SQUIRE PATTON BOGGS

Squire Patton Boggs has more than 100 lawyers in 25 offices across the US, UK, Europe, Middle East, Asia Pacific and South America working on both domestic and cross-border cases and restructurings. Our UK practice covers all formal categories of insolvency ranging from all forms of receivership, administration and liquidation to bankruptcy and voluntary arrangements. We also have a specialist contentious team. Our clients include clearing banks, asset based lenders, the major accountancy firms and insolvency practitioners and we have particularly strong sector experience in the fields of retail, media and leisure insolvencies, as well as pensions-related insolvency issues.

Sector Focus

Author Cathryn E. Williams

Phones for who? Focus on technology companies

KEY POINTS

- Phones 4U went into administration in September 2014.
- Technology companies in the US have also faced a difficult market.
- Phones 4U's complicated financing structure contributed to its downfall, as did its reliance on one or two key suppliers.
- The Protection of Essential Supplies Order will have considerable ramifications for tech suppliers when it comes into force.

PHONES 4U COLLAPSE: PART 1

Phones 4U Limited, the leading independent mobile phone retailer with an annual turnover of £1bn, went into administration on 15 September, closing all its 720 outlets and placing 5,596 jobs under threat. In the days that followed, the cause of the collapse was bitterly debated across broadcast and print media.

Phones 4U claimed it had a profitable business, but in January 2014 it lost its contract with O2. Later Vodafone announced it would not renew its contract, followed finally by EE who refused to renew its contract with the company when it expires in September 2015. Was the Phones 4U collapse really the failure of a technology company, or were the reasons for failure more complex?

Margins of network operators have in recent times been under increasing pressure, as a result, for example, of the EU stamping down on roaming charges and increasing competition from the service providers themselves (with EE, Vodafone and O2 already having opened 500 stores selling directly to consumers). It has been argued that Phones 4U failed because the network operators were simply trying to squeeze Phones 4U out of the supply chain to maximise their own share of each transaction.

However, there may be other factors at play here. Phones 4U was founded by entrepreneur John Caudwell, but was acquired by private equity firm BC Partners in 2011. In September 2013, Phones 4U placed bonds in the Irish Stock Exchange enabling BC partners to take out its investment. In contract renewal negotiations with Vodafone and EE, Phones 4U blamed its inability to offer more favourable commercial terms to the network operators on the amount of interest it had to service on its bonds. This complex financial structure meant that the company had a large number of Senior Secured Noteholders with whom it needed to negotiate when restructuring was needed to avoid the failure of the company. The bonds are now close to worthless.

No doubt the business was also affected by the general malaise in the high street resulting from consumers' increasing preference for "clicks, not bricks". While Phones 4U also sold online, the rents it had to pay on its large number of retail stores ate into profit margins and made it less competitive than wholly online suppliers.

According to figures provided by R3, the Association of Business Recovery Professionals, there are 55,284 technology and IT firms in the UK. In September 2014, 31.68% of such businesses were considered to have a higher than normal risk of insolvency within the next 12 months. This is significantly higher than the retail sector, where 24.9% of retail businesses have a higher than normal risk of insolvency. Following this logic, a retail business specialising in technology and IT is going to be at particular risk.

A difficult market for US tech companies

This is not just a problem in the UK. In the US, NII Holdings Inc, which provides mobile phone services to millions in Latin America, entered Chapter 11 bankruptcy proceedings in September 2014. It had reported steep revenue declines over several quarters while it sought to upgrade its networks in Latin America, although it is hopeful of agreeing a debt restructuring plan with its major stakeholders shortly.

Last year, Nokia sold its mobile phone manufacturing business to Microsoft. This led to Microsoft cutting more than 12,000 jobs in the US and making a restructuring charge of over $1.1bn dollars. It also led to high value litigation being commenced in August 2014 by Microsoft against Samsung. Samsung was due to pay Microsoft about $1bn in licensing fees to use its technology in gadgets running Google's Android system. Samsung argue that Microsoft's acquisition of Nokia in 2013 invalidated the agreement.

Another US technology company which has recently entered Chapter 11 is GT Advanced Technologies (GTAT), which made sapphire screens for Apple. GTAT partnered with Apple to build the biggest sapphire factory in the world. Apple made a $580m prepayment to fund the factory's start-up costs. Unfortunately, the new iPhone does not use sapphire screens, leading to GTAT's bankruptcy filing.

Teetering on the edge is US electronics giant, Radio Shack. It has 4,485 stores and sells mobile phones, personal computers and other electronic equipment. It has been trying to stave off bankruptcy and has agreed a refinancing with hedge fund Standard General to restock its stores to enable it to continue trading.

PHONES 4U: PART 2

Back in the UK, the good news is that the administrators achieved a sale of 58 stores to EE (saving 359 jobs) and over 140 stores to Vodafone (saving 887 jobs). Dixon Carphone said it would hire the 800 people who worked at Phones 4U concessions in its stores. Unfortunately, the remaining 362 stores (employing 1697 staff) were closed down and 628 jobs were lost at the company's former headquarters in Newcastle-under-Lyme, where it was one of the

Biog box

Cathryn E. Williams is a partner at Squire Patton Boggs where she leads the London restructuring & insolvency team. Email: cathryn.williams@squirepb.com

biggest employers in the region. The administrators retained 720 people on short term contracts to assist with the closure programme.

The *Financial Times* has reported that EE has agreed to acquire Life Mobile from the administrators. Life Mobile was created by Phones 4U last year in an attempt to diversify its offering and avoid total dependence on the existing four UK networks. It had about 85,000 customers and the network was already run by EE under a wholesale agreement, making it easy for EE to take over the contracts directly.

The final point of interest is that the administrators applied to court for an order enabling them to sell the business and assets free from fixed charge security under para 71(1) Sch B1, Insolvency Act 1986. That provides that administrators may ask the court for an order enabling them to dispose of the company's property as if it were not subject to a fixed charge. The court can make the order if it thinks the disposal of the property would be likely to promote the purpose of the administration. Any order will require the administrators to pay to the secured creditors not only the net sale proceeds, but also any additional money the court determines is required to make the net proceeds up to the full amount the secured creditors could have expected to receive on a sale of the property at market value.

How will the Protection of Essential Supplies Order 2014 affect IT suppliers when it comes into force?

After years of lobbying by R3 and others, the Enterprise and Regulatory Reform Act 2013 (ERRA) received Royal Assent in April 2013 and gives the secretary of state power to amend s 233 of the Insolvency Act 1986. This section was originally introduced in 1986 in an attempt to assist insolvency practitioners achieve a business rescue, by ensuring continuity of supply of utilities and telephone services to enable trading during a formal insolvency. In the years since the provision was originally enacted, information technology goods and services have become an essential part of business life. Without computers, the internet, websites and domain names, businesses would grind to a halt, whether they are involved in ecommerce or not.

Demanding "ransom" payments or varying the terms of supply to increase tariffs and recoup arrears can put even greater pressure on the finances of an insolvent business at a critical time, damaging the chances of survival by preventing funds from being used to facilitate a rescue. Such payments may also result in certain creditors effectively receiving "preferential" treatment at the expense of other creditors, obviating the basic insolvency principle of all creditors in the same class being treated equally and potentially resulting in lower returns to other creditors.

The Insolvency Service held a consultation from July to October 2014 called Continuity of Supply of Essential Services to Insolvent Businesses in which it circulated a draft regulation called the Protection of Essential Supplies Order 2014. It is currently analysing the feedback received. While there is no commencement date set, the government has said it wants to see new legislation in force before May 2015. The proposed change would extend s 233 to include:

> "a supply of goods or services...by a person who carries on a business which includes giving such supplies, where the supply is for the purpose of enabling or facilitating anything to be done by electronic means."

The additional goods and services to be included are:

- point of sale terminals;
- computer hardware and software;
- any service enabling the making of payments;
- information, advice and technical assistance in connection with the use of information technology;
- data storage and processing; and
- website hosting.

The wider aim of the policy is to enhance the prospects of successful business rescue, leading to improved returns to all creditors and greater employment preservation. The main policy objectives are:

- preventing essential utility and IT suppliers from withdrawing supply to insolvent businesses by relying on contractual termination clauses;
- preventing essential utility and IT suppliers from demanding "ransom payments" as a condition of continuing supply; and
- clarification that "on-sellers" (intermediate providers) of these essential services would also be subject to the provisions.

There is no doubt that, when this comes into force, this will mean a big change for IT and other tech companies faced with insolvent customers. They have been used to having huge commercial advantage to renegotiate terms or demand payment of arrears due to their ability to terminate supplies of essential IT services. It may put additional pressure on IT companies which are themselves struggling financially. While the proposed regulation contains some protections for IT suppliers forced to continue to supply insolvent customers, this will be a big change for the IT industry. However, their interests are being rebalanced for the greater good of the insolvent business and its creditors as a whole, including its employees.

CONCLUSION

Reflecting on the experiences of Phones 4U, it should be stressed how important it is that the underlying contracts between the parties accurately reflect the commercial deal which they are signing up to (ie, the agreements are clear as to term and termination rights). This is also a lesson of why any business model should avoid being reliant on one or two key suppliers/customers, with no attempt to diversify or have a backup plan in place if one of them pulls the plug.

Further reading

- Selling an online retail business [2013] 6 *CRI* 191
- Private equity investors: entrepreneurial catalysts or risky retail leverage junkies? [2013] 2 *CRI* 63
- LexisNexis RANDI Blog: What do the latest insolvency statistics tell us?