

US 'Chapter 11': Should it be adopted in the UK?

The US business rescue procedure, Chapter 11, has enjoyed positive press and parliamentary coverage in the UK, with a number of commentators calling for the UK to adopt a similar procedure. Whilst there are a number of benefits to the Chapter 11 regime, it is however largely incompatible with the UK's Court system, business and lending environment.

This briefing outlines the advantages and disadvantages of Chapter 11 and concludes that Chapter 11 is not the right solution for the UK. R3 believes the UK should 'cherry pick' specific aspects of the regime rather than adopt it in its entirety.

What is Chapter 11?

In the US, a company (or its creditors) experiencing financial difficulty can file with the federal bankruptcy court under Chapter 7 or Chapter 11 of the US Bankruptcy Code. In Chapter 7, the business stops operating and a trustee sells its assets and distributes the proceeds to creditors (liquidation). In most Chapter 11 cases, the original management continues to run the business as a 'debtor in possession' in an attempt to rescue the business, but all major business decisions must be approved by the bankruptcy court.

A successful Chapter 11 is a restructuring rather than a liquidation. Companies are given protection from creditors, under the supervision of the court, allowing them the much-needed breathing-space to restructure. In successful cases, jobs are protected and the value of business assets is retained. Chapter 11 is open to all companies but generally it is used by corporates rather than small businesses due to the costs involved.

In most Chapter 11 cases, the company will try to develop a plan to return to profitability and compromise with creditors at the same time. If a plan is not developed, the company is liquidated. The rescue plan has to be voted on by the creditors and stockholders, and confirmed by the bankruptcy court. Even if creditors or stockholders reject the plan, the court can still confirm the plan if at least one impaired class of creditors has voted to approve the plan and it concludes that the plan treats objecting creditors and stockholders in classes being "crammed down" fairly.

World Bank comparison of the UK and US insolvency regimes

World Bank data from 2014¹ ranked the US as the 4th best regime in the world, with the UK at 13th. However, when analysing the data in more detail, the UK fares much better than the US in terms of the speed and cost of insolvency, and the amount returned to creditors: insolvency takes on average 1 year in the UK compared with 1.5 years in the US; the cost is 6% of the estate in the UK compared with 8% in the US; and returns to creditors are 88.6 cents in the dollar in the UK compared with 80.4 cents in the dollar in the US. Therefore, the UK has a faster insolvency system, which is cheaper and returns more money to creditors, than its US counterpart.

The UK falls short of the US system on issues such as 'continuation and provision of contracts' and 'creditor participation'. R3 believes that these features of the US system should be considered further for the UK system.

¹ <http://www.doingbusiness.org/data/exploretopics/resolving-insolvency>

What are the advantages of Chapter 11?

1. *Chapter 11 appeals to company directors*

Chapter 11 allows the management of the company to continue to run it. This often leads directors to seek advice at an earlier stage of financial difficulty which, in turn, usually results in a greater chance of long-term survival.

2. *Courts make an objective decision on the rescue plan*

US courts are directly involved in the decision making process of the company. If some classes of creditors reject the plan, the court will take an objective approach and over-ride creditors should the plan be in the best interests of the company and all creditors.

3. *It is a true rescue procedure*

Chapter 11 is a complete, self-contained, pragmatic, court-driven process. A court supervised negotiation with effective implementation measures provides a range of tools to promote restructuring. When Chapter 11 works, the company emerges from the process as a healthy company – it is a true rescue procedure.

There are four specific elements of the Chapter 11 regime that the UK should consider:

1. *Automatic stay holds businesses together during restructuring*

One of the US' best features is the automatic stay companies receive when they file for Chapter 11. The stay is designed to hold the business together through the plan process and provide the company with a 'breathing space'² from creditors – preventing them from taking certain actions against the company (e.g. taking enforcement action against the company's property). While the administration procedure in the UK provides a similar stay or moratorium management ceases to have control of the company and as a consequence administration is more of a last resort. The introduction in the UK of a moratorium for struggling companies before the commencement of any other formal insolvency process could encourage earlier and more effective recovery action.

2. *Continuity of Supply*

The enviable feature of the Chapter 11 stay is that it prevents suppliers and customers terminating their contracts with a company on grounds of insolvency alone, which can significantly increase the chances of survival.

R3 campaigned³ for a number of years to introduce 'continuation of supply' in the UK, and so welcomed legislation in 2015 that extended the existing provisions to IT providers and other essential suppliers. Under these provisions such suppliers must continue to supply following formal insolvency and in the future would be unable to vary their terms of supply or increase charges. R3 estimates that around 2,000 businesses in the UK could be rescued under this new legislation. Over time, we would like to see the government add more types of suppliers to the legislation.

² Bankruptcy Code, Rules and Forms, 1997 Edition Case Administration, Historical and Revision Notes. Pg 109

³ <https://www.r3.org.uk/what-we-do/working-in-parliament/holding-rescue-to-ransom>

3. *Creditor involvement is key to a trusted insolvency regime*

The World Bank data measures creditors' participation and rights during liquidation⁴ and re-organisation proceedings – the US rates very highly as '3' whereas the UK achieves '2'⁵ (ranking between 0-4). Creditor participation is vital for a trusted and transparent insolvency regime. In 2015 R3 launched (with support from government, the British Property Federation and Chartered Institute of Credit Management) a website guide for creditors to guide them through the insolvency process. The UK government has also introduced a number of initiatives designed to improve creditor engagement. R3 also calls on government departments to actively participate more in creditors' committees. Engagement from these large unsecured creditors helps other unsecured creditors such as small businesses to engage in the process and therefore increases the likelihood of a better outcome for that small business.

4. *Super priority funding can facilitate restructure*

During a Chapter 11 rescue, under certain conditions, lenders who provide funds to the company during the restructuring process can "leap frog" existing secured creditors if the company does eventually go into liquidation – i.e. they're the first to be repaid out of the assets recovered. Super priority is widely accepted as a means to encourage new (or existing) lenders to put money into the struggling company, which can dramatically increase the company's chances of survival. R3 sees merit in the principle of extending the availability of rescue finance like this in the UK, but recognises that this must be balanced against the rights of existing secured creditors.

What are the disadvantages of 'Chapter 11'?

1. *The majority of Chapter 11s fail*

In order to successfully re-organise, companies under Chapter 11 have to develop a re-organisation plan. Estimates suggest that somewhere between 17% and 33% of companies that enter Chapter 11 successfully confirm a plan of re-organisation. Research has found that more than half of companies in Chapter 11 do not produce a plan at all⁶. Furthermore, the majority of companies that enter Chapter 11 do not come out the other side.

The American Bankruptcy Institute published a report in 2014 on the Chapter 11 regime in the US⁷. The report revealed a growing consensus for the reform of Chapter 11, with agreement that the general areas of Chapter 11 practice no longer work as effectively as possible. The Commission's research found that these deficiencies in Chapter 11 are having an adverse impact on distressed companies and their stakeholders, particularly with respect to small and medium-sized enterprises.

2. *Chapter 11 can be slow and expensive*

Chapter 11 is a court-driven process with extensive creditor involvement through committees. This process is both time-consuming and costly. Creditor groups/committees and other groups of stakeholders with a genuine interest in the assets are entitled to advice and representation at the expense of the company. In the UK, most restructuring takes place outside formal insolvency

⁴ Four elements are measured, creditors participation in: 1. the selection of an insolvency practitioner; 2. approval of the sale of substantial assets; 3. the right to access information; 4. if an individual creditor can object to a decision of the court or insolvency practitioner to approve or reject claims against the debtor brought by the creditor itself or by other creditors.

⁵ The UK can fall down in criterion 1 in scenarios where the banks' can appoint an administrator out of court without other creditors able to participate in the selection process (although creditors can object to the appointment); the UK can fall down in criterion 2 in cases of a pre-packaged administration where the creditors' approval prior to sale is not sought.

⁶ The success of Chapter 11: a challenge to the critics, Elizabeth Warren and Jay Lawrence Westbrook is

⁷ <http://commission.abi.org/>

processes or under the supervision of Insolvency Practitioners, making the process more flexible, faster and more cost-effective.

There is no time limit on Chapter 11 bankruptcies, so companies can be in them for several years. By contrast, administrations in the UK are comparatively swift and realisations are distributed to creditors promptly.

3. Directors who preside over decline remain in place and the processes can punish other companies by distorting the market

Inadequate or incompetent management is a common reason for business failure. Chapter 11 allows directors who have presided over their company's financial decline (failing to reverse the trend and even, in some cases, exacerbating it) to remain at the helm of the company through the restructuring. A company in Chapter 11 is effectively operating under the "protection" of the court, which can give the company a significant advantage over its competitors, distorting the market and harming competing businesses.

Chapter 11 isn't the right solution for the UK

1. Chapter 11 isn't suited to the UK's business climate

Chapter 11 is open to companies of all sizes, but the process can be extremely expensive, and it is funded by the company. As a result, Chapter 11 is generally seen as the preserve of larger companies. Given the SME climate in the UK (99% of businesses are classed as small), a Chapter 11 model would do little to prevent the most widespread business failures in the UK.

2. The court system in the UK is not designed for Chapter 11

The court system in the UK would require dramatic modification to handle business restructuring in the US style. US judges need to be directly involved in the decision making required to run companies, and sometimes the negotiations between the company and its creditors. UK judges do not have this type of experience and the courts are not structured in a way that is able to deal with such decisions.

3. The UK is not ready for 'super-priority'

As outlined above, 'super priority' funding has many advantages. However, it has proved to be contentious in the US, and banks in the UK have expressed concerns about the impact its introduction could have on lending. In the US, the law gives "adequate protection" to existing creditors to ensure that they are not unfairly 'bumped down' by new lenders – but there is ongoing debate over what "adequate protection" should entail in practice. The continual debate over this, as well as the way property rights are respected in the UK, suggests that adopting super-priority financing in the UK could be a real challenge.

The UK's insolvency regime is world class

1. Our insolvency regime is envied abroad

The rehabilitative, progressive insolvency laws in the UK are envied by companies operating in many other jurisdictions. A number of international businesses consider relocating their management headquarters to England to give themselves, through access to UK procedures, a better chance of

survival in the economic downturn than they would otherwise have: a phenomenon known as ‘bankruptcy tourism’⁸.

2. *The UK system provides significant potential for rescue*

The UK insolvency regime is world class but there is always room for improvement. However, it is full of useful and flexible procedures to help rescue businesses, as evident in 2013/14 when UK’s insolvency practitioners rescued 41% of insolvent businesses.

A Company Voluntary Agreement (CVA), for example, is very effective at helping companies that are profitable in the long term to overcome a period of short term financial difficulty. Unlike Chapter 11, there is little court involvement - the CVA is under the control of a licensed and experienced Insolvency Practitioner who acts as a supervisor while the company’s management, sometimes strengthened, remains in post.

Conclusion

There are elements of Chapter 11 that are attractive and could be adopted in the UK. However, R3 believes that the disadvantages of Chapter 11, in conjunction with its incompatibility with the UK’s Court process and the UK’s business, lending and insolvency climate, means the UK should not adopt Chapter 11 in its entirety.

About R3

R3 is the trade body for the UK insolvency profession, representing the UK’s insolvency practitioners. From senior partners at global accountancy and law firms to practitioners who run their own small and micro-businesses, our members have extensive experience of both corporate and personal insolvency. For more information, please contact Georgina Waite (Senior Public Affairs and Policy Manager) on 020 7566 4214 or georgina.waite@r3.org.uk

A few facts about the UK insolvency regime

- The UK’s regime is one of the best in the world, according to the World Bank. The UK regime returns more money to creditors, faster and cheaper than those in the US, Germany and France.
- UK Insolvency Practitioners (IPs) return more than £4bn a year to creditors (including HMRC and businesses).
- There are approximately 1,700 IPs in the UK and around 12,000 professionals who work in insolvency.
- Most IPs are accountants or lawyers. They are all qualified and regulated, and have a statutory objective to maximise returns to creditors.
- In 2013/14 UK IPs saved more than 235,000 jobs and rescued more than 41% of insolvent businesses.

⁸ Example of press on this issue: http://www.huffingtonpost.co.uk/2012/11/23/bankruptcy-tourism-why-foreign-companies-and-individuals-are-choosing-to-go-bankrupt-in-britain_n_2177924.html