvency proceeding. Creditors may be prepared to tolerate a limited degree of cramdown in a pre-insolvency workout if the only alternative is an even greater degree of cramdown in an insolvency proceeding.
- The London Approach was based upon an informal standstill, a voluntarily agreed informal moratorium. A more formal moratorium would probably be needed now. Key questions would include: How would one initiate this? How is the company run during the moratorium? How does the company exit the moratorium?
- Where new money is introduced during the moratorium, another issue concerns the degree of priority it should have.
- What about recognition of the existing seniority of claims?
- What about the principle of sharing losses in similar creditor groups?
- How might the process deal with more far reaching financial change as part of restructuring?

Another group of issues concerned the need to protect netting and set off, and the rights of holders of financial contracts to close out. Protection for set-off and netting arrangements must be made clear (big issue in Banking Act). One other issue with the EHYA proposals concerned the disapplication of negative pledges. This could well cause unintended consequences, e.g. on the willingness to provide unsecured finance, possibly leading to more secured financing.

Some parts of the EHYA proposals are good, but should be subject to an independent review of the business to ensure that companies were indeed viable in the long term. Not all businesses necessarily deserved to be rescued.

Therefore, although some of the ideas are promising, there are still many questions to be answered.

A specialist lawyer in banking and finance, (Geoffrey Yeowart, Lovells, City of London Law Society), then gave his views. He agreed with the previous speaker, suggesting that the London Approach (as restated in the INSOL Principles for a global approach to multi-creditor workouts) is still relevant and can preserve value. As it works by way of contract, success depends on achieving unanimity. In this increasingly complex world, informal, consensual restructuring can be more costly and take longer where a minority of financial creditors do not adhere to those Principles.

Some form of statutory mechanism for a moratorium and "cramdown" in large company restructurings might be useful. There is a case for a power to cram down a whole class of creditors in a scheme of arrangement, subject to ensuring fairness and not putting them in a worse position than applies in a liquidation. There is also a case for a moratorium but serious questions arise about its scope (there is a strong argument that it should not go beyond the moratorium which applies in an administration). A balance needs to be struck between creating a period of stability to facilitate a restructuring and not exposing creditors to increased risk. Carve outs would also be necessary for financial collateral and other arrangements protected by UK regulations implementing EC directives. On whom would the moratorium bite? It would need to apply to all creditors but a basic principle of the London Approach is that trade and non-financial creditors be paid in full in the course of continued trading. More checks and balances would be essential, particularly with regard to the initiation process – should directors alone decide? No, as a safeguard, the consent of a prescribed majority of larger financial creditors should be required at an early stage.

What other alternatives (e.g. CCAA, Canada) might be considered for possible adaptation, and what features are considered to be of primary importance, viewed from an international perspective?

An international restructuring expert (Bob Sanderson, INSOL International) with particular emphasis on financial institutions gave his views. He suggested that in essence, this is a business issue that needs to be solved in a societal context. There is too much debt out there. If you change the rules, you have to make sure you don't conflict with societal expectations and the way a country operates on a wider scale is not affected. You can get friction because people in one society don't like what they see elsewhere.

You need to get the balance right as far as possible i.e. the balance between rescue of corporate/business and liquidation and balance of out of court and formal procedures. Out of court works if the alternative is ugly!

He then talked about the Canadian approach. It is a principle based, simple and very flexible system. The law codifies the practice. It needs a high level of Judicial activism, with the court available 24/7. Individuals on the Bench have to be available to give their opinions/decisions. You don't have to wait on legislators to fix a problem, practitioners find a way, then go to a judge or Monitor for approval.

Role of Monitor might vary depending on which judge is in charge. Demonstration to the court that restructuring is the best option compared to other alternatives is necessary.

Need threshold to get in, which is currently set too low. Only largest entities can afford it. The danger is it goes away from being a business deal and everyone tries to use the court to gain an advantage. Costs can then escalate, destroying company value. This can then lead people to go the informal, out of court route. Therefore the right balance should be struck.

Also have issues with forum shopping, between US and Canada.

2) Moving to the specific terms of the EHYA proposals

The moderator then asked for the views of the chief executive of a professional body representing banks (Angela Knight, BBA). She stressed that you can't directly import ideas from one jurisdiction to another without modifications to suit the jurisdiction where change is being made. Also the specific detail of any legislation is important, not just the basic ideas. The EHYA proposals need more detail. Banks are different to other corporates, and one cannot extrapolate from Lehmans.

Banks have a variety of concerns with the EHYA proposals. The reality is, despite complex funding arrangements, in the long term, companies need to go to banks for funding. Some of these EHYA proposals may add costs to funding and in the most extreme scenario, the funding may not be there. Specifically the overriding of negative pledges is a big no-no for banks.

There is also concern with the amount of judicial involvement/preference in the process, would prefer less involvement, more out of court decision-making. No real problems with the cramdown provisions, could be helpful. However, believe the stay is too broad - need to work out the implications of its breadth. Too long, has consequential effects. Super-priority - Can't agree to new funding overriding existing funding.

Agree there is an issue here, but believe solution lies in an improvement/review of the London

Approach with teeth, rather than an imported system.

Dan Hamilton challenged this, arguing that the London Approach is not enough. Nowadays, financing involves a lot more players than just banks. Sometimes, it isn't that creditors do not want to help find a solution, it's just that they can't.

Knight responded that she was not arguing for the London Approach as it is but a strengthened version of the London Approach.

The first session then concluded.

SESSION 2: VALUATION AND THE FURTHER ROLE OF THE COURT

1. Judicial observations

Contentious matters are likely to arise at several points in the process - at the initial application for the stay; at any application by a creditor for a lifting of the stay on the ground of undue prejudice; at the stage of establishing the valuation on which to determine those classes which are to be involved in the voting procedure, and which can be excluded from any capability to block the adoption of the agreement; and at the final confirmation by the court. What are the views of the judges regarding the conduct of such litigation at the trial and appellate levels? Will special procedures be required in view of the time-critical nature of such disputes?

Firstly, a current Law Lord (Lord Neuberger) gave his views on these issues. His immediate view is that the EHYA proposals will have a profound effect on the judiciary if they are adopted. This is much more a court-based process, which will lead to more lawyers and more court room activity. This will impact on case management, time, and expertise with the consequent resource implications. It had been hoped that the Civil Procedural Rules ("CPR") would make Courts/judges more pro-active, but there has been limited change.

The proposals will also require a high level of judicial activism. Judges would need to be more pro-active. A judge would need to step in, even more so than in ADR (alternative dispute resolution) and more mediation would be necessary. Previous experience of new court procedures suggests this won't happen easily. Current court role is just to decide who gets what from the pot, not actively engage in rescuing companies.

Proposals would need the judge to run the show and make business decisions. Experience of mediation will help. Most judges would traditionally be unhappy with making business decisions. However, Chancery judges currently interpret/apply business common sense in making risk-based decisions in commercial cases. Nevertheless, it would still be a big step and change in culture to make business decisions, in this sense.

Valuation decisions - already do some of this, but these proposals require a degree of expertise, adding to the learning curve. On the whole, judges would be unfamiliar with this. The US has a specialised Bankruptcy Court. The EHYA proposals would require more judges and perhaps the creation of a specialised bankruptcy court in the UK. However, there are already specialists in the Chancery Division.

All the judicial changes required will be very costly, including timing and accommodation (especially if 24/7 provision), and it is extremely difficult to obtain funding for the judiciary. It may be that, if there were a feeling this would rescue businesses and save jobs may get political clout to bring it in.

Also need to consider the role of the Court of Appeal. With any new law, there will always be contentious issues/points. Court of Appeal would need to be less inclined to second guess judge's decisions or it will increase uncertainty. Therefore need to give guidance, let parties act quickly and also be prepared to let judges act quickly too.

Finally, he pointed out that the English system is not as inflexible as some have suggested, using the Maxwell case as an example of where the English courts/judiciary demonstrated great flexibility.

Next, a sitting Chancery Judge (Justice Blackburne) with vast experience of insolvency issues gave his views. He felt he could run/live with the EHYA proposals, or something similar.

However, he was not in favour of judicial activism, being called upon 24/7 to make business decisions. The CPR haven't really succeeded in making Courts more proactive. The proposal could have the problem of excessive appeals, as is happening in Canada, making the whole process more costly, if you are going to court all the time to resolve issues.

With regard to the initiation/activation of the procedure:

Mr Justice Blackburne opined that the court process should not be initiated by the directors of the relevant company alone but only with the consent of a majority of larger financial creditors. Otherwise, there is the possibility of a large number of appeals and even more litigation.

DIP - He feels there is an excessive involvement of professionals in Administration; it would be preferable to have a system of DIP with a Monitor. He often asks how the original proposed outcome in the administrator's proposals stacks up against the reality of the actual outcome and is often not impressed. Valuation should be carried out by professionals.

Valuation disputes are inevitable - needs a mechanism that does not create an adversarial approach, e.g. Courts could have the power to appoint an assessor to help.

2. Valuation methodology

<u>What are the possible alternative methods to use when carrying out the valuation of the business and its assets, and which is the appropriate one to apply in this process?</u>

An academic (Dr Maria Carapeto) gave her view based on her own research and also other studies she had read. The main idea is to preserve value, comparing the going concern value and liquidation value. If liquidation value is better, do that.

You can have different types of restructuring, not just asset restructuring but also operational, financial and managerial. What if bad management was to blame for company's problems - should we leave them in control?

DIP financing/new funding - this is crucial if the company is to survive. Much higher survival rates

found and also greater recovery rates for creditors. What about exit financing when company emerges from restructuring.

Priming liens - tends to lead to unsecured creditors being worse off and a greater chance of liquidation. Therefore no need to rank new lending highest and give it priming, most important thing is that it is given priority over other unsecured creditors.

Some research shows that there is a wide variation in the valuations of businesses/assets under Chapter 11 plans of reogranisation, looking at the highest and lowest values, but the average is generally consistent across the board.

An insolvency lawyer with experience in commercial and banking law, insolvency and litigation on both sides of the Atlantic (Nick Segal, Freshfields) then gave his views:

The EHYA proposal requires a valuation "calculated on a going concern basis on the assumption that the restructuring has completed successfully". This is unacceptable unless other changes are also made to the scheme of arrangement procedure.

Currently, where a scheme of arrangement is proposed valuations are relevant to determine whether creditors have no economic interest in the debtor. If they do not, a creditors' scheme can proceed even if such out of the money creditors receive no benefits under it. This means that other senior creditors can be made parties to and receive benefits under the schemes and the court, at the stage of deciding whether to sanction the scheme, will allow the scheme to proceed. Under current law, the court, when determining whether the scheme is fair to such out of the money creditors, considers what they would get if the scheme was not approved. The court therefore considers the alternative to the scheme, often although not necessarily an insolvent winding up, and works out what the opposing creditors (who have not been made parties to the scheme and therefore whose legal rights are not being varied or discharged by it) would have received thereunder. This is why in most cases currently a valuation is done on the basis of a winding up valuation.

The EHYA proposal will result in a higher number for the value of the debtor. This will enfranchise creditor groups who currently, for the reasons mentioned above, would not have to vote on a scheme and could be ignored. That of itself is not the problem - the problem is that under current law, there is no ability to have a scheme approved against the wishes of a dissenting class. As a result, if the EHYA proposals are adopted without amendment, and these junior creditors are now given a vote, they will have a right of veto as English law currently stands - and there will be more hold outs and problems rather than less.

The EHYA proposal, in particular the idea that the valuation has to be prepared on the assumption that the restructuring has completed successfully, is based on the approach in chapter 11 reorganisations (which is based on various US Supreme Court decisions of the 1930's and 1940's). But it is dangerous to lift one element of a carefully constructed and interconnected procedure without taking or dealing with the other parts. The reason why the US approach is acceptable and makes sense is because whilst on the one hand it results in a higher valuation than in English schemes and enfranchises junior creditors it protects senior creditors by providing for the cramdown of dissenting classes based on explicit criteria that establish what junior classes have to receive under the plan in order to have their rights varied without their consent. If the EHYA proposal is to be adopted in England, we would need similar provisions.

It is also worth noting that in the US (in particular in the bankruptcy law literature) there are

increasing concerns over the impact of litigation in bankruptcy court over valuations and the reliability of judicial determinations of value - and some discussion of finding alternative methods of establishing, and fora in which to establish, the value of a debtor's business.

Does the prospect of having a predictable method of valuation offer improved prospects of concluding a binding 'deal' quickly and effectively, and if so, does that come at the expense of possible allegations of unfairness/expropriation for some parties? Do the plusses outweigh the minuses?

An experienced fund manager/investor (Terry Hughes, Silverpoint) gave his views. Unsurprisingly, the obvious answer is yes. A predictable method of valuation is a huge benefit. It gives an improved degree of predictability to the whole process.

However, valuation is only one question that needs to be considered when looking at any potential deal. Need to consider the extent of the stay, availability of DIP financing, etc. - you need to take/consider all these factors in the round. Also have to consider that some valuations may be incorrect.

From experience, in nearly all the successful reorganisations/outcomes, a crucial component is that there is someone taking the lead. They work on getting an agreed consensus. This role is possibly more than that of a Monitor, but would occur before a judge sees the case (normally you have quite serious problems if you are taking things before a judge). This party would need to have the confidence of all parties involved.

In addition, in today's world, there are more stakeholders' views to be taken into account, e.g. pensions, unions, etc. You have to consider a multitude of factors in addition to valuation when looking at a deal.

3. Holdout/Cramdown issues

How does the proposed method of valuation affect the operation of cramdown at the stage of voting on the terms of the restructurings? Are there any practical ways in which the delay and cost of valuation litigation can be kept to a minimum?

A specialist in financial sector restructuring and insolvencies (Richard Heis, KPMG, R3) gave his views.

Holdout strategies tend to lead to increased costs. System would benefit from greater predictability due to holdout of junior creditors, but it is very important that this does not destroy the benefits of the current flexible system.

He struggles with the practicalities/details of how any valuation regime will work. What will the future entity look like? Should all the creditors benefit from a valuation that incorporates financing provided by some creditors or operational improvements conditional on the financial restructuring? Is there a level playing field regarding availability of information?

Although the idea is sensible, you have to make sure the practicalities don't drag it down, and valuation does not become another "card to play". Something that allows genuinely out-of–the-money creditors to be ignored (not "crammed down") would be welcome, but Heis was nervous about a big and complex valuation process.

What role might the Monitor play during this phase of the process? Might s/he, as an officer of the court, perform a role as independent arbiter of fair value, enjoying access to sensitive information that the company might not wish to disclose to all interested parties? What status/qualifications should a Monitor be required to have?

Richard Sheldon, Q.C. who has advised on several high profile restructuring and insolvency cases gave his views.

The role of the Monitor must be carried out by a regulated professional. A regulated Insolvency Practitioner is the obvious person, and the Monitor must also be an officer of the court.

The role should be kept flexible, don't want it too prescriptive, otherwise don't have room to manoeuvre and ability to deal with ad hoc requests. Not all cases will be the same.

It is important to report to creditors, to keep them in the loop.

The valuation method needs to be settled. The Monitor could get the information together to help achieve this. They could bang heads together to try and get an agreement amongst all parties but this could be difficult to achieve in practice.

What further protection may be required to ensure fairness and transparency are not sacrificed on the alter of "the deal"? Does recent experience with CVAs and with pre-packaged administrations reveal any special dangers that would have to be addressed?

An academic with extensive experience of empirical research in the corporate insolvency field (Dr Sandra Frisby), most recently pre-packaged administrations gave her views.

She feels that the issues of transparency that have arisen in pre-packs are unlikely to arise in the EHYA proposals. However, the moratorium would need to be advertised – Would this erode value?

Have to make sure that the valuation method is appropriate and fair and fits the likely end outcome, i.e. restructuring or liquidation.

Have to be specific about what role the Monitor has? Operational aspects of the company – no role.

Have to consider the overall impact of undergoing any insolvency/restructuring procedure, even if a completely new procedure, i.e. Trade creditors – may give them the wrong impression. They might think there is something wrong with the company, but this may not be the case.

4. Reflections on the proposals "in the round": is there a case for further reform?

Dr. Joanna Perkins, Secretary, Financial Markets Law Committee, gave her views:

She stressed that the laws of secured lending and the laws of insolvency are closely linked. The development of a particular approach to factoring, the registration of charges and choice of law rules is often specific to the legal and cultural framework within which insolvency law operates. It is difficult to tamper with some laws and not others. We do not want to create uncertainty.

Of particular concern could be the impact of the introduction of DIP financing, with the attendant concepts of super priority or super seniority. Also the effects of the moratorium need to be fully

considered, particularly in the context of the Financial Collateral Arrangements Directive.

As an aside, perhaps consider which insolvency regime incentivises bad behaviour mentioned earlier, namely the seeding of negative press articles aimed at undermining a company's creditworthiness by those whose interests run counter to the company's own interests.

A time of illiquidity is a bad time to introduce DIP financing.

Taking overall the views expressed today, the least controversial proposal is that of cramdown, and the most controversial is DIP financing.

Has experience shown that the problems addressed above can already be met using existing procedures such as Administration coupled with a Scheme? Do cases such as *My Travel* and *Federal Mogul* offer conclusive proof that there is no need for additional reforms/new procedures? Or, conversely, are there crucial elements which are lacking in the current procedures?

Richard Sheldon, Q.C., initially gave his views.

The case of My Travel:
Restructuring was blocked by junior class creditors. Eventually they managed to restructure after lots of litigation. The case highlights the current deficiencies:

1. It would be helpful if the court were given a discretionary power to decide on threshold levels. Don't want "out of the money" creditors having too much of an influence. The court should also be able to decide a wider range of issues.

2. There is a danger that the Court is being sucked into the process as a regulatory tool. However, should not decide all issues of valuation. A lot can be done at a later stage, when fairness issues are being considered.

Cramdown – Court cannot alter the existing rights of creditors or shareholders, even if they are "out of the money". He would like the Court to be able to cramdown these, and would like consideration to be given to the power of the Court to approve scheme proposals, even if 75% majority is not obtained. Currently, in Australia the Court has the residual discretion to do this.

Finally, Mark Andrews of Denton Wilde Sapte, a highly experienced and well regarded insolvency lawyer gave his views.

First, he explained that the history and outcome of the Federal Mogul case would not have been affected by the EHYA Proposals.

The EHYA believe that change is needed, not because they are dissatisfied with existing procedures. These were generally good and reasonably flexible, although he feels we do need an enhanced stay.

The issue was essentially that the EHYA were dissatisfied with our current approach to pre-insolvency restructuring. There is as much value lost here, as in a formal insolvency.

Existing procedures cannot solve the problem. Administration is a possibility, but it would, at this time, require too much of a cultural change.

A new procedure is required to solve the perceived problem. The quintessential EHYA member is currently squeezed between, at the bottom, the equity holders who are “out of the money”, and, at the top, the senior secured creditors with, in pragmatic terms, almost unlimited power.

The senior secured creditors dominate restructurings. They can pre-empt the debate regarding valuation by selling the business to themselves (by a pre-pack), appropriating to themselves all the value in the restructured business. This is unfair. Mr Andrews noted that [Nick Segal of Freshfields] had already outlined the differences between the 2 valuation approaches very clearly. In Mr Andrews' view, a US valuation method of the type used in Chapter 11 (i.e. basing the valuation on a successful re-organisation of the whole business) offers a much fairer way of distributing value between competing groups. However, this would require substantial changes in our law.