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Restructuring & Insolvency 2021

A practical cross-border insight into restructuring and insolvency law

15th Edition

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Preface

Welcome to the 2021 edition of *ICLG – Restructuring & Insolvency*. Macfarlanes is delighted to continue to serve as the Guide's contributing editor.

The detailed content of year's edition is very different from years gone by, primarily as a consequence of the government reactions to the consequences of COVID-19, and I expect that there will be yet more change to reflect in the chapters of this Guide in the years to come. A lot of what we have seen in the past year could be described as 'crisis management'. For example, suspensions of director liability for late insolvency filings and blocks on creditor action to recover unpaid debts in many jurisdictions have helped to ensure that formal insolvencies are much lower than the historic average. However, those types of measures fail to address the massive accrual of liabilities on corporate balance sheets through the deferral of tax payments, the non-payment of rent to landlords and borrowing under government-backed loan schemes. If the post-pandemic economic recovery is not to be drawn out for many years to come, practitioners will need to come up with appropriate solutions – potentially with the assistance of further legal reform. My colleagues Simon Beale and Amy Walker consider this in their Expert Analysis chapter, which I commend to you.

This year's edition contains contributions from many leading practitioners, including an insight into the issues in restructuring and insolvency across 25 jurisdictions. We are very grateful for their support and we trust that you will find it valuable. Please do get in touch with relevant contributors directly, should you need to understand the most recent developments in any particular place.

I hope that you keep well.

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What is Next for Businesses to Repair Their Balance Sheets?

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Introduction

The COVID-19 pandemic has placed significant stresses onto businesses across the globe. However, by and large, this has not yet manifested itself in an increase in corporate insolvencies. In the UK, for example, since the start of the first lockdown in March 2020 the rate at which companies have entered formal insolvency has fallen compared to pre-pandemic levels. The London Gazette confirmed that there were 12,557 corporate insolvencies in 2020, a 27% decrease from 2019's figure of 17,196.

This reduction in company insolvencies has been due to the government support measures that have been introduced since the onset of the pandemic. In the UK alone, these are expected to exceed £300 billion. The support measures in the UK include, for example, funding support packages, tax reliefs and the Coronavirus Job Retention Scheme ("**CJRS**"). As at March 2021, UK government statistics show that almost £180 billion has been provided by the government in loans to businesses, which represents over one quarter of UK businesses, and that the overall cost of the CJRS is around £58 billion.

The pandemic has already given rise to many new pieces of national legislation. In the UK, the Corporate Insolvency and Governance Act 2020 ("**CIGA**") became effective on 26 June 2020 and introduced temporary measures in response to the COVID-19 pandemic as well as accelerating the implementation of permanent measures. To provide companies and directors with the necessary breathing space during the pandemic, the temporary measures include (i) a moratorium on creditor actions designed to result in the company's liquidation, unless it can be shown that the debt relied upon has not arisen as a consequence of COVID-19, (ii) a moratorium on landlords re-taking possession, and (iii) the suspension of certain director liabilities that might otherwise arise from continuing to trade prior to a formal insolvency. We will describe the permanent measures later.

A number of the UK's government support and legislative measures were extended further in March 2021 and may potentially be extended yet again. Other countries have both introduced and extended similar measures. However, given the cost of the support measures both in the UK and elsewhere, they must eventually come to an end, and businesses worldwide will need to be prepared for this.

In the short term, political factors will doubtless play a part here. We might therefore expect, for example, that France and Germany will need to extend high levels of government support to businesses at least until their national elections later this year and perhaps beyond, dependent on the politicians' promises. In comparison, the UK is unlikely to have another national election until 2023 or 2024. The UK government therefore has an early opportunity to make decisions that are less popular in the short term, as this is unlikely to negatively impact future elections, but achieve what is needed in the longer term. However, ultimately most countries will come to face the same problems.

Financial Position of Companies

There is little doubt that businesses worldwide will now owe a high level of financial debt. This financial debt may have been incurred in at least two different ways:

- financial debt borrowed prior to the pandemic which, as a result of the effects of the pandemic, the borrower group will no longer be able to repay on maturity; and
- financial debt borrowed from government lending (or government-guaranteed lending) schemes introduced during the course of the pandemic, but which the borrower group will again be unable to repay on maturity.

These may well have had a cumulative effect for many companies. In addition, companies may be left with a higher debt burden in other ways as a result of the pandemic. For example:

- companies with leased premises may have taken advantage of measures preventing their landlords from pursuing them for unpaid rent during the course of the pandemic. While the situation may differ from country to country, in the UK this unpaid rent will merely have been deferred and will still become due and payable at some later date. In practice, in the UK we have seen some businesses and landlords re-negotiating the terms of the leases or, in some cases, companies going through a company voluntary arrangement process to implement significant rent reductions and to exit unprofitable leases;
- companies may have had to furlough a number of employees during the pandemic. Whilst in the UK the CJRS provides a contribution towards the employment costs of furloughed employees (up to 80% of wages, capped at £2,500 per month), the wages may be significantly in excess of those amounts being made available by the government. Therefore, in order to retain those employees, particularly those which are critical to the businesses, many employers have had to bear the extra costs of paying these wages in full, despite not being "open for business"; and
- finally, the pandemic has brought significant challenges to businesses in relation to stock planning. For example, retail businesses will have invested in seasonal stock and therefore, unless they have an online platform, this stock will now have to be replaced. Similarly, in the food and beverage sector, stock will have perished as a result of the government restrictions. We have, however, seen a lot of adaptation and innovation in this sector with many restaurants now offering a takeaway service, in order to use stock and to maintain a source of revenue.

Consumer behaviour and spending has also changed considerably throughout the pandemic. Therefore, the level of demand for certain businesses and sectors coming out of the pandemic is difficult to predict. With the uncertainty around what the "new normal" will look like, companies are having to consider how to survive on a short-term basis and review their longer-term strategy, and how to address their liquidity issues. Businesses that have mothballed, and that are low on cash, will need to find ways to replenish stock levels, invest in capital expenditure and "re-open for business". Many of these companies will have maximised their debt capacity and will therefore need to find ways to get the working capital cycle going again.

Approaches Available to Governments

This article looks first at the approaches taken following the 2008 financial crisis and the lessons that might be learned from this. It then considers several possible approaches that governments might take from here:

- introduce new restructuring procedures;
- take a public stake in businesses by converting government-guaranteed debt into equity or even by investing further government money;
- provide a route for private sector investors to invest by way of equity; or
- allow certain companies to go into insolvency.

In this respect, again we focus particularly on our own experience with the UK. However, we would hope that at least some of what we say is also applicable to many other jurisdictions throughout the world.

The Strategy Following the 2008 Financial Crisis

In the aftermath of the financial crisis, the UK government's strategy was to intervene in privately owned corporates only to the minimum extent necessary. The government acted quickly to stabilise the major banks, and two of the "Big 4" banks were duly taken into majority public ownership. However, the government did not intervene to any great extent in other private sector businesses.

There was an initial focus in the UK on public sector investment as the tactic for reviving the economy. However, the general election in 2010 introduced a Conservative/Liberal Democrat coalition government in place of the previous Labour government. They were concerned by the growing size of the UK's national debt and preferred a policy of austerity and of reducing public sector expenditure, which was broadly in line with the policy favoured by other larger EU Member States at that time. The UK government's desire, among other things, was for companies to invest capital that they had built up on their corporate balance sheets in their own businesses.

So far as the banks were concerned, the UK duly avoided the collapse of any large, systemically important financial institutions. However, it is also true to say that the UK's clearing banks did not resume new lending on the scale seen prior to the crisis. They preferred to exercise a degree of caution in ensuring that they were better capitalised. In their place, a host of new lenders have entered the market, or dramatically increased their presence within it.

The economic downturn following the 2008 financial crisis saw a far lower number of formal insolvencies than many insolvency professionals had been expecting. Lenders who wrote down debt or who enforced as a result of payment defaults would be obliged to recognise the loss they had suffered. Rather than recognising losses early, therefore, many lenders preferred to extend the maturity dates of unpaid debt. Provided the borrower was able to service the interest, and to pay any associated fees and other charges, those lenders would suffer no immediate hardship.

This did not resolve the fact that the lending arrangements were unsustainable. Instead it led to the result that borrower groups were obliged to expend a high proportion of their available cash servicing their finance debt, which meant that they had few or no available funds left for capital expenditure and the other investments they needed to develop their businesses. This in turn led to a growth in the number of so-called "zombie" companies who were able to continue to exist but not to grow and invest.

The cumulative effect of successive UK governments' policies since 2008 has been a higher rate of employment during the 2010s than in many other comparable countries. However, there are potential concerns about the UK's lower rate of productivity than many of those same countries. Many voices in the UK have suggested that we now have an opportunity to find different solutions, or to "build back better".

Introduce New Restructuring Procedures

One particularly significant way in which the COVID-19 pandemic differs from that following the 2008 financial crisis is how companies have been impacted operationally. Following the financial crisis we saw groups with viable businesses unable to pay their existing finance debt at maturity. However, in larger groups the problem frequently manifested itself within the stacks of holding companies that had been established to facilitate complex financial arrangements. Below these holding companies, operating subsidiaries continued to generate the cash they needed to part their own day-to-day trade creditors.

When COVID-19 hit, however, it quickly became clear that companies were likely to face problems at operating level as well. As mentioned above, in addition to introducing a range of temporary measures to prevent landlords and other trade creditors taking action against debtors, the UK rapidly accelerated a number of insolvency reforms by way of CIGA.

The three main permanent changes introduced by this piece of legislation were:

- a new, standalone "pre-insolvency" moratorium procedure for companies in financial difficulty;
- a new form of restructuring plan for companies that are in, or likely soon to be in, financial difficulty; and
- new provisions to protect supplies to companies that have entered one of a number of formal insolvency procedures or other restructuring procedures by making it harder for suppliers of goods and services to amend or terminate contracts.

None of these changes were unexpected to UK restructuring professionals. As long ago as 2016, the government published a consultation paper seeking views on measures to update the UK's corporate insolvency regime. One of the stated aims was to improve the UK's standing in the World Bank's annual "Doing Business Report". The measures included within the paper were also broadly in line with the aims of then-current proposals for an EU directive on introducing preventive restructuring frameworks that might help a company avoid a more extreme insolvency process. The latter have subsequently evolved into Directive (EU) 2019/1023 of the EU Parliament and of the Council and will therefore be familiar to restructuring professionals in various other EU Member States.

The UK government's consultation sought views on four proposals. The first three of these were variants of the moratorium, restructuring plan and protections of supplies now introduced. The fourth proposal was to create greater opportunities for companies to obtain additional funding while undergoing a rescue process, but the UK ultimately chose not to introduce any new form of debtor-in-possession financing.

The restructuring plan in particular allowed the use of "cross-class cram-down" for the first time in the UK whereby, subject to certain statutory and judicial safeguards, one or more classes of creditor voting in favour of a restructuring plan might still impose a debt restructuring plan on one or more classes of creditor voting against it. This raises the possibility, for example, of finance creditors voting to impose such a plan on operating creditors. Indeed, the UK's first restructuring plan, which avoided the formal insolvency of Virgin Atlantic Airways Limited, duly encompassed restructuring of both finance and trading debts, albeit in that case the required majorities of all classes voted in favour. A subsequent restructuring plan for three companies in the Deep Ocean group has seen the cross-class cram-down mechanism used successfully.

Throughout the world, other countries have been making permanent changes to their own restructuring regimes, the aims of which are similar to those of the UK.

In practice, we have doubtless seen these new tools used less so far than they will be in the future due to the present levels of government support. However, even then the new restructuring procedures may not prove a panacea if, once again, companies merely downsize their finance and other debts to a level that they are able to service or indeed choose not to restructure at all in the absence of a genuine burning platform.

Take a Public Stake

What is already different to the aftermath of 2008 is the level to which governments now have a direct financial interest in many businesses, whether as a direct lender or as a guarantor of debt. In the UK, more than 1.5 million businesses have been granted loans through government or government-backed schemes.

The possible options for government to intervene in debt restructuring include the following:

- providing companies with the opportunity to turn existing government support loans into public-owned equity. In this case, the state would become a part-owner of the company in return for a reduction in its debt burden. Indeed this has already occurred on a small scale in the UK, via the capitalisation of loans offered through the government's Future Fund; and
- repaying government-guaranteed debt in return for the issue of equity by the company. Certainly, the government may see this as a better alternative to an insolvency where it is called on to pay out under its guarantee without receiving a benefit in return.

Separately, there is the possibility of government equity injections. This is a form of support that the UK has so far been slow to adopt. In the early stages of the pandemic, the UK government developed Project Birch, a support scheme for viable companies that have exhausted all options and whose failure would disproportionately harm the economy. While there was no shortage of applicants for government bailout through loans or equity, so far the only company to receive support through the scheme was Celsa Steel UK, the UK's largest steel rebar manufacturer. Whilst the government has not confirmed the amount, media reports have suggested that Celsa was provided with a £30 million bailout and this was in the form of a loan. We understand the company was given a series of legally binding conditions to adhere to, and told that the money was to be repaid in full.

An example of equity injections in Europe last year includes Germany forming a €600 billion public equity fund called *Wirtschaftsstabilierungsfonds*. A major justification for this was to protect against foreign takeovers of businesses badly hit by the pandemic, with the aim in turn of protecting jobs in Germany.

This raises the further question of how a public stake might be held. The ultimate long-term aim might be to establish a citizens' wealth fund to hold a variety of stakes in many companies. One possibility is that the government or other lenders of government-backed loans convert some or all of the debt into equity. The equity is then sold to a fund, which invests in a number of companies. Institutional investors and affluent individuals may then invest in this fund. The main advantages of this route is that it would not involve the government taking a shareholding in private companies and it would ensure that support was only provided where an independent fund manager believed that a business was viable. However, a realistic, shorter-term aim might be a national investment bank.

Doubts will remain as to whether the state, even though a quasi-autonomous body, is genuinely the most objective investor or best steward of the equity of a wide portfolio of companies in the longer terms. It could be viewed that political factors, such as a wish to win votes in a particular election, will never play a part in its decision-making.

Private Sector Investors

An oddity of the past 12 months is that, while a variety of private sector investors, including private equity, venture capital, overseas sovereign wealth funds, insurers and pension providers continue to hold between them a vast arsenal of "dry powder" capital, they have had fewer than ever opportunities to deploy this.

Funds specialising in distressed investment have reported a frustrating year, where they may feel that government support schemes have denied them the opportunities that would otherwise exist. There will also have been many of the funds' portfolio companies that will have required additional support throughout the pandemic. Therefore, more resources will have been directed towards liquidity and operational issues of companies that were otherwise performing well pre-pandemic, rather than the focus predominantly being on new opportunities.

Clearly, the availability of private sector funding will not in itself resolve the difficulties of businesses that are already over-indebted, but they could play a significant role in post-pandemic recovery. One possible solution is that the government, rather than holding its newly acquired equity, sells it on into the private equity market. This would enable the government to recover sums owed by the company or de-risk itself in relation to the guarantees and would provide private sector investors with a sharp increase in investable opportunities.

Increase in Corporate Insolvencies

Without government intervention, there is a risk that we could again see a proliferation of zombie companies. However, the fact that many companies may soon be left facing problems paying operational creditors rather than just financial creditors could lead to a different result.

Given the reduction in corporate insolvencies throughout the pandemic and a fall in GDP of 9.9% in 2020, there is likely to be a significant backlog of businesses that have been kept solvent due to the support measures, but otherwise would have failed. Whilst we anticipate that some government support measures may be extended past 30 June 2021, an astute government might choose to wind down its support on a sector-by-sector basis. Therefore, if the support measures are retained for the sectors that have been most impacted by the pandemic, such as the retail and leisure sector, then the unwinding of the government measures can be tested on other sectors first, that have been less impacted by the pandemic.

The pandemic has clearly affected different sectors in different ways and therefore governments need to strike a careful balance between continuing to extend the support measures and just opening the floodgates to enforcement against businesses at a time when they need to recover. We can expect, however, that the cliff edge is on the horizon and there will be a sharp rise in corporate insolvencies when the government support measures come to an end.

For a number of reasons, we might also see larger and smaller businesses affected in different ways. The government might decide to place its emphasis on the rescue of larger corporate entities if it decides that these are most important to the economy rather than also trying to ensure the long-term survival of a host of other small and medium-sized enterprises. The new tools described about may well provide opportunities that did not previously exist, but some of these – for example, the UK's new restructuring plan – will be expensive to use and the cost may prove prohibitive for small and medium entities. The largest corporates are likely to have access to all of the professional advice they need, but this may not be true of less sophisticated entities, who may not know to whom to turn until it is too late or who may turn to the wrong source of advice. In the absence of external support, some corporates will simply decide that formal insolvency is a more attractive option than an energy-sapping process of trying to rebuild a business while simultaneously undergoing many rounds of debt-restructuring discussions with creditors.

In the UK, for the more viable businesses, we may see a shift back to a more old-fashioned solution of saving businesses rather than corporate entities, where over-indebted companies enter formal insolvency proceedings and their businesses are acquired by new, third-party investors. While this goes against the trend for saving corporate entities, it may ultimately be the best route to avoid another rise of the zombie companies. It may provide the boost these businesses need if it provides their best chance of right-sizing their debts and of securing new, private sector investment at an early stage. It will be interesting to see whether anything similar occurs in jurisdictions that are traditionally more debtor-friendly, or whether different solutions emerge.

Finally, there will be quirks that are specific to different jurisdictions. For example, in the UK, notwithstanding the pandemic, the UK's tax authority ("**HMRC**") was reintroduced as a preferential creditor. Therefore, large amounts of source taxes (such as PAYE, VAT and employee NIC) that were deferred as part of the government support packages will now have priority over many other creditors, both secured and unsecured, in the event of an insolvency. This will therefore make HMRC a very powerful creditor in any restructuring scenario and their change in status may make lenders unwilling to lend to certain businesses, which again could contribute to an increase in corporate insolvencies.

Conclusion

COVID-19 has accelerated change in many different sectors, and we have seen adaptation, innovation and new ways of doing business over the last 12 months. Some of these changes, such as the shift to online platforms, will continue. There will, however, be a number of complex challenges that companies will face when we return to a "new normal" and the government support measures come to an end. Governments will therefore need to focus on which companies they most wish to continue to support through to recovery, and which may be allowed to fail. There will also be certain sectors, impacted the most by the pandemic, that the government will need to continue to support for a longer period than others.

Overall, companies will now need to focus in the short-term on servicing their debts, repairing their balance sheets and engaging with key stakeholders to find solutions for the business, rather than being able to invest, expand and prepare for the future. At the same time, they will need to review their operations, overheads and how they need to adapt to reflect changes in consumer behaviour and spending as a result of the pandemic. This will ultimately impact the long-term strategy of these businesses and productivity. It might take a long time for the world's economies to recover from the pandemic, but it could be the actions taken from now on by their respective governments that decide how long.

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