Lawyers to the finance industry

Enterprise Act
Lender's perspective

Summer 2003

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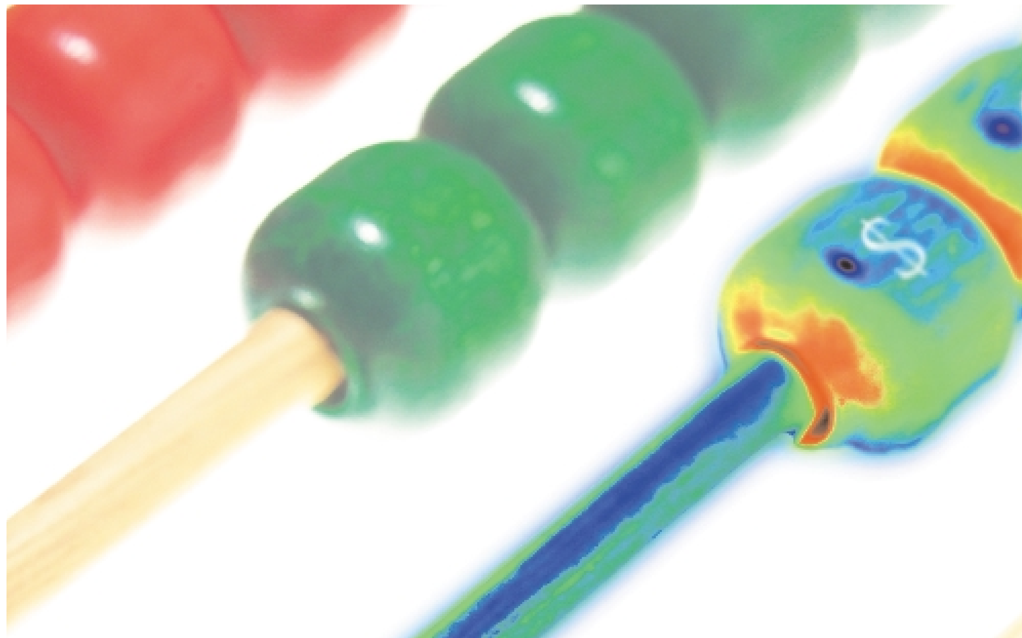
Introduction

The Enterprise Act 2002 (the "Act") received Royal Assent in November 2002 and will be implemented into law later this year. The Act covers consumer affairs, fair trading and competition but it is the amendments to the existing corporate insolvency regime which will be of particular significance to lenders.
Of these amendments, those of particular interest to lenders will undoubtedly be the abolition of administrative receiverships and the creation of a 'fund-pool' for the benefit of unsecured creditors.

This flyer examines the amendments to be introduced by the Act and the implications that such changes will have on the finance industry in practice.



Objectives

The Act has been introduced by the Government and is intended to encourage responsible risk taking, to reduce the stigma attached to honest failures and to give companies in financial difficulties a second chance. Indeed, the Government has stated that its main objectives in implementing the corporate insolvency changes are:

- to encourage a culture of corporate rescue, the idea being that helping companies to survive will preserve competition; and
- to create a fairer system with a greater emphasis on collective insolvency proceedings in which all creditors can participate and where a duty of care is owed to all creditors.

The main changes proposed to corporate insolvency law are as follows:

- the abolition of administrative receiverships subject to certain limited exceptions
- the reform and expansion of the administration procedure
- the abolition of Crown preference in all insolvencies
- the creation of a new 'fund' for unsecured creditors

A qualifying floating charge

A floating charge "qualifies" if it is created by an instrument which expressly states that the relevant section of the Act applies to it or it purports to empower the holder of the floating charge to appoint an administrative receiver or administrator of the company. The floating charge must also be over the whole or substantially the whole of the company's property. It is therefore paramount that floating charges created after the date when the Act comes into force comply with these requirements.

"The amendments made to the administration procedure pursuant to the Act are intended to simplify and facilitate a much quicker initiation of the administration process. The new system may therefore prove to have the attributes of the old administrative receivership appointment in terms of speed and limitation of costs."

Administration and Administrative Receivership -

The fundamental difference

In reality, an administrator and an administrative receiver possess similar powers and the amendments made to the administration procedure pursuant to the Act are intended to simplify and facilitate a much quicker initiation of the administration process. Therefore, in this respect, the new system may prove to have the attributes of the old administrative receivership appointment in terms of speed and limitation of costs. The fundamental difference between an administration and an administrative receivership is in relation to the duties of the receiver and the administrator.

Administration

- administrator appointed by the Court
- the holder of a floating charge who is entitled to appoint an administrative receiver must be given notice of any application for an administration order and if the floating charge holder appoints an administrative receiver, the Court must dismiss the application for the administration order unless the appointor consents to the making of the administration order
- the company enjoys a moratorium from legal proceedings or enforcement action by individual creditors during the administration process
- an administrator is an officer of the Court and owes a duty to the creditors of the company as a whole to perform his functions in order to achieve the purposes for which the administration order was granted.

Administrative receivership

- an out of Court procedure whereby an administrative receiver may be appointed by a floating charge holder as permitted by the Act when its charge becomes enforceable
- the receiver owes his primary duty to the appointing charge holder, rather than the company or the creditors of the company as a whole.

Administration and administrative receivership

The new regime

The Government had expressed concern at the way in which administrative receiverships operated under the existing regime, in particular:

- the ability of the floating charge holder to block the making of an administration order;
- the fact that the receiver's primary duty is to the appointing charge holder; and
- the fact that the receiver's primary function is to seek repayment of the debt owed to the appointor.

The Government has therefore sought to address the above concerns by the removal of the floating charge holder's right to appoint an administrative receiver.

The Act provides that, subject to certain defined exceptions (details of which are set out on pages 4 and 5)) and notwithstanding any provision to the contrary, after the date at which the Act becomes law, no administrative receiver may be appointed by a floating charge holder.

As recompense for the removal of administrative receivership, the Government has extended and attempted to streamline the administration procedure in an attempt to reduce the expense and delay which have previously been associated with obtaining an administration order.

A key change which will be introduced by the Act is that an administrator may be appointed both in and out of Court. Those that may apply to the Court for an administrator to be appointed now include the holder of a qualifying floating charge as well as the company, the directors of the company or one or more of the creditors of the company. The holder of a qualifying floating charge, the company and the directors of the company may now also appoint an administrator out of Court.

There are certain requirements which must be satisfied prior to appointing an administrator pursuant to an out of Court procedure and the appointment of the administrator will take effect when such requirements have been satisfied. A notable prerequisite to an application to the Court or for an out of Court appointment of an administrator by the company or the directors of a company is that the company must be insolvent, that is, that the company is or is likely to become unable to pay its debts. This requirement does not, however, apply in the case of an application by a holder of a qualifying floating charge.

As with the existing regime, the company will enjoy a moratorium whilst it is in administration.

Administration - new purposes

A significant amendment in the Act is to clarify and amend the purpose of administration by essentially replacing the four current statutory purposes with one overreaching purpose of rescuing the company. An administrator is now required to perform his functions in pursuance of one of the following objectives:

- rescuing the company as a going concern
- if the above objective is not reasonably practicable or that objective would not provide the best result for the company's creditors as a whole, achieving a better realisation of assets for the company's creditors as a whole than would be likely if the company were wound up
- if neither of the above objectives is reasonably practicable, realising property in order to make a distribution to one or more secured or preferential creditors (although the administrator may only act if he does not unnecessarily harm the interests of any unsecured creditors)

Whichever of the above objectives is reasonably practicable in each individual case will clearly be based upon objective reasoning and will require administrators to exercise commercial and professional judgement.

The exceptions for the appointment of an administrative receiver

(i) *Existing floating charges*

A holder of a qualifying floating charge which is created before the Act comes into force will be able to choose whether to appoint an administrative receiver as under the present regime or opt to appoint an administrator under the Act.

(ii) *Capital market arrangements*

It will remain possible to appoint a receiver under an "agreement" which is or forms part of a capital market arrangement if a party to the arrangement incurs (or when the arrangement was entered into was expected to incur during the lifespan of the arrangement) a debt of at least £50 million under the arrangement and the arrangement involves the issue of a capital market investment.

In this context, a capital market investment means an investment in commercial paper or bonds which are rated, listed or traded or designed to be rated, listed or traded or which are issued to designated classes of persons as set out in the Financial Services and Markets Act 2000.

(iii) *Public private partnerships*

It will remain possible to appoint a receiver of a project company (which should ideally be a SPV dedicated solely to the project) where the project is a public-private partnership and includes step-in rights.

A public-private partnership project is one for which the resources are provided partly by one or more public bodies and partly by one or more private bodies or one which is designed wholly or mainly to assist a public body in discharging a function.

(iv) *Utility projects*

It will remain possible to appoint a receiver of a project company (which again, should ideally be a SPV dedicated solely to the project) where the project is a utility project and includes step-in rights.

A utility project means a project designed wholly or mainly for the purpose of a regulated business. In this context, a regulated business encompasses those businesses within the following industries: telecommunications, gas, electricity, water, sewerage, postal service, railways and tramways.

(v) *Project finance*

It will remain possible to appoint a receiver of a project company (again which should ideally be a SPV dedicated solely to the project) where the project is a financed project (that is, a project under which the debt is or is expected to be at least £50 million) and includes step-in rights.

This exception is intended to cover large project financings which fall outside the public-private partnership and utilities exceptions. It seems possible that this exception could encompass development and property finance or finance provided for another type of project which is provided to a special vehicle where the finance is provided by one or a syndicate of lenders and exceeds £50 million or its equivalent.

However, the Act is vague as to which transactions are intended to constitute a 'project' and it will remain to be seen, as the new provisions come into play, the situations that the Court considers should fall within this exception.

(vi) *Urban regeneration projects*

It will remain possible to appoint a receiver of a project company (which, as with the other project company exceptions, should ideally be a SPV) where the project is designed wholly or mainly to develop land (in a area outside Northern Ireland) which at the commencement of the project has wholly or partly been designated as a disadvantaged area by the Secretary of State and the project includes step-in rights.

In this context, 'develop' means to carry out:

(a) building operations (which will encompass the demolition of buildings, rebuilding, structural alterations of, or additions to, buildings, the filling in of trenches

and any other operations which are normally undertaken by a person carrying on business as a builder);

(b) any operation for the removal of substances or waste from land and the levelling of the surface of the land; or

(c) engineering operations (which, in this context, will include the formation and laying out of means of access to highways) in connection with the activities mentioned in paragraphs (a) and (b) above.

Although, as mentioned above, it seems possible that the project finance exception could include development finance, this additional exception clearly would include such transactions. In addition, it should be noted that this exception does not include any requirement for a minimum level of finance. As defined, the disadvantaged areas to which this exception applies are the same areas as have been designated disadvantaged areas in respect of stamp duty relief and will therefore cover extensive areas of land within the UK.

(vii) *Financial market contracts*

It will remain possible to appoint a receiver by virtue of market charges, system-charges and collateral security charges taken in connection with the dealing of uncertificated securities within specified financial market regimes.

(viii) *Registered social landlord*

It will remain possible to appoint a receiver of a company which is registered as a social landlord under the Housing Act 1996.

(ix) *Water companies, protected railway companies and licence companies*

It will also remain possible to appoint a receiver of a company which is (i) a company which has been appointed by the Secretary of State to be the water or sewerage undertaker for any area of England and Wales in accordance with the Water Industry Act 1991 (ii) a protected railway company within the meaning of section 59 of the Railways Act 1993, that is, a company which is both a private sector operator and the holder of a passenger licence or a vehicle licence, a station licence or a light maintenance depot licence or (iii) a licence company within the meaning of section 26 of the Transport Act 2000 which will essentially cover companies holding an air traffic licence.

In the future, it is important to remember that the impact of the Act will need to be carefully considered in all secured financing transactions and, in particular, advice sought as to whether the transaction will fall into any of the specified exceptions.

Impact of the Act on LPA and other receiverships

The Act will not affect the law of receiverships beyond removing the right of floating charge holders to appoint administrative receivers.

Therefore, a charge holder will still be able to appoint a receiver, usually under the terms of the charge itself, over fixed assets of a company or pursuant to the statutory power contained in the Law of Property Act 1925.

However, if an administrator is appointed, the appointment of any fixed charge receiver will be frozen and any such receiver may be required to vacate the position if so requested by the administrator. After any such appointment of an administrator is made, no other steps may be taken to enforce any security or to take possession of any property comprised in the security except with the consent of the administrator or the leave of the Court.

Abolition of crown preference - “fund pool”

As a preferential creditor, the Crown can currently claim its debts from an insolvent company ahead of both secured creditors who hold only a floating charge and unsecured creditors. The Act will abolish the Crown's preferential status in certain areas:

- debts due to the Inland Revenue for twelve months prior to the relevant date (that is the date of the liquidation or administration);
- debts due to Customs & Excise for the six to twelve months prior to the relevant date; and
- social security contributions for the twelve months prior to the relevant date.

However, preferential status will be retained for:

- contributions to occupational pension schemes; and
- remuneration of employees for the relevant period.

The Act provides that, in any post-Act administration, a 'fund pool' will be established for the benefit of any unsecured creditors of the company which will rank immediately below the above preferential payments. The fund pool will represent a percentage share of the company's net assets (that is, the amount otherwise available to repay the holder of the floating charge).

The current proposal is that where the net property of the insolvent company exceeds £10,000, the ring-fenced sum will be 50% of the first £10,000, with 20% thereafter, subject to a maximum ring-fenced sum of £600,000. If the net property of the insolvent company does not exceed £10,000, the ring-fenced sum will be 50% of the first £10,000.

The fund pool effectively replaces the preferential creditors and it will ensure that floating charge holders do not reap the benefits of the extra assets available as a result of the removal of the Crown's preferential treatment.

However, if the company's net property is less than £10,000 and the administrator considers that the cost incurred in making a distribution to the unsecured creditors would be disproportionate to the benefits, the administrator can elect not to distribute any sum to the unsecured creditors, for example, if there is a small amount of money available but a large number of unsecured creditors, the cost of making the distributions could potentially absorb virtually all of the money.

The Act also provides that the duty to create a fund pool ceases if the administrator obtains a court order on the ground that the cost of making a distribution to unsecured creditors would be disproportionate to the benefits.

If a company has granted both pre- and post-commencement floating charges, the liquidator will make payments in the following order: (i) fixed security holders (ii) the expenses of the winding-up (iii) the remaining preferential claims (iv) the pre-commencement floating charge holder(s) (v) the prescribed part of the balance to the post-commencement floating charge holder(s) after having made a deduction for the fund pool. It should therefore be noted that one advantage to the holders of existing floating charges will be that they will benefit from the abolition of Crown preference without being disadvantaged by the new requirement for insolvency practitioners to make a fund-pool available to unsecured creditors.

Choice of administrator

If a company or its directors apply to the Court for an administration order, notice must be given to a qualifying floating charge holder. Upon receiving such notice, a qualifying floating charge holder is entitled to apply to the Court for the appointment as administrator of its preferred insolvency practitioner.

The Court shall be obliged to make the appointment unless it considers that the circumstances of the case justify a refusal to do so.

If a company or its directors choose to appoint an administrator pursuant to the new out of court route, they must give to the floating charge holder at least five working days notice in writing of their intention to do so. The floating charge holder may either agree to the proposed appointment or appoint its own choice of administrator. The fact remains, however, that the administrator will be under a fundamental duty to act in the interests of all creditors.

Other changes:

Procedural Changes

- The administrator will now be obliged to send his proposals to creditors within 8 weeks of the administration order and call a meeting of creditors within 10 weeks rather than the 3 months currently allowed.

- The length of administrations has also been curtailed. Under the current draft legislation, administration orders will last for 12 months subject to extensions by the Court for a specific period.

- Unsecured creditors have been given enhanced rights to sue administrators. The draft provisions have lowered the threshold a creditor needs to satisfy to intervene in an administrator's actions. A creditor of a company may also now bring misfeasance proceedings in the administration against an administrator. In those proceedings, if the unsecured creditor can show that the administrator "breached a fiduciary or other duty in relation to the company" or "has been guilty of misfeasance" the administrator may be required to compensate the estate. If an administrator, therefore, conducts a case as if it was an administrative receivership, he may be at risk of a misfeasance claim by one or more of the creditors.

Other changes:

Foreign Companies with UK Assets

The Act empowers the Secretary of State by order to provide for the Insolvency Act 1986 to apply (with or without modification) in relation to a company incorporated outside Great Britain. However, the Act does not enable an administrator to be appointed to such a company at present except for companies incorporated in another EU Member State (except Denmark) having their centre of main interests in England, for the purposes of the EC Regulation on Insolvency Proceedings.

Accordingly, in circumstances where a foreign company has executed a general English law security document which contains fixed and floating charges with the ability to appoint a receiver, it is thought that the charge holder will continue to be able to appoint a receiver in order to enforce the security, particularly where it is not possible for an administrator to be appointed.

Practical Steps for Lenders

- Check your existing security packages to ensure that you have floating charges in place. This will then enable you to use the administrative receivership procedure even after the implementation of the Act.

- Ensure that you do not release any old security, specifically old-style floating charges, inadvertently.

- Ensure that any new floating charges which you take comply with the requirements for a qualifying floating charge.

- Ensure that the event of default provisions contained within your security documents are extended so as to be triggered by an application under the new out of Court appointment procedures.

- Consider carefully and obtain advice as to whether any of the specified exceptions, in particular, the project financing exceptions, will apply to the transactions with which you are dealing.

- Note the increasingly significant role which will be played by SPV's in the various exceptions where it will still be possible to appoint an administrative receiver.

- Note the significance of step-in rights and ensure that where transactions have the potential to fall within the various project exceptions, step in rights are taken in your favour.

Conclusion

In light of the amendments to be introduced by the Act, it is inevitable that, in time, lenders will increasingly find themselves dealing with administrations rather than administrative receiverships. However, as mentioned above, the holder of a floating charge which pre-dates the date upon which the Act comes into force will be able to choose between appointing an administrative receiver under the existing regime or appointing an administrator under the new regime.

Although lenders will have some element of control in the administration procedure in that a holder of a qualifying floating charge will be able to ensure that an administrator of its own choosing is appointed, the duty of the administrator is to act in the interests of the creditors as a whole. Consequently, the interests of the lender will not be paramount to the administrator.

As mentioned above, a holder of a floating charge will no longer have the ability to block an administration. A key element of administration is that the company enjoys a moratorium whilst it is in administration. This moratorium therefore affects the effectiveness of lenders entering into alternative routes of enforcement, for example, enforcement pursuant to the terms of individual security documents or the appointment of LPA receivers. We may, therefore, see lenders seeking to preserve old style debentures for as long as possible. Conversely, bondholders and major unsecured creditors may seek to ensure that companies require their banks to discharge old style floating charges and take charges under the new regime.

As stated above, the Act contains certain exceptions to the general abolition of administrative receiverships and it is inevitable that at least some of the transactions which lenders will be financing will fall within one of these exceptions or can be structured in such a way so as to be covered by one of the exceptions.

For example, it may be possible to structure transactions so as to fall within the capital markets exception. Additionally, there is the project finance exception. Although it is, as yet, unclear as to which projects are intended to be covered by this section, some development and property finance transactions will fall within this exception.

There is also the urban regeneration exception which will certainly encompass development finance transactions. This exception will apply to areas of land which have been designated as disadvantaged areas by the Secretary of State.

The introduction of the 'fund pool' for unsecured creditors is likely to place an increased relevance for lenders on the *Brumark* decision as to whether a charge over book debts is considered to be a fixed or floating charge. If such a charge is considered to be a fixed charge, the lender will receive payment ahead of all other unsecured or preferential creditors. However, if a charge is deemed to be a floating charge and it is created after the date upon which the Act comes into force, payments in respect of the remaining preferential creditors and the 'fund pool' will be made before any payments to the floating charge holder.

It is clear that the Act intends to bring about major changes to the objectives and process of administration as an insolvency procedure. However, whether these changes will prove to be more beneficial and less costly than the existing procedures is something that remains to be seen and will depend on how the provisions of the Act are interpreted and implemented by the Courts.

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The contents of these notes have been gathered from various sources. You should take advice before acting on any material covered in Enterprise Act.

The information in this publication is based on the information available as at August 2003. Please also note that the information is based on draft regulations and the detail of such regulations may therefore change prior to the Act being finally implemented into law.

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