

Alert | Restructuring & Bankruptcy



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Changes to the Special Administration Regime for UK Water Companies

To modernise the restructuring toolkit available to special administrators, the UK government has introduced changes to the English special administration regime (SAR)¹ for distressed water companies. The changes follow reports of significant stress in the water services sector.

New Changes

- Building on the existing SAR, a new “rescue” purpose for special administrations now applies to a water company which is or is likely to be unable to pay its debts.
- This means a special administrator can seek to ensure the water company exits special administration as a going concern, rather than being liquidated following a transfer of its assets.
- A special administrator will now also be able to “hive-down” assets into a subsidiary in preparation for a share sale with the goal of maximising value in any sale process compared to a sale of the water company’s assets.

¹ A special administration regime in the UK is a system used to manage and reorganise financially troubled but systemically important companies to ensure continuity of services.

Proposed Changes

- There is also a proposal which would enhance the ability of special administrators to dispose of fixed charge property without the consent of the charge holder, which requires that the fixed charge holder need only receive “appropriate value” rather than the standard test of “market value”. This development may lead to an increase in valuation disputes in challenges to administration sales of water company fixed charge assets.

Background

Regulated water supply companies in the UK have recently become subject to new laws which add to, and streamline, the powers of “special administrators” that can be appointed by the government to safeguard the consumer and public interests in the event of an insolvency. These changes to the SAR, some of which have been partially implemented and others of which are still in draft form, may have a significant impact on the interests of stakeholders in water companies, including their shareholders and creditors.

Like other utility companies operating in sectors of national importance, given their position as part of the critical infrastructure of the UK economy and society generally, water companies have previously been subject to the SAR. Whilst to date the SAR has not needed to be used on any water company, in the last 12 months there has been heightened focus on the financial health of operators in the water industry, prompting the government to modernise the SAR in line with comparable regimes for other utility sectors.

The water industry has suffered increased financial stress recently, following periods of high interest rates, unsustainable debt burdens and significant unfunded capital expenditure commitments. In addition, there has been political pressure as a result of poor performance and environmental damage caused by sewage spillages. This is on top of increased regulatory scrutiny and pricing pressures, which in turn has impacted investor confidence in the sector and its ability to raise new equity capital.

The Existing SAR

Special administrators can be appointed to water companies by a petition of the Secretary of State or the water industry regulator, Ofwat. Amongst other grounds, an appointment can be made under the SAR when a water industry company:

- is or is likely to be unable to pay its debts (the “insolvency ground”); and/or
- there has been, is or is likely to be a contravention by the water company of any of its principal duties which are serious enough to make it inappropriate for the company to continue to hold its appointment or licence (the ‘performance ground’).

Like “standard” administration of non-regulated English companies, the SAR takes control of the water company away from the board of directors and places management of the company and its property in the hands of licenced insolvency practitioners, being the special administrators. Unlike other administrations, the trigger for the SAR is not just insolvency but also the occurrence of regulatory breaches by the water company under the “performance ground”. There is no ability for secured creditors who otherwise could appoint an administrator via a court order to do so under the SAR (for example if they had a qualifying

floating charge over the water company) or, without giving 14 days' notice to the Secretary of State, to enforce security.²

The SAR applies to regulated water companies, rather than their holding companies. However, the fate of a water company's subsidiaries will clearly impact the stakeholders of its holding companies, in particular where a holding company's creditors are subordinated to the water company's own creditors, as is often the case with contractual or structural subordination.

Key Changes to the SAR

Prior to the SAR changes, and following their appointment, a special administrator was confined to exercising his/her powers for the purpose of transferring the water company's business to a new provider, thus subjecting the water company to liquidation and then dissolution. Prior to such asset transfer, the purpose of the special administration was to carry on the water company business and ensure continuation of services to UK consumers.

The latest changes expand the scope of the SAR to provide for (i) the rescue of the water company as a going concern and (ii) the ability to "hive-down" the water company's assets to a subsidiary to more efficiently facilitate a sale to a third party in an insolvency.

Rescue:

- A purpose of the SAR now includes the rescue of the legal entity placed into special administration, with the view of that water company restructuring its debt and exiting the SAR as a going concern. This potentially prevents the water company from needing to exit the SAR following a transfer of assets and then a liquidation. The special administrator will only be required to pursue the transfer route if it is not likely to be possible to rescue the water company as a going concern or if a transfer is likely to secure more effective performance of the functions or activities of the water company.
- The rescue option is only available for water companies which enter the SAR via the "insolvency ground". It is not available for water companies that enter the SAR solely by reason of the "performance ground".
- If the remaining SAR draft changes are implemented, a special administrator would be able to rescue a water company subject to the SAR using certain restructuring tools available to English companies generally (but modified for the SAR), including schemes of arrangement, restructuring plans, and company voluntary arrangements. These tools could be used to right-size a water company's balance sheet via write downs (via debt for equity swaps for example) as an alternative to an asset transfer followed by a liquidation of the water company.

Hive-Down:

- Hive-down is a restructuring and reorganisation practice used to ring-fence value in order to attract potential buyers of a business. A hive-down for a water company in SAR can now be achieved by the special administrators transferring all or part of the company's business and assets to a newly created, wholly owned subsidiary, and then selling the shares in that new subsidiary to a third-party buyer.

² One of the proposed amendments under the draft Water Industry (Special Administration) Regulations 2024 clarifies that an administrator may not be appointed in relation to a water company, whether by court order or otherwise, under Schedule B1 to the Insolvency Act 1986.

- Hive-down is attractive to potential purchasers as it could allow them to acquire a “clean” water company which does not come with existing liabilities (which remain with the seller) or surplus assets which are not required by the purchaser. There may also be potential tax efficiencies associated with a sale following a hive-down.
- These features may help to maximise value in the water company in any sale transaction, thereby increasing the proceeds available to the special administrator to apply in the repayment of creditors.

These new options available to a special administrator, once appointed to a water company in the SAR, increase the risk profile for the water company’s investors. The special administrator now has additional tools to clean up a water company’s capital structure, potentially making it more likely that shareholders and subordinated holding company creditors, with no recourse to the water company, will be disenfranchised in a restructuring under the SAR. This means that in an OpCo/MidCo/Holdco structure, typical for water companies in the United Kingdom, the structurally subordinated stakeholders (often PPN holders) will be increasingly vulnerable to operational underperformance and the insolvency of the water company OpCo entity.

Further Changes³

Other key changes to the SAR planned to be introduced are as follows:

Right for special administrators to utilise certain English restructuring tools:

- In unregulated industries, directors and (in theory) creditors of English companies can propose compromises and arrangements with their creditors and members under Part 26 (in relation to schemes of arrangement) and Part 26A (in relation to restructuring plans) of the Companies Act 2006.
- The changes to the SAR would clarify that these “pre-insolvency” restructuring tools are now only accessible for a water company in special administration by the special administrator. In theory, this would not prevent the use of the restructuring tools by the directors prior to the appointment of the special administrator, but in practice, Ofwat may could potentially exercise its right to appoint a special administrator to achieve the purposes referred to above before meetings for a scheme or restructuring plan are convened.

Preferential treatment of funding provided by the Secretary of State:

Where a water company subject to the SAR receives certain funding by way of grants or loans (for example by the Secretary of State), repayment of this funding would receive priority treatment in the special administration, ranking above the special administrator’s own remuneration.

Enhanced ability for special administrators to dispose of fixed charge property:

- The changes would also water down the safeguards the court must apply before sanctioning any disposal of property subject to a fixed charge by a special administrator.
- In a standard administration, a court can permit the disposal of such secured property provided the fixed charge holder will at least receive the “market value” (if greater than the sale proceeds actually

³ The further changes take the form of two draft statutory instruments (The Water Industry Act 1991 (Amendment) Order 2024 and The Water Industry (Special Administration) Regulations 2024), which are currently under review by Parliament, although it is not known when Parliament will vote on them. If passed, they will amend the Insolvency Act 1986, the Companies Act 2006, and the Water Industry Act 1991, as they would apply to water companies in special administration.

received for the assets). The changes to the SAR would modify this safeguard for water companies in special administration, replacing the “market value” threshold with a new “appropriate value” threshold, being “the best price that could be reasonably available on a sale which is consistent with the achievement of the purposes of the special administration”.

- This reference to the purposes of the special administration in justifying value achieved in a sale (rather than to the usual test for market value involving a willing seller in the open market) would potentially increase the risk for valuation disputes in such disposal processes. The new variable may make it easier for the special administrator to sell the fixed charge assets. On the other hand, fixed charge holders may be incentivised to challenge the special administrator’s decisions to sell assets on the grounds that a sale for a lower price is not necessarily consistent with the purposes of the special administration.
- The changes would partially curtail the ability for stakeholders to challenge the decisions of special administrators (compared to standard administrators).

Conclusion

The above SAR changes have been introduced primarily to protect water companies’ customers. The current financial and operational pressures facing water companies have increased the likelihood that a water company will need to be subject to the SAR in the future and, from a UK consumer’s point of view, the changes are particularly timely.

However, the interests of the average water customer and a water company’s financial stakeholders are not always aligned, and the changes may lead to financial stakeholders, such as bondholders and other debt providers, reassessing the risk profile of their investments and adjusting the pricing of their debt accordingly. This may indirectly lead shareholders to be less willing to contribute new capital into a structure given the corresponding increased risk to their equity position.

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