# Golden Oldies: How Traditional Insolvency Law Concepts Are Invaluable in Restructuring

#### **Contributing Editor:**

Sandy Shandro Freshfields Bruckhaus Deringer; London sandy.shandro@freshfields.com

**Editor's Note:** *In this article, we examine* a remedy well-known in Commonwealth legal systems: that of administrative receivership. It is a "remedy" as opposed to an "insolvency process" because it arises by contract and, in theory, has nothing to do with the insolvency of the debtor (save insofar as some of the events of default give rise to the right to exercise the remedy based on a particular financial condition). This remedy is unknown in the United States and continental Europe and is wholly out of step with the modern trend toward "collective procedures." It is a very useful tool in certain circumstances, as it provides a useful increase in predictability.

Just as (we are told) turquoise is the new black, so restructuring is the new M&A. The roots of a restructuring may be simple: liquidity problems, overindebtedness and/or market pressures. But the sophisticated financial products held by most debtors these days require equally sophisticated tools to modify or unwind them and require players who are as familiar with putting together the deals as they are with taking them apart.



Sandy Shandro

That is not to say that the insolvency-biased tools of yore are redundant. In this article, the traditional English law procedure of administrative receivership is described in the context of a US\$2 billion private equity

restructuring recently completed in the United Kingdom. It will be demonstrated that administrative receivership is very much at the heart of modern restructuring law and practice.

### The Context

Polestar is the leading independent printer in Europe, with more than 10 percent of the U.K. printing market and operations in Spain and Hungary (where Polestar is one of the leading printers in each jurisdiction) and France. It was

#### About the Author

Sandy Shandro is head of the Restructuring and Insolvency Group at Freshfields, an international firm with fully integrated offices in all of the major financial and industrial centres of Europe. Ben Jones and Ryan Beckwith of Freshfields Bruckhaus Deringer, London, who were part of the team who advised the steering committee of senior lenders on the Polestar restructuring, also contributed to this article.

formed in 1998 by a series of mergers sponsored by Investcorp, a Bahraini investment fund.

Prior to the restructuring, Polestar's total indebtedness exceeded US\$2 billion. Its creditor profile was very complex, incorporating more than 10 layers of debt and a spectrum of creditors with

Polestar's senior lenders and, exceptionally, a hedge fund that held subparticipations in the senior debt. The restructuring plan that was adopted involved the sale of the group to a bankowned Cayman investment vehicle and its recapitalisation via a debt-for-equity swap and the provision of new monies to the group so as to reduce its bank indebtedness by approximately US\$1.4 billion.

### The Administrative Receiver

The sale of the group was essential to the restructuring. A credible debt-for-equity swap had to leave the equity (and hence control and "hope value" on a future sale) in the hands of those taking the "pain" (i.e., the senior banks). There was not enough time to engage with the former sponsor, whose interests were in any event not aligned with the interests of the banks.

But how to deliver a sale? Could management be trusted to execute the

## European Update

competing interests. A large number of overseas creditors (particularly U.S.-based funds) had bought into the debt, which was trading as distressed on the secondary market. In addition, Polestar had a pensions "black hole" of over US\$250 million on an Financial Reporting Standard 17 (FRS17) basis and over US\$570 million on a buy-out basis.

Polestar's difficulties were compounded by the continuing decline of the printing sector, which in 2006 had claimed a number of its competitors. In Q3 2006, Polestar's financial crisis crystallised and it breached its covenants under its facilities. It was immediately clear that a full-blown restructuring was called for: attempts to find a buyer for the group had failed (largely due to the pension deficit); the sponsor, Investcorp, was unwilling to commit any new funds to support a restructuring; and there were no "easy" sources of untapped liquidity, the group having already been restructured several times.

## The Restructuring

The restructuring was coordinated by a steering committee comprising three of

banks' restructuring? What if a consensual restructuring could not be reached? The answer to these questions came in the form of an administrative receivership. The administrative receivership regime is a tried-and-tested procedure under English insolvency law and, in essence, is a relatively simple tool that can be used by a secured creditor to implement a restructuring deal.

# What Is Administrative Receivership?

Administrative receivership is a contractual remedy available to certain secured creditors. In summary, an administrative receiver may be appointed by a secured creditor holding a floating charge granted by the debtor over the whole or substantially the whole of its assets. The process of appointment is very simple: There is no active involvement of the court. The administrative receiver must be a qualified insolvency practitioner, and typically, in upper-midmarket and top-market deals, two partners from a major firm of accountants will take the appointment. The administrative

30 March 2007 ABI Journal

receiver when appointed takes over control of the management of the debtor; the directors' powers are significantly curtailed, but they remain in office.

From a legal perspective, the administrative receiver occupies a unique position, for his duties are owed primarily to his appointor (i.e., the bank), but for the purposes of performing his activities he is an agent of the debtor, albeit one not owing the typical agent's duty of undivided loyalty to its principal. (This agency relationship was devised as a means for banks to minimise their risk of exposure as a mortgagee-in-possession). In practice, this means that the administrative receiver can, within reason, be counted upon by the banks to deliver their deal. Further, provided that the banks do not direct the administrative receiver, the administrative receiver's status as agent for the debtor will be preserved.

This regime—the availability of administrative receivership as a remedy for the holder of a floating charge—was, however, a victim of the government's policy to foster a "rescue culture." Therefore, save for limited exceptions (such as security securing capital market instruments and project financings), no floating charges created after Sept. 15,

2003, may confer the right to appoint an administrative receiver. We are, therefore, now in a period of "run-off," as those leveraged deals put in place before the prohibition was made are restructured. In its place, and as discussed below in more detail, the government made the administration insolvency procedure more flexible so that an administrator can now be appointed on an extra-judicial basis.

## Advantages of Administrative Receivership in a Restructuring

Control. As suggested above, the banks must take care not to direct the administrative receiver in the performance of his tasks, which could visit upon the banks all the transaction risk otherwise carried by the administrative receiver. The key is to appoint a vigorous, independent-minded practitioner who will protect the banks' position by protecting his own. Nevertheless, in practice there is no disputing the fact that in most cases banks will gain greater deal certainty by appointing the administrative receiver of their choice rather than relying on current management.

No duties to unsecured creditors. Generally, an administrative receiver

owes no duties to unsecured creditors. It is accepted that the interests of unsecured creditors will be adequately protected by the specific duties owed by the administrative receiver to the debtor (such as duties of good faith, and to take reasonable care to obtain the proper price on a sale of assets). Contrast this with the position of directors. Under English law, duties are owed to the debtor's stakeholders; as the financial condition of the debtor worsens, the identity of the stakeholder swings from its shareholders to creditors, for which no distinction is made between secured and unsecured.

Independence. Long gone are the early 1990s, when the prospect of administrative receivership was a threat shouted across the negotiating table. Done properly, administrative receivership can be more than a method of executing the deal. It can also be used as a selling point, as the administrative receiver will have had to carry out his own (limited) due diligence and taken steps to ensure he has discharged his duties to the debtor. Provided that the administrative receiver supports the deal (and it is our experience that a proposed administrative receiver

continued on page 42

Copyright 2007

American Bankruptcy Institute
Please contact ABI at (703) 739-0800 for reprint permission.

## European Update: How Traditional Insolvency Law Concepts Are Invaluable

from page 31

will not shy away from carrying out extensive stress-testing before doing so), he will bring his, and his firm's, reputation to the deal.

Sophistication and resources. The sale counterparty will be the

administrative receiver. In larger restructurings, the administrative receiver is likely to have resources (including sophisticated tax and legal advisers) at hand that are significantly greater than those available to management (whose

structure will be geared to running a business, not restructuring it). Further, the administrative receiver himself will in all likelihood have sector experience. As a result, in certain circumstances the administrative receiver can relieve a

42 March 2007 ABI Journal

substantial burden from management in taking over the sale process.

Mitigation of risk for the banks. English law does not recognise a distinct legal concept of lender liability. However, banks may expose themselves if they become "shadow directors" of the debtor. A shadow director is any person with whose directions or instructions the directors of the company are accustomed to act. At no time is this risk greater than during a restructuring, as the duties of the directors shift toward the banks (and all other creditors) and the banks take an active role in protecting their exposure. An advantage of putting in administrative receivers is that, provided the banks keep at arm's length from the administrative receivers, the risk of successful collateral challenge is greatly reduced on a sale.

# Is Administration as Good as Administrative Receivership?

As mentioned above, administrative receivership is on its way out. However, the essence of this process is still at the very core of insolvency proceedings. The enforcement strategy of an extra-judicial administrator, save where court administration is mandatory, has largely replaced the administrative receiver. Interestingly, the administrator, who acts as both officer of the court and agent of the company, is entitled to exercise all the statutory powers conferred by the Insolvency Act 1986 on an administrative receiver to dispose of property and make distributions.

In circumstances where one has the luxury of choice between an administrator and an administrative receiver, it is more likely than not that the latter will be the better choice from the perspective of a secured creditor. This is because administrative receivership still favours the appointor, whereas an administrator owes his duties to all creditors. Further, there can be significant tax advantages on a sale for the banks if the sale is effected via a pre-packaged administrative receivership rather than an administration.

The majority of restructurings involving the appointment of an insolvency officeholder are pre-packaged sales (where the deal is negotiated before appointment, and appointment occurs as part of the execution steps). Increasingly, concern is being voiced in insolvency circles about the appropriateness of pre-packaged sales by administrators. If those concerns cannot sensibly be resolved, we

may see an increasing reluctance of administrators to enter into pre-packs, or, at the very least, we could see an increased reliance on indemnities provided by the banks.

A significant advantage of administration over administrative receivership is the potential for recognition under the European Insolvency Regulation and chapter 15 of the U.S. Bankruptcy Code.

There is potential for more value leakage in an administration than in administrative receivership. This is a direct result of administration being a collective procedure. There is a cost associated with factoring in the interests of unsecured creditors. The most obvious source of leakage is the requirement for the administrator to set aside a "prescribed part" out of assets otherwise for the account of the floating chargeholder. The size of the prescribed part may not exceed £600,000 (c.\$1.1m). In the context of big-

ticket restructurings, this may not seem significant. However, that sum will be taken as cash and, therefore, will have to be funded—an issue where old debt is being repackaged and there is little new money being provided.

A significant advantage of administration over administrative receivership is the potential for recognition under the European Insolvency Regulation and chapter 15 of the U.S. Bankruptcy Code. For a cross-border restructuring, there may therefore be strong reasons in favour of administration, even where administrative receivership is an option.

### **Conclusion**

Polestar was successfully restructured at the end of 2006. A critical element in that restructuring was the role played by the administrative receivers, who finely balanced their loyalties to their appointors and to the debtor with the result that the deal was executed smoothly and in a considered manner. Although administrative receivership remains a tool available in many current restructurings, for the next wave of leveraged deals to become unmanageably distressed, the similar, but not identical, administration regime may come to the fore.

Copyright 2007 American Bankruptcy Institute Please contact ABI at (703) 739-0800 for reprint permission.

ABI Journal March 2007 43