WORK-OUTS

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Mr Chairman, Ladies and Gentlemen.

I feel I must say first how honoured I am to be asked to address this conference and I would like to thank the Banking Law Association for both this and its hospitality. I feel I am among friends; many of your members I have had the pleasure of working with over a fifteen year period, and I hope therefore that I am not under the kind of threat that was communicated to me recently by a Boston attorney when he sent me an extract from his staff handbook which read: "Solicitors: Solicitors are not permitted on our premises. If any solicitors are encountered, notify the support services department, extension 8484. They will in turn escort the person from the building."

I have been asked to speak to you today on the UK Insolvency Act and in particular the administration procedure coupled with our experience of how the procedures under the Act are working. And also contrast it with our experience of contractual restructurings.

I hope you are not doing anything else today, because that is a vast topic and one which would take many hours to do justice to. I have in mind however, that it is in some manner a sequel to my partner, Philip Wood's talk to you of last year - a kind of Return from the Future, Part 2. Philip does not normally stint his words. Any of you who have read "The Law of English and International Set Off" cover to cover, all 1200 pages, know that well. But Philip I think passed quite briefly on the subject and posed the philosophical question of whether you should be aiming for procedures in line with our own administration or in line with Chapter 11 in the United States.

I have come here to hear your answer, and I hope in some measure to assist in your deliberations. As a well known lover of compromise rather than confrontation as the basis for all successful negotiations, I may perhaps hope that your reply will be a mixture of both systems, with perhaps a little of the Irish and even the Spanish ***suspension de pagos***, or Italian ***administrazione controllata*** thrown into the recipe for good measure and extra flavour. First then to the Act itself.

The Insolvency Act 1986 represented the most important reform of insolvency law in Great Britain for over a century. As far as companies are concerned these provisions brought in new procedures for dealing with corporate insolvencies (including the administration procedure, voluntary arrangements and the new position of administrative receivers). It imposed, together with the Company Directors' (Disqualification Act) 1986, new disqualification and personal liability sanctions on directors of companies which became insolvent. It also set out new rules governing transactions at an undervalue, preferences and other arrangements.

Before the passing of the Act there were only two procedures for dealing with a corporate insolvency: liquidation or receivership. And there was no satisfactory procedure for carrying out a rescheduling or similar scheme in a way which made it binding on all the company's creditors. Neither of these procedures permitted the appointment of a person to run the business for the benefit of the creditors as a whole. A liquidator had to act for the benefit of creditors generally, but had only limited powers to carry on trading, while a receiver, who did have authority to trade, was responsible only to the bank or creditor who appointed him and not to the creditors generally. Moreover, if there was no creditor with security over all the company's assets, liquidation was normally the only available procedure unless a rescheduling of the company's debts could be negotiated among all its creditors.

As regards procedures for carrying through reschedulings and similar arrangements, the main methods were either for all creditors (or all financial creditors) to sign a rescheduling agreement or to carry out a scheme of arrangement under s425 of the Companies Act 1985. The first method required the consent of each creditor whose debt was to be rescheduled, and this requirement of unanimity gave individual creditors a disproportionately strong bargaining position. The second procedure was cumbersome, involving applications to the court and sometimes difficult questions of law about which creditors constituted a separate "class", separate classes having to give their consent at separate class meetings.

With a view to making good these deficiencies, the Act introduced two new procedures: administration and voluntary arrangements. It also introduced the new concept of the administrative receiver, ie a receiver appointed of the whole or substantially the whole of a company's assets under security which includes a floating charge. It is necessary if the secured creditor wishes to have the ability to appoint an administrative receiver for his security to contain a floating charge even if almost all the assets are subject to fixed charges.

Whether an appointee is or is not an administrative receiver is a question of fact, depending on whether the statutory conditions are fulfilled. The advantage of being an administrative receiver is that the receiver is given certain additional powers by the Insolvency Act (although a well drafted security would give most of these powers to a receiver who was not an administrative receiver). They also include the power to carry on the company's business and under s43 of the Insolvency Act the power to apply to the court for an order to dispose of property free from any prior charge, the prior charge instead attaching to the proceeds of sale. This power is not capable of being given to non-administrative receivers by way of the terms of the security under which they are appointed. However, the crucial point for lenders and as to why they should seek the power to appoint an administrative receiver is that the valid appointment of such a receiver prevents the making of an administration order.

As an aside it may be noted that a receiver or manager who is not an administrative receiver need not be qualified to act as an insolvency practitioner.

The Company Directors' (Disqualification Act) 1986 places a positive duty on administrative receivers to report in detail to the Secretary of State where they are satisfied that certain directors or shadow directors of the company are unfit to be concerned in the management of the company. The duty to report on a director or shadow director only arises where the company has become insolvent during or at any time after the director's tenure of office. The Secretary of State then has up to two years from the date of the appointment of the receiver to make an application to the court for a disqualification order.

It is of course entirely possible for able and energetic management, provided the creditors co-operate, to rescue their company from financial difficulties, yet it is not uncommon for weeks or even months to be needed to persuade everyone concerned to reconstruct or to rescue the company. As a result directors are often less willing or frankly, because of creditor pressure, quite unable to trade during the lengthy interim period while the rescue package is put together. With a view to making good these deficiencies, the Act introduced the two new procedures of administration and voluntary arrangements.

The idea of the administration order is to offer the possibility of the preservation of a business in severe financial trouble. The statutory list of powers granted to the administrator is identical to the list of those deemed to be included in any floating charge under which an administrative receiver is appointed. He also has far wider powers to dispose of assets subject to a mortgage or charge, a retention of title claim, or even assets on lease. The procedure involves a petition to and subsequent order by the court. It has similarities to the American Chapter 11 procedure, however unlike administration, where an insolvency practitioner is appointed administrator to take over the running of the company's affairs, a company "in Chapter 11" in the United States retains its existing management. It seems that in the United States, the devil you know is preferred to the devil you don't.

The introduction in the reform of insolvency law of liability for "wrongful trading" was intended as a telling means of encouraging directors to petition for administration at a time sufficiently early in their company's financial difficulties that the order might have a real hope of success. If a director fails to take, once he knows or ought to know that his company has no reasonable prospect of avoiding insolvent liquidation, every step to minimise potential loss to creditors, he may be made personally liable for such amount as the court thinks fit.

A critical aspect of the administration procedure is that on presentation of a petition there is an effective freezing of the company's position. In that moratorium creditors cannot bring proceedings against the company without the court's leave. Without the court's permission no security granted by the company can be enforced, no distress may be levied or execution commenced or continued on the company's goods, and further, owners of goods supplied to the company on hire purchase or certain leases or on sale terms providing for retention of title are not permitted to repossess. Additionally, the court cannot make an order to wind up the company and the shareholders cannot pass a winding up resolution. In short, the company is given a breathing space, protected from precipitated action by its creditors, particularly its secured creditors. The making of the administration order fixes the moratorium in place for the duration of the order.

Now for the court to make that order it must be satisfied that the company is or is likely to become unable to pay its debts, and it must also be satisfied that the making of the order would be likely to achieve one or more of the following. First, the survival of the company and the whole or any part of its undertaking as a going concern. Second, the approval of a voluntary arrangement under the Act. Third, the sanctioning of a scheme of arrangement under the Companies Act and finally, a more advantageous realisation of the company's assets than would be effected on the winding up of the company. The court in its order will specify the purpose of the administration, and of the above the most common grounds are either the first or the last.

Judges and creditors are anxious that companies should not obtain sham administration orders merely to take advantage of the protection from creditors that the order provides.

The result has been that petitions relying on the survival or more advantageous realisation grounds have been dismissed unless the independent insolvency practitioner's report, which is required by the court in support of the petition, contains cogent and compelling evidence that an administration order based on one of these purposes is likely to achieve that end.

It was thought by some that administration would have little chance of being a successful procedure, mainly because of the power of floating charge holders to block the making of the order and it is true that many more floating charges have since 1986 been taken by lenders for just that purpose. But nonetheless there have also been many administrations and I will speak more to that later.

The administrator can dispose of properties subject to a floating charge even if it has crystallised, and with leave of the court, dispose of properties subject to a fixed charge or reservation of title. The court may grant leave where it is satisfied that the disposal would be likely to promote the purpose or purposes specified in the administration order. Where property is disposed of in this way, the chargeholder is protected in the same way as when an administrative receiver sells charged property by being given the same priority in respect of the proceeds of sale as he would have had in respect of the property subject to the security. Those proceeds of sale, if less than the charged property's market value, must be topped up by the administrator to that market value.

A further important consequence of the administration order is to bring into play the sections of the Insolvency Act under which transactions at an undervalue, preferences, and floating charges can be set aside in certain cases.

The Insolvency Act states that an administration order is an order directing that the affairs, business and property of the company in administration shall be managed by the administrator for so long as the order operates. Following his appointment the administrator will follow the same initial steps as an administrative receiver. He will want to ensure that the company's property and assets are in his possession or under his control as soon as possible. There is much to be said for the administrator keeping the directors, (albeit with reduced responsibility) in place, at least if a rescue is envisaged, in order to assist him in understanding the company and its business. The administrator will take control of all assets to which the company appears entitled and not just those items which the company owns. An administrative receiver on the other hand will normally take into his possession only those assets which might be covered by the security under which he is appointed.

The administrator is then required to produce a statement of proposals within three months of his appointment. In formulating those proposals, the administrator will usually try to come to an agreement with a number of key creditors, including the company's bankers if the business and administration is to survive. Such creditors will usually have asked the administrator for a fairly detailed idea of the plans for the company before giving their agreement and so the approval of the proposals presented to the creditors are in some cases simply a formal matter.

What proposals are put forward by the administrator will depend upon the purpose for which he was appointed. For example, if it was to achieve a better realisation of a company's assets, the proposals may cover a short period of continued trading with a view to selling the business as a going concern. If the administrator's purpose is to achieve the survival of the company, the proposals may be coupled with a voluntary arrangement. If the administrator considers at any time that "substantial" changes should be made to the original proposals he can then call a meeting of the creditors to approve such changes.

The Act, as I have said, introduces a new procedure by which voluntary arrangements, agreed to at separate meetings by a specified majority of shareholders and a specified majority of its creditors, can be made binding on the company and all the creditors. The majorities are, in the case of both shareholders or creditors' meetings, 75 per cent in value of those voting or more than 50 per cent of those entitled to vote.

In order to fall within these new procedures it must satisfy three conditions. It must involve either a composition in satisfaction of a company's debts, and this means an arrangement by creditors to accept less than 100 pence in the pound in full satisfaction, or a scheme of arrangement of the company's affairs. It must provide for an insolvency practitioner to act in relation to the composition or scheme, and the proposals for the arrangement have to be put forward by the company's directors, by its liquidator, or by its administrator. Unlike schemes of arrangement under the Companies Act, these voluntary arrangements do not in general have to be sanctioned by the court.

The company and the creditors cannot, however, approve any proposal which affects a secured creditor's right to enforce his security unless he himself consents. Similarly, they cannot approve a proposal under which a preferential debt would lose its priority or would be paid in a smaller proportion than other preferential debts. Unlike an administration order therefore, a voluntary arrangement gives no power to override a secured or preferred creditor who is not prepared to support the company's rehabilitation.

On the other hand, a person who has delivered equipment or goods to the company under a leasing or retention of title arrangement is not a secured creditor for this purpose and the only way that he can prevent his rights being adversely affected under a voluntary arrangement which he has opposed, is by applying to the court, and it is possible, on the basis of unfair prejudice, for a creditor, liquidator, administrator or supervisor to apply to the court for an order setting aside an arrangement which has been otherwise approved by meetings of the company and the creditors.

So, which should one choose: administration or receivership? There is not always a choice. The court, for whatever reason, may not be willing to make an administration order. Not every holder of a floating charge entitled to appoint an administrative receiver will permit an administration order to be made. Thus, the choice if there is one, lies in the hands of the charge holder who must be given notice of any presentation of a petition for administration. In this context one needs to note that the practice of taking featherweight floating charges has grown up as a way of reserving to the lenders the power to block the administration order.

The principal advantage of administration is the realisation of one of the purposes for which the order is made. As a means of achieving that purpose, administration also carries with it certain other advantages or material aspects among which are the following. Whereas receivership or liquidation, even if the receiver or liquidator wishes to sell the company's business as a going concern, may have a gravely negative effect on the commercial attractiveness of the business to its customers as well as potential purchasers. It was hoped that administration would not have such an effect, and I will refer to that again later on.

The advantages of an administration from the viewpoint of the secured creditor, and it is necessary that a floating charge holder who could block an administration is so persuaded, may be that the rescue plan prepared and embodied in the administration in simple terms provides the best chance of the secured creditor being repaid the money he is owed. It might be that the creditor is adequately secured by the charges in his

debenture or personal guarantees and the amount due to him is too small to justify a receivership. Alternatively, supporting or acquiescing in a petition for administration may be seen as a more positive and helpful attitude from an institutional secured creditor and may for public relations reasons alone be preferable to receivership. Another reason might be that there are no preferential creditors in an administration. Where the secured creditor has a floating charge and the preferential creditors are likely to be high in value, there may be little likelihood of a return in a receivership, as preferential creditors, including in the UK the Inland Revenue and the Customs and Excise for VAT, are paid in a receivership out of the realisation of assets subject to the floating charge and therefore little would be lost in giving the administration a chance. Other possible reasons might be that much of the company's stock is subject to retention of title clauses and the company's capital equipment is on lease, meaning that the receiver might not be able to carry on the company's business as the stock suppliers would reclaim their goods and all the lessors terminate the chattel leases and repossess the equipment.

Alternatively, the management of the business may be difficult and the secured creditor would prefer any public battles with creditors to be borne by an administrator. Also, an administrator can attack transactions at an undervalue and preferences which cannot be attacked by a receiver. Lastly, the floating chargeholder might fear that his security is for one of a number of reasons invalid. If so, then the appointment of an administrative receiver may well be set aside and will not prevent the making of the administration order. It might be better to keep quiet and hope that no challenge will be forthcoming and go first to the administration.

Research by Mark Homan, a leading insolvency practitioner, shows that in 1987 about 40 per cent of cases where administration orders were made were in circumstances where a floating charge holder refrained from appointing an administrative receiver. In the early days of administration orders a number of such cases involved football clubs where, under the Football Association Rules the players of a club who were its main assets would revert to the control of the Football Association if the company for which they played went into liquidation. This would be a bit of an own goal by anyone seeking to put the company into liquidation. The banks therefore may well have considered administration a better option since it gave a chance of preserving control of the assets.

Of less importance now, because of up to date contracts and the way they are drafted to take account of the administration procedure, the making of an administration order may not be an event of default under commercial agreements, allowing the counterparty to terminate, while receivership or liquidation might well be such an event. The wording of a contract's events of default can be important as a party's right to terminate is not subject to the administration moratorium.

The disadvantages of an administration for a secured creditor are the cost, both in terms of time and expense, of setting up an administration, whilst a receivership or liquidation can be put into operation quickly and cheaply. To obtain the administration order a report by an insolvency practitioner must be exhibited to the court in support of the petition. Affidavit evidence must also be presented. The court hearing can last for days.

Once the administration order is made, the secured creditor is unable without the court's leave to enforce its security. Although a receiver is technically obliged to be his own master and must follow the constraints of his duty without regard for the wishes of his appointor, such duties are narrowly centred on obtaining recovery of the secured debt of his appointor. For both reasons, administration represents a loss of control and a loss of influence for a floating chargeholder.

In many cases for secured creditors the appointment of their own receiver will be preferred to an administration. It constitutes a tried and tested remedy which it may not be easy to persuade the secured creditor to give up.

The speed with which a receiver or an administrator may be appointed, as I have said, will be a factor in the decision making process. At least five days notice before the hearing of a petition for administration has to be given to all those who might appoint an administrative receiver and thus prevent the making of the order. This period of delay may be fatal to the company's survival. The court may sometimes make an order that the five day period be shortened where the company's affairs are in a parlous state, but the demands of natural justice mean that the court will always allow the floating charge holder reasonable time to consider whether or not to appoint the administrative receiver.

A receiver or administrative receiver on the other hand can be appointed within a matter of hours provided the charge under which he is appointed is valid and contains a power to appoint which has become exercisable, usually on demand being made for repayment of the secured debt. A company need not be given very long to meet a demand for repayment, just long enough to put in hand the process of meeting the demand by modern electronic banking means. A period of two hours during ordinary banking hours is thought sufficient while a shorter period of 45 minutes might be enough.

You may be familiar with a UK press report that the board of directors of a company has invited the appointment of receivers. Such an invitation serves two purposes. Firstly it probably represents a proper discharge of the directors' duties in that they conclude that they cannot continue the company's business. And second, the invitation effectively waives any right of the company to challenge the formalities of the receiver's appointment.

Sometimes the question of who pays the piper may be a factor. Often administration will occur where a company's cash flow is in a difficult position and where few, if any liquid assets are immediately available. If the administrator is to carry on the company's business as a going concern then funding will be necessary. Although the Insolvency Act gives the administrator the power to borrow and to grant security over property, this will be of little use if the assets are already charged unless an independent source of funding is available. In reality the funding may well need to come from the creditors. If the creditors agree to fund the administration this may be a cheaper option for the secured creditor than a receivership where he might well have to bear the whole of the cost of funding the realisation of the assets subject to the security.

A receiver, if there is cash available, may trade the company; or if little or no cash is at hand or easily realisable, he may simply do his best to sell the charged assets for the best price. He can very often obtain an overdraft from his appointor, if that appointor is a bank, which will be repaid as a cost of the receivership. The difficulties over financing administrations may involve close scrutiny of fixed charges on future book debts and secured creditors may wish to side-step this issue by appointing their own receiver.

I have mentioned earlier the possibility of effecting a rescheduling on a contractual basis. In some cases, for instance, administration may not be a practical alternative. For instance, the company may have important subsidiaries located in jurisdictions which do not recognise administration. In general it has to be said that contractual rescheduling on a negotiated basis is to be preferred to administration if it is an option that is open to the parties. It is quicker than the whole administration process and less expensive. The people who are in the driving seat, ie the banks, can press for security, and while it may

be suspect initially, it will hopefully harden in due course. It is also possible to contractually subordinate those who are closest to the company itself. For instance, subsidiary or parent company loans may be subordinated, as may loans from directors. It may also be possible to control dividends and other benefits flowing from other parts of the group to directors and major shareholders.

The company will still be trading perfectly normally from a legal point of view and the management will still be in control. This may or may not be acceptable to the banks concerned, but in general they can impose terms such as the appointment of a new chief executive or some other company doctor to improve the position of the company. It is possible too in such a situation, to organise a more orderly disposal of the assets of the company. The likelihood is that it can be timed better and not seen as so much of a fire sale. In this respect it is a better position than on liquidation, receivership or administration. There is also the possibility for banks who are involved to charge fees and to increase interest margins which, provided the company survives, will improve their overall position as banks. It is also possible for banks to negotiate equity kickers in the company concerned.

However, there are drawbacks to trying to achieve a contractual rescheduling. There is usually a need for new money and it may be difficult to achieve this. It effectively needs every bank to agree; the idea of one bank creditor getting paid out in preference being not acceptable. It is still possible for people to bring suits against the company. It may be difficult to negotiate with the holders of public bonds, particularly bearer bonds, and suppliers of goods who may have no interest in supporting the company. It is not really available if the situation is critical. It may leave the directors exposed to wrongful trading and it may in any event be necessary to get an administrator in to stop people moving against the company.

Generally, contractual rescheduling gives greater flexibility. The possibility of bringing everyone in, in one document, leaving out those who you want to, approving a regime for all lenders, and making everyone ***pari passu*** through the group, or alternatively, having an override agreement which does not disturb the underlying credits is an obvious bonus. There have been some notable successes of rescheduling agreements in recent months in the UK. Beresford, News Corporation which of course was in Australia, UK and the United States, and Waterford Wedgwood, to name but three in which I have had some personal interest.

In general, banks would certainly prefer a contractual rescheduling if it can be achieved. If such a rescheduling is impossible or if the problem goes deeper than that, then administration may indeed be preferable to a receivership.

Does administration really work? Recent surveys have shown that seven out of ten accountants prefer it. I am not sure what that means! The administration procedure is being used more widely than many commentators have anticipated. The figures to the end of 1989 show that in 1987 there were 131 appointments, in 1988 - 198, and in 1989 - 135. This was against 1265, 1094 and 1706 receiverships in the same period and in excess of 14,000, 13,000 and 14,500 liquidations of all sorts in the same years. In 55 per cent of administrations examined for Mark Homan's survey up to the end of 1987, the procedure enabled all or part of the business to survive and in 9 cases, the procedure not only enabled the company and its business operations to survive, but also resulted in the company's debts being honoured in full.

The latest Cork Gully brochure on corporate rescue and recovery quotes an instance of an administration order really working. Within 12 days of their appointment to a

company, it states, in the North East of England, the company had been sold. If the company had been liquidated, the dividend would have been 12 pence in the pound. The final return to creditors was five times greater, at over 60 pence in the pound.

Administration is not, however, the panacea for all ills that some had hoped for. Perhaps its greatest benefit has been flexibility and choice. The number of administrations has been small in comparison with the overall level of insolvencies, but this is not surprising. In general the problems have been so deep-seated that no simple breathing space will suffice. There has also been the problem of the ability of a floating charge holder to block the appointment. The fact is that most, but not all administrations have been the prelude to the demise of the company, albeit with part of the business being sold or otherwise saved. It has not, except in a very few circumstances, enabled the restoration of a company and its directors to the previous status quo. This is partly because it is still seen as the end of the road. The name in itself suggests it. Administration implies that the company does not have power over itself. It is being administered by a third party. If only we had called it something different, reconstruction perhaps. Directors have one eye over their shoulders at the "wrongful trading" legislation, but since the directors both lose control of the company and the appointment of the administrator and the carrying out of his functions is expensive to a company probably already stretched to the limit, the directors are extremely reluctant to get involved in the administration procedure. They carry on until reconstruction is impossible and receivership or liquidation is inevitable.

To this extent then maybe Chapter 11 can give you some benefit. And maybe too the Irish experience. While you have deliberated in both your jurisdictions for long the procedures you wish to see in place, last summer the Irish imposed a system overnight in a most untypically Irish fashion. The Irish company of Larry Goodman, a friend of politicians and debtor of many banks, faced imminent collapse. Forays into strategic stock market stakes in Beresford and others coupled with huge receivables due but not received from Iraq for meat exports, threatened one of Ireland's largest companies. The banks started serving notices demanding repayment and liquidation seemed inevitable. The Irish Parliament, somewhat controversially, passed legislation in a 24 hour period introducing a procedure of examinership which left the management in control. The examiner, in conjunction with the management, made proposals which were sanctioned by the court for the reconstruction of the company and its debt. I am of course not admitted to practice in that jurisdiction. But while the legislation may have been hasty and ill-drafted, it certainly served its immediate purpose and in the view of some, is based on principles which others, maybe including yourselves, should emulate.

About noon one day, an American couple were passing Runnymede,and saw the sign "Magna Carta, signed here, 1066". The wife said to the husband: "Say George, what a pity. I guess we just missed it." Ladies and gentlemen, do not continue to miss it. Do not delay. Determine now which route you wish to take.