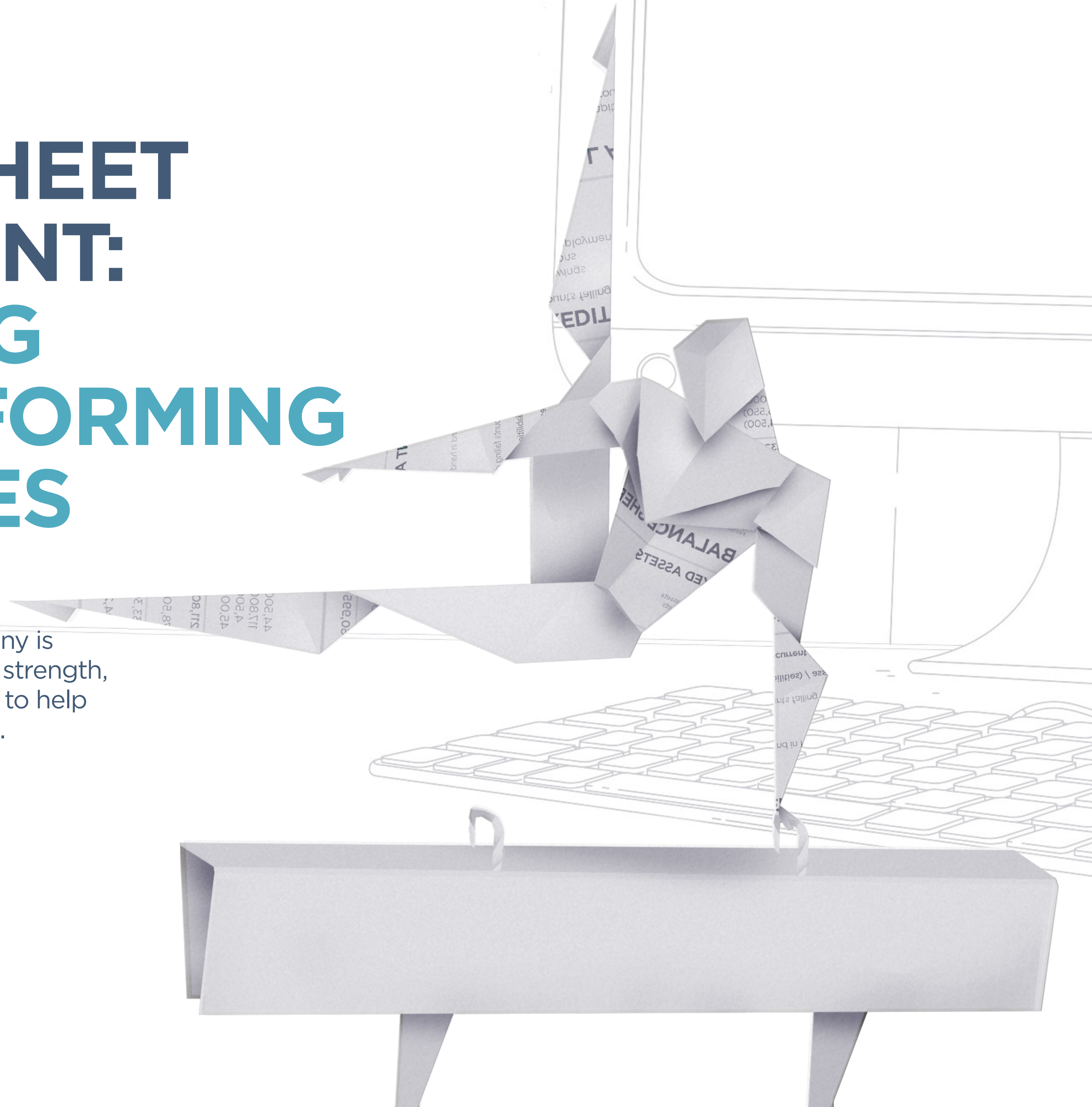
BALANCE SHEET IMPROVEMENT: ADDRESSING UNDERPERFORMING SUBSIDIARIES



Essential points to consider if your company is looking at ways to improve balance sheet strength, whether strategically, opportunistically, or to help repair the damage done by the pandemic.

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60 SECOND BASICS

WHAT IS IT

Corporate shareholders and PE sponsors may see underperformance in a subsidiary, rather than an entire group/ portfolio. The shareholder/ sponsor must decide in a timely manner whether a balance sheet restructuring, capital injection, sale, or solvent wind-down is a feasible course of action, or whether an insolvency is inevitable.

WHY DO IT

- Restructuring certain of the subsidiary's liabilities could successfully optimise its balance sheet, enabling subsequent trading on a going concern basis.
- Conditional capital injections (debt or equity) by a shareholder or sponsor could provide emergency liquidity for an otherwise viable subsidiary.
- An interim moratorium/ administration could provide a subsidiary with 'breathing room' before being rescued as a going concern or, alternatively, be used for a pre-pack or post-pack administration business sale, sometimes to re-acquire it shorn of liabilities.
- A members' voluntary liquidation is a quick and cost-effective method of winding down a solvent subsidiary. 'Underperforming' does not necessarily mean insolvent.
- A formal insolvency 'solution', i.e. administration or liquidation, may relieve directors from an increasing risk of wrongful trading and can preserve the assets and underlying business in a pre-pack sale benefiting many stakeholders in the long term.

WHY AVOID IT

- Distress may be caused by stronger market forces which cannot be remedied long term by lighter restructuring processes (e.g. recent retail restructurings).
- Injecting capital via additional equity risks the sponsors being further 'out of the money' in an eventual insolvency scenario, absent extracting concessions from the subsidiary's other stakeholders.
- Wrongful trading risk for the subsidiary's directors if the subsidiary continues to trade during the 'twilight period'.

WORKOUT ESSENTIALS

CRAMMING DOWN DISSENTIENTS

The new restructuring plan under Part 26A of the Companies Act 2006 enables a debtor to cram down its creditors across different classes, and can be a powerful tool to restructure various liabilities (both secured and unsecured) differentially at the same time, and even where the debtor is a foreign company.

ALTERNATIVE RESTRUCTURING TOOLS

Debtors also have schemes of arrangement and company voluntary arrangements at their disposal, although the former do not have quite the same flexibility as the restructuring plan in dealing with holdout creditors, whilst the latter has no class concept and is only really available in respect of unsecured liabilities. The nature of the subsidiary's balance sheet liabilities will determine which tool is the most suitable.

DOES THE PROPOSED RESTRUCTURING OR INSOLVENCY PROCESS HAVE CROSS-BORDER ELEMENTS?

As a result of the UK no longer benefitting from the EU's restructuring and insolvency frameworks post-Brexit, there may be implications in having to apply to foreign courts for recognition of the applicable UK restructuring process but often it will be recognized readily in many global jurisdictions.

USE OF NEW MORATORIUM PROCESS

Consider whether a moratorium is necessary to protect the subsidiary against hasty creditor action while its options are assessed. The new moratorium process provides protection for 20 business days (and may be extended for a further 20 business days) while a 'light touch' administration enables directors to retain day to day control of the business while benefitting from moratorium protection throughout the administration during which an arrangement or restructuring plan may be proposed.

NEGOTIATING POWER OF THE SPONSOR WHEN PROVIDING DEBT

In situations where a subsidiary urgently needs cash but its lenders are reluctant to provide further financing, sponsors may be able to lend on a super-senior basis, if no funding at all would leave the lenders worse off, and may be able to negotiate debt write-offs by lenders if the value of the sponsor's 'sweat-equity' role is compelling.

SHIFT IN STAKEHOLDER INTERESTS

Directors have a duty to manage the company for the benefit of its creditors (as opposed to shareholders) when they know, or ought to have known, it is probable that the subsidiary will become insolvent as equity value may be negligible at this stage. Any deviation from this duty comes with personal liability risk.

MAINTAINING A DEGREE OF SEPARATION

Shareholders and sponsors should always be mindful of the 'corporate veil' being pierced and potential liability extending to them in the event of the subsidiary's insolvency. Veil-piercing is unlikely absent fraud or other unusual circumstances such as the commingling of funds and improper accounting. Similarly parents/sponsors exerting too much undue control over a subsidiary's board could be held to be shadow directors, with any liability risk for the subsidiary's statutory directors also extending to the parent/ sponsor.

CALLING IT QUITS: CREDITORS' VOLUNTARY LIQUIDATION

While there may be a stigma attached to placing a subsidiary into a CVL process, this may be the only feasible option if a genuine turnaround of the subsidiary is unrealistic. Unlike an MVL, there is no requirement for the parent to ensure that the subsidiary is 'solvent' beforehand. Directors must be cognisant of when to finally 'face the music', especially in a post-COVID economic environment.

GET IN TOUCH

We are helping businesses with a wide range of strategies to improve the strength of their balance sheets. For an informal view on what we're seeing strategically and at the coalface, or to help accelerate your business strategy, please get in touch:

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BALANCE SHEET STRATEGIES ON WHICH WE ARE ADVISING:

- Additional borrowings
- Amendments to share rights
- Bringing intangible assets onto the balance sheet
- Buybacks, redemptions and reductions of capital
- Capital raisings
- Corporate simplification
- Debt for equity swaps
- Diversification
- Divestment
- Replacing equity/investor-sourced financing
- Sale and leaseback of real estate assets
- Sale and leaseback of receivables financing
- Distressed opportunity and special situation investment

WHY ADDLESHAW GODDARD?

WE ACTED FOR **43 FTSE 100 COMPANIES** IN THE LAST 2 YEARS

OUR TIER-1 RANKED CORPORATE LAWYERS HELPED DELIVER **£8BN+ OF STRATEGIC DEALS** LAST YEAR

WE HELPED MAJOR CLIENTS TACKLE OVER **1,000 RESTRUCTURING CHALLENGES** GLOBALLY IN THE LAST 18 MONTHS

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