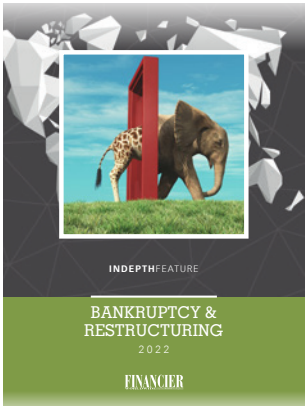

SHEARMAN & STERLING

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BANKRUPTCY & RESTRUCTURING

Financier Worldwide canvasses the opinions of leading professionals around the world on the latest trends in bankruptcy & restructuring.

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Q. Reflecting on the last 12-18 months, how would you characterise the UK in terms of failing businesses and bankruptcy filings?

A. England is a sophisticated jurisdiction with a rescue culture. A balanced and considered approach to restructuring and insolvency has continued and been enhanced throughout the coronavirus (COVID-19) pandemic with the government both implementing temporary legal measures to support businesses and accelerating some permanent changes to the insolvency and restructuring landscape. The temporary COVID-19-related protections for directors and businesses have now ended and, in combination with the cessation of various financial and other government-funded support initiatives, we have seen a moderate rise in insolvency filings, particularly among small firms, albeit from historic lows in 2021, relative to the last decade or so. A positive and permanent change has been the introduction of a Companies Act procedure called a restructuring plan to assist a company in achieving a restructuring without the support of all its creditors. Over the last 12-18 months, several large corporates with complex capital structures have resolved their financial difficulties utilising this tool.

Q. Could you outline the primary macroeconomic trends currently affecting businesses? Are any particular sectors demonstrating structural weaknesses, resulting in distress?

A. Rising inflation, interest rates and energy costs, labour and commodities shortages, and supply chain disruption are the most relevant macroeconomic trends presently affecting businesses. Depending on the type of business, these factors are, to varying degrees, constraining levels of productivity, output and ultimately sales, while simultaneously increasing input, logistics, operational and financing costs. The Ukraine/Russia conflict has exacerbated these macroeconomic trends. The recently imposed sanctions have disrupted supply chains further, while groups with Russian business lines or connections will need to navigate these restrictions carefully as the landscape evolves. The sectors most affected by these trends are those with a heavy reliance on commodities and energy, such as

manufacturing, automotive and industrials. Persistent inflation and high or increasing energy costs, combined with the fact that wages are not rising at the rate of inflation, will, if it has not done so already, start to impact sectors that are dependent on discretionary consumer spending, such as retail, travel, and hospitality and leisure.

Q. Have any recent restructuring trends or cases in the UK captured your attention in particular?

A. While there are a variety of tools and practices that can be used to restructure the debts of both English and overseas companies, the arrival and enthusiastic adoption of the new English law restructuring plan has been a notable trend over the last 12-18 months. The most novel features of the restructuring plan as a matter of English law are cross-class cram-down and the disenfranchisement of classes with no genuine economic interest, who can still be bound to the plan. The combination of these new elements, together with the fact that a plan's procedural elements and case law follow well-established scheme of arrangement principles, means that it has quickly become an attractive restructuring option for companies facing financial difficulties. We anticipate that the trend for restructuring plans will continue, with participants in the restructuring market keenly following instances where restructuring plans are used, especially if that leads to any new opportunities or limits their application.

Q. How easy is it to renegotiate existing debt in the current market? Is there funding available to support distressed companies and finance restructurings?

A. Due to government support measures, vibrant debt capital markets and an oversupply of private capital, 2021 was a record year for refinancings and new money, with many borrowers refinancing their debt stacks on more favourable terms or tapping into previously unavailable funding structures or sources. In that environment, stressed debtors, who might have otherwise struggled to refinance or access liquidity in a less bullish market, were able to recut their entire capital structures. In addition, incumbent financial creditors have generally supported stressed businesses

through the pandemic, including those with pre-COVID-19 challenges, in the form of additional liquidity, amend and extends, payment in kind (PIK) interest and waivers of pandemic-driven covenant breaches. Where creditor consents were not forthcoming, restructuring tools have helped management and shareholders to retain control of businesses. At the start of 2022, the general expectation for the year was a return to normal business operations and a renewed focus on the delivery of business plans. However, that expectation is being challenged by the current macroeconomic turbulence and borrowers will likely face stiffer refinancing challenges than in 2021.

Q. What trends are you seeing in the market's appetite to purchase troubled assets? How would you describe recent distressed M&A activity?

A. The supply of distressed assets has been low in the current cycle, and exceptionally low during the COVID-19 pandemic. The relatively benign economic environment, supportive shareholders, plentiful liquidity and government interventions have combined to provide underperforming businesses with significant assistance to avoid moving from 'underperforming' to 'troubled'. Significant fundraising has occurred over the last couple of years and some special purpose acquisition company (SPAC) structures will be running up against deadlines to deploy, so there is plenty of dry powder out there. Should troubled assets come to market, we believe that there will be significant demand for businesses that have a reason to exist, provided the price is right.

Q. Could you outline some of the personal risks facing D&Os of a company that nears insolvency or enters bankruptcy in the UK?

A. When a company starts to struggle, there is a shift in directors' duties from the company's shareholders to its creditors – the 'zone of insolvency'. At this time, directors should take steps to guard against subsequent allegations of wrongful trading, which occurs when a director knows, or should reasonably have known, that the company could not avoid insolvent liquidation. Judging whether a company is in the zone of insolvency, and whether a director could be liable for

wrongful trading, is not an exact science. To minimise risks, a board should, among other things, meet regularly, consider up-to-date financial information, take regular legal advice on duties and be aware of potential conflicts of interest and entering into transactions which might subsequently be challenged. There are multiple solutions for a company which is experiencing difficulties, and the earlier a board engages with those options, the more likely a successful outcome for the company can be found.

Q. How do you expect restructuring and bankruptcy activity in the UK to unfold for the remainder of this year, and beyond?

A. As the impact of COVID-19 begins to subside, we expect that large corporates may start to exercise more scrutiny over underperforming business lines that have been impacted by the pandemic and assess whether such businesses are core or worthy of support. That may result in increased M&A opportunities, asset sales or business closures. Given that COVID-19 support measures have all but ended and considering continued

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macro headwinds, we expect an increase in defaults, insolvencies and levels of distress more generally this year and into 2023, albeit this is an uptick from a very low base. The most likely pressures to stimulate restructuring activity for debtors will be liquidity difficulties and impending audit requirements. An increase in distress may trigger greater activity in the secondary debt market, which may change the constituency, dynamics and priorities of financial creditor groups and result in the implementation of more fulsome restructuring transactions. ❑

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