Threadneedle Street
London
EC2R 8AH

Fax: (+44) (0)20 7601 5226

Email: fmlc@bankofengland.co.uk

Website: www.fmlc.org

Financial Markets Law Committee

CHAIRMAN:
THE RT.HON. THE LORD WOOLF

25 July 2008

Mr Nick Howard
Director of Policy, Development, Review and International Issues
The Insolvency Service
Policy Unit
Area 5.7
21 Bloomsbury Street
London
WC1B 3QW

Dear Mr Howard,

FINANCIAL MARKETS LAW COMMITTEE
ISSUE 135: EHYA SUBMISSIONS ON INSOLVENCY LAW REFORM

The remit of the Financial Markets Law Committee ("FMLC"), established and partly sponsored by the Bank of England, is to identify issues of legal uncertainty in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

It is from this perspective that I write on behalf of the FMLC, to comment on the European High Yield Association ("EHYA") proposals for the reform of English Insolvency law.[1] The proposals recommend the introduction of a new insolvency proceeding "dedicated solely to restructuring financially distressed companies" and this has become known, colloquially, as a recommendation to introduce "US-style Chapter 11" insolvency rules. The substantive proposals are essentially three: 1) an extended stay on enforcement actions by creditors, including reform of the law on contractual termination provisions; 2) a judicial process for valuing a company to be restructured and resolving disputes between creditors (senior and junior) and shareholders; and 3) the removal of shareholders' (and/or junior debtholders') legal rights to influence the restructuring process once their *economic* interest in the company has been effectively wiped out by its loss of value. The proposals also refer to the desirability of a legislative regime for Debtor in Possession ("DIP") financing.

Those proposals have already been the subject of a number of market-led responses. These include responses from the Insolvency Law Committee and the Financial Law Committee of the City of London Law Society.[2] The gist of the response of the CLLS Insolvency Law Committee was that struggling companies could benefit from an extended moratorium on the exercise of contractual termination provisions (subject to a financial markets exemption) but that wholesale changes to the UK insolvency regime should not be necessary to bring this about. The CLLS Financial Law Committee, on the other hand, wrote to express its strong opposition to any rule prohibiting reliance on contractual rights to terminate for insolvency,

---

[1] As set out in letters dated 23 April 2007 and 22 February 2008 respectively, from the EHYA to the Enterprise Team of HM Treasury. You may be also be aware that the EHYA is an affiliate of the Securities Industry and Financial Markets Association ('SIFMA'). According to the EHYA's letter of the 23 April 2007, the International Committee of SIFMA has approved the EHYA's proposals.

[2] Both addressed to Stephen Leinster at the Insolvency Service and dated 17 January and 18 February 2008, respectively.

arguing that such a rule would "[attack] the fundamental supremacy in English law of party autonomy and freedom of contract".

Against this background, the FMLC wishes to make a couple of general comments in respect of the proposals and a specific one in respect of termination provisions.

The EHYA's proposals reflect a policy view on corporate restructuring which is in line with the US bankruptcy regime in that they strongly favour the "rescue culture" in insolvency proceedings because of the desirability of preserving the value of potentially viable businesses. Their respondents have emphasised in turn the importance of party autonomy in contracts and the perceived commercial value to creditors of knowing that they can enforce the security they have taken. The FMLC is not in a position to comment on the balance of policy considerations in this very important debate. Its Members would observe, however, that the US and UK financial markets are very different, both in principle and in practice.[3] The corollary of these differences is that it might not be possible, let alone prudent, to transplant a regime effectively from one jurisdiction into another, without extensive and consequential changes both to insolvency law and to related areas of law. For example, a move to a "Chapter 11-style" restructuring regime, with the consequent abrogation of the enforcement rights of senior creditors, might have the consequence that providing secured and traditional unsecured financing to solvent businesses was a riskier or costlier proposition for lenders. In other jurisdictions, businesses might turn instead to forms of financing which do not depend on the creditworthiness of the business itself but rather of its customers and counterparties, such as receivables financing and financial leasing. However, the popularity of such forms of financing in other jurisdictions almost certainly depends on legal provision which is favourable to the relevant industry, e.g. the factoring industry. For those industries to expand and flourish to the same extent in the UK might arguably necessitate fundamental changes to the law - inter alia, on the characterisation of title transfer arrangements for security purposes, on floating charges, on the registration of charges, on retention of title and even on the conflict of laws - which would further disadvantage other financial industries such as the securitisation industry and the capital markets. On the other hand, a move to establish DIP financing in this country would probably have a significant impact on the manner in which insolvencies themselves are administered and the way for which they are paid.

Another concern is the compatibility of the proposals with European law. In order to implement the proposed regime effectively, it would be necessary to avoid any conflict with legislation at the European level and, in particular, the Shareholders' Rights Directive ("SRD") (Directive 2007/36/EC), the Settlement Finality Directive (Directive 98/26/EC), the Financial Collateral Arrangements Directive ("FCAD") (Directive 2002/47/EC). It seems unlikely that a withdrawal of shareholders' voting rights, for example, once their economic interest has been wiped out, is compatible with the SRD while it is evident that the FCAD would require an exemption from any administration moratorium in respect of the collateral arrangements to which it applies.

The overriding importance of upholding termination provisions to capital markets and structured finance activities has been well documented over a long period of time. It was recognised at the time that the Enterprise Act was passed in 2000 that its provisions suspending rights of termination should not apply to capital markets activities and that acknowledgement has remained unquestioning and unquestionable. The FMLC wishes to stress that if further amendment to the law on contractual termination provisions is contemplated, the importance of a wide exemption for all bank-to-bank financial activity and for all capital markets activity, including derivatives and structured finance, whether or not involving corporates, is critical. Yet wider exemptions for situations involving the provision of cash, securities or loan collateral will also be required by the SFD and the FCAD.[4]

---

[3] Others have made the point, for example, that the US banking industry is fundamentally different to that in the UK. It consists of a significant number of small and mid-sized banks and financial organisations, whereas the UK markets are largely dominated by fewer, much larger financial institutions. There is no certainty that a regime that works well in the US for small, structurally simple banks would transfer well to the UK.

[4] The FMLC accepts, however, that there are currently cases where the existing provisions on the right to terminate or rescind a contract on administration may produce unfair results. These are eminently the reliance of companies in a dominant bargaining position, e.g. as the sole supplier of parts to a

The FMLC would welcome the opportunity to discuss these issues further with you if that would be helpful.

Yours sincerely

Lord Woolf

manufacturer, on termination provisions to insist on punitive contractual amendments vis-à-vis struggling counterparties.