TREASURY, RISK
AND FINANCE
PROFESSIONALS
ACT

Ms. Eleanor Mack
Enterprise Team
HM Treasury
Area 3N/1
1 Horse Guards Road
London SW1A 2HQ

17th September, 2007

Dear Ms. Mack

Re: Submission on Insolvency Law Reform to you from the European Insolvency Reform Working Group of the European High Yield Association (23rd April 2007)

The Association of Corporate Treasurers is a professional body for those working in corporate treasury, risk and corporate finance. Further information and contact details are provided at the end of this letter and on our website, www.treasurers.org.

This letter is on the record and may be freely quoted with acknowledgement.

We have consulted our membership and other interested professionals on this subject through our Policy and Technical Committee.

We propose that the time is right for government to commission a major enquiry into corporate insolvency.

Background

We read the EIRWG's letter to you with interest.

We think that these issues go wider and deeper than the EIRWG sets out and we do not consider that the EIRWG's proposals are well adapted to current and expected circumstances. We also think the proposals are put forward from a point of view adapted to the interests of only one class of the many stakeholders in a company as it nears or enters financial distress. However, we do agree with the EIRWG that a number of issues arise concerning UK/EU insolvency provisions.

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We also agree that the EIRWG is correct to identify that a well adapted corporate insolvency regime is important to helping keep down the cost of capital to companies and help encourage investment and entrepreneurship.

UK current situation

The UK position has developed over time. The 2002 Enterprise Act introduced significant reforms to the fundamental structure of the 1986 Insolvency Act and the EC Insolvency Regulation overlays several important principles of recognition.

The old "London Approach" to financial distress for companies promoted by the Bank of England, has vanished. There were many reasons for this. Chief among them were the growth of bond finance, and the changing nature of those holding corporate loans at such times of financial distress and their reluctance to be subject to the London Approach. This was reinforced by the growth in distressed debt trading.

Since the Enterprise Act, the situation in practice has moved on in many ways.

The number of highly leveraged companies which tend to be subject to a wider range of covenant restrictions has been both supported by and brought about by the development of new types of financial institution specialising in such high risk lending. Secondary market trading of credit risk via derivatives and of corporate debt positions between banks and the newer institutions has added to the influence of the latter which have in any case, especially for highly leveraged and generally weaker credits, become major participants in the primary loan markets.

In the stressed arena specialist funds have been established which acquire debt issued by distressed companies at low prices in the expectation of trading on the debt, extracting a high price from would-be rescuers in exchange for agreeing to the rescue terms or swapping debt for equity.

Many of the "new" investors and those who advise them have transatlantic backgrounds and they are familiar with and supportive of US arrangements. They can tend to see any differences from US practice as clear deficiencies.

The multi-faceted trading of some of the newer institutions and their lack of internal "Chinese walls" between their staff trading in different markets has greatly changed the way in which borrowers can provide information to and deal generally with debt holders. Many of the newer investors are smaller and less easily able to segment activities.

So (in order not to become insiders, precluded from dealing), some holders do not wish to receive non-public information and accordingly may absent themselves from some syndicate decision making. Lenders which have passed their credit risk on to others through credit derivatives may be less interested in the rescue process than they otherwise would have been. All this can accelerate a company's movement from anticipation of some financial difficulty to full blown financial distress and insolvency. A recent article in the Financial Times by the ACT's Policy and Technical Director on this point is attached (Appendix 2, p.8).

Certainly the changed nature and attitude of the players in corporate debt and their interaction with the statutory and behavioural environment has made the structuring of relationships with lenders, choice of covenant sets etc. more difficult and risky.

Relationships between subsidiaries in a group and a parent company – including formal guarantees up and down – together with deliberate subordination of some lenders and restrictions on subordination of others and various methods of giving or restricting access of creditors to various assets in different jurisdictions and in different members of the group have added to the complication of corporate refinancings to avoid financial distress or of managing actual distress.

We think that a well adapted statutory framework, rules for practitioners and behavioural practice by practitioners towards corporate rescue as much as to corporate failure is very important for wider financial stability as well as for the many stakeholders in individual companies.

Over and above the probably direct interest of stakeholders in corporate survival, the greatest public interest at times of corporate financial distress is to ensure the survival of as much of the real option value[1] implicit in the company as possible. Frequently, especially for early stage and growing companies, most of their value is in those real options rather than in tangible assets and such options are not easy to transfer from a failing company. It is society as a whole which suffers from destruction of these options. Failure of mature, stable, utility-like companies has less cost to society because often others can more easily take over activities with less value destruction.

Europe

At the same time, the wide range of pressures generally summarised as "globalisation" has seen more companies with operations spread through Europe and wider. Conflicts between the insolvency arrangements in different countries have become a wider problem. Differences between national traditions, including whether to recognise such arrangements as security or subordination have become more important.

At the same time "forum shopping" is a real risk, as seen in the efforts of creditors to migrate German companies to the UK where they perceived advantages in the regime over the applicable regime in Germany.

This may mean that in due course the EU will seek to review insolvency arrangements throughout the Union. Reaching agreement at this level will be difficult and long drawn out, of course.

It is desirable that by such a time the UK has a well thought out and integrated approach to insolvency.

Stakeholders

We are conscious that there are many stakeholders who can be affected by corporate financial distress: customers and suppliers, employees, the communities in which firms operate as well as creditors, including providers of debt finance, and shareholders. Naturally the EIRWG write from the narrow point of view of debt holders. The EIRWG is, of course, mainly concerned with large companies while most corporate users of insolvency services are small companies.

The US model

[1] See discussion of real options in
Appendix 1, The importance of real options, p. 7

We would be very concerned at an attempt to “cherry pick” parts of the US model which could have very different effects out of the context of the whole insolvency model and general US legal system and business practices. The basis of valuation, voting-rights and required majorities may sound easily separable questions but are complex in themselves and their interactions and review would require a comprehensive study in the context of an overall review of insolvency practice.

Conclusion

We do not think that it is appropriate to comment at this stage on the substantive proposals of the EIRWG. However, we do not think the UK Government should take any action in direct response to the proposals of the EIRWG.

We propose rather that the time is right for government to commission a major enquiry into corporate insolvency, consulting all stakeholders and taking account of the changes in the environment in recent years, of the interests of companies and all their stakeholders and of the increasing importance of overseas interests for companies of any size.

If the actual behaviour of practitioners is to be affected by its recommendations, those recommendations must be both sound and accepted by practitioners.

We have seen successful reconstructions outside a formal process but perhaps using a scheme of arrangement. We believe that practitioners generally, suppliers and customers in the UK all tend to treat appointment of administrators as being a step towards sale of the business and assets rather than towards corporate reconstruction and the formation of a viable continuing company as was the intention of the Enterprise Act. There are many examples of the former, such as Barings, but few of the latter whereas in the US reorganisation as a going concern is relatively common.

The lesson we draw is that changing behaviour is harder than changing the law. Certainly, though, some small changes in the law could be found which would make administration a more attractive route to restructuring, though this is not the place to advocate specific changes[2].

Changes elsewhere, such as in France recently, as they work through in more cases, will also provide material for study by such an enquiry. The French example reaffirms that administration need not be value destructive for society as a whole if it is used to achieve a restructuring with benefits to all stakeholders as creditors become more confident that they will be paid.

We recognise that such an enquiry as we propose would take a significant time. However, we think that it is important that any changes in the insolvency regime be both soundly based, intellectually and in practice, and consistent with any expected EU level interventions.

Such an enquiry could take account of any further experience with the Enterprise Act and from developing market conditions during the period of the study. Interim reports may identify some of the easily implemented small changes referred to above for early adoption.

[2] The sort of thing we have in mind would be to reconsider creditors’ ability to change the administrator which could make management fearful of finding itself, weeks down the track, having to start all over again with a new administrator parachuted in.

The report of the enquiry would give the government a solid foundation on which to base its legislative proposals. It could also be a key part of changing attitudes to administration or other restructuring processes. It should be influential in other countries which decide to examine their insolvency regimes. And it should give the UK a good platform from which to approach any proposed insolvency developments in the EU and perhaps the wider international community.

Yours sincerely,

Richard Raeburn
Chief Executive

Cc: Clive Maxwell, HM Treasury
Paul Tucker, Bank of England
Gilbey Strub, European High Yield Association
Hector Sants, FSA
Sally Dewar, FSA
Douglas Hull, FSA
Nick Sabin, Insolvency Practitioners Association

TREASURY, RISK AND FINANCE PROFESSIONALS
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The Association of Corporate Treasurers (ACT)

The ACT is the international body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the worlds leading examining body for treasury, providing benchmark qualifications and continuing development through training, conferences, publications, including The Treasurer magazine and the annual Treasurers' Handbook, and online.

Our 3,600 members work widely in companies of all sizes through industry, commerce, financial institutions and professional service firms.

Our guidelines on policy and technical matters are available at http://www.treasurers.org/technical/resources/manifestoMay2007.pdf.

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The importance of real options

Real options are choices arising in a firm in response to events or possibilities which may occur in the future. They have a value, but the value is usually not represented in any current cash-flow projections made about the firm.

"Real options are important because they represent a portion of the value of future opportunities that cannot be explained by the present value of future cash flows."[3] "Real options are especially valuable for projects that involve both a high level of uncertainty and opportunities to dispel it as new information becomes available."[4]

They are thus of greatest relevance when uncertainties about real choices which may arise are greatest. Typically the proportion of firm value represented by real option value (rather than the cash flow value) is greatest in early stage and rapidly growing companies.

For example:

> Choosing to undertake initial research might reveal a possible new technology which looks promising, in which case there could be a real option to invest in a wider programme of research that may lead on to opportunity to undertake development possibilities and ultimately to an opportunity for investment in commercial exploitation.

Start-up, early stage companies and fast growing companies tend to have nil or low leverage. For shareholders to potentially cede to lenders control over the real options in these cases is seen as too costly. (This is a significant factor explaining why the take-up of government or government-backed start-up and early-stage company loans has generally been low.) The highest geared firms are more established and the highest geared the low-real-option-value utility or utility-like firms.

Real options lost as one firm founders may not be taken up to others. In many cases, especially in high-tech/bio-tech areas, the confluence of ideas and skills and opportunities in a single firm during start-up/early stage development is not easily replicable and high-value real options open to a firm, if not exploited, may be simply incapable of exploitation by other firms. Real options once destroyed by insolvency of the firm, will often never be exploited at all. At later stages, the then less radical or more established technology is more likely to be taken up and not lost to society, although this will be a cost due to the need to replicates groupings of skills, knowledge, equipment and access to markets.

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[3] Lee, Seung-Hyun and Peng, Mike W., Bankruptcy Lae and Entrepreneurship Development: A Real Options Perspective, *The Academy of Management Review*, Volume 32, Number 1 / 2007 pp 257-272, at p. 258

[4] Thomas E. Copeland and Philip T. Keenan; Making Real Options Real, The McKinsey Quarterly, 1998 NUMBER 3 pp 128-141, at p. 130

Appendix 2

FT REPORT - FT FUND MANAGEMENT:

Borrowers and lenders adjust to new relationships

By John Grout, Financial Times
Published: May 14, 2007

Share capital is expensive. Debt is cheaper, but the risk is sacrificing control.

Old certainties about relationships between borrowers and lenders have gone. New ways of working will take patience to develop.

For the moment, debt costs have come down. Lenders will lend more, for longer, on easier terms. Low-geared companies can attract leveraged takeovers.

Loan covenants cede some control to lenders even before default and bankruptcy. Traditionally granted to banks in medium term loans, covenants are now being enjoyed by non-banks working in the "bank-loan" market.

High investment grade borrowers do not give covenants. At the bottom of the credit market, in the high-yield sector some, but not all, debt is being sold with minimal covenants. For mid-market companies covenants remain an issue.

Covenants, however, have become more dangerous.

Banks, regulated institutions with a lender of last resort, have a common law duty of confidentiality and loan agreements are private matters. From a borrower, banks expect a flow of profitable ancillary business and non-public information (for use in credit decisions), making them, to that extent, insiders.

Loan covenants should allow a company freedom to operate its normal business. They encourage discussion between banks and companies before significant financial distress sets in.

Previously, in case of need, covenants could routinely be modified quite quickly, cheaply and confidentially by negotiation with the banks.

In case of limited financial distress, before bankruptcy loomed, an "orderly workout" under bank supervision used to be possible. Banks would agree new advances subject to taking of "super security" over the company's assets and regular review of even more confidential information.

Today, lenders in syndicated "bank" loans may not be banks. Non-banks may come into syndicates to boost the amount raised. And loans can now be traded commodities. Banks sell credits to take them off their balance sheets. Buyers may be non-banks.

Non-banks, usually un-regulated, do not have a lender of last resort or a common law duty of confidentiality. They may lack "Chinese walls": if, as loan participants, they receive non-public information their other trading activity may be blocked.

Such lenders may thus be unwilling to receive non-public information at all. So the company cannot explain at the start what it intends to do with the money raised or why an initial set of covenants is appropriate or, later, why a covenant change is sought - or even that a change is wanted at all.

That makes managing a syndicate challenging.

Non-banks are unlikely to want to hear about an orderly workout. For a start, they lack other profitable business with the company to protect. In times of financial distress they may be more interested in using their syndicate voting rights to benefit other positions related to the company - even their interests in a competitor or potential buyer of the company or part of it.

Long-term financing is also changing. Bonds are generally public affairs.

Sterling bonds always had covenants but companies could ensure they were relatively harmless. There was an accepted, if expensive, mechanism for early redemption of a bond if need be.

Euro-bond investors are often anonymous - un-registered or holding through nominees. This mattered little, because Euro-bonds used to have practically no covenants for investment grade borrowers.

Now, bond holders are asking for covenants - relevant ones too. Some, perhaps dealing with a change of control of the borrower, are not so difficult for companies to agree (if they are not seen as poison pills). Others are more difficult given the public nature of communications and the lack of rapid, low cost mechanisms for changes. Proposals for a change or waiver risk expose the company to "greenmail" by purchasers of effective blocking holdings.

The use of credit derivatives means that all types of lenders can shed or acquire credit-risk in a company and leave companies with little idea of who actually carries their risk.

If a company seems to be nearing financial distress some lenders protected by derivatives may actually benefit by its early default or bankruptcy.

These factors, taken together, greatly narrow the gap between a company nearing financial distress and falling into bankruptcy.

The balance between equity and debt appropriate for a particular company has become much more difficult to choose.

John Grout is policy and technical director at The Association of Corporate Treasurers