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BRIEFING PAPER

Number CBP8291, 5 December 2019

Corporate insolvency framework: proposed major reforms

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Summary

The Department for Business, Energy & Industrial Strategy (BEIS) has consulted on new proposals aimed at improving the UK's corporate governance and insolvency framework. The overriding aim being to ensure the highest standards of behaviour in those who lead and control companies in, or approaching, insolvency. The three separate consultations were as follows:

- In May 2016, BEIS launched "A Review of the Corporate Insolvency Framework: A consultation on options for reform". It consulted on a package of insolvency reforms all intended to help businesses to continue trading through the restructuring process. The consultation closed on 6 July 2016 and BEIS published a summary of responses on 28 September 2016.
- In March 2018, BEIS published "Insolvency and Corporate Governance". Views were sought on proposals to reduce the risk of major company failures occurring through shortcomings of governance or stewardship, to strengthen the responsibilities of directors when companies are in or approaching insolvency, and to ensure a fair balance of interests for all stakeholders. This consultation ended on 11 June 2018.
- Tackling corporate insolvency and the risks associated with phoenixism was also included in the Autumn Budget 2017 and Spring Budget 2018. The Government announced that it would explore ways to tackle those who deliberately abuse the insolvency regime in trying to avoid or evade their tax liabilities, including through the use of phoenixism. Comments were invited on two potential approaches to this problem: (i) transferring liability from corporates to directors and other officers in certain circumstances; and (ii) joint and several liability for those linked to the avoidance or evasion.

  On 11 April 2018, HMRC published a discussion paper "Tax Abuse and Insolvency". The consultation ran until 20 June 2018 and HMRC published a "Summary of Responses" on 7 November 2018.[1] In this response document, the government said it would legislate in 2019 to 2020 to allow HMRC to take directors and other persons involved in company tax avoidance, evasion or phoenixism jointly and severally liable for tax liabilities that arise from those activities where the company becomes insolvent.[2]

The March 2018 consultation was partly triggered by several high-profile business failures, including BHS Ltd and Carillion plc. On 9 February 2018, Stephen McPartland MP, Chair of the Regulatory Reform Committee, had called on the Government to bring forward proposals to reform the insolvency framework. For many stakeholders, the 2016 consultation was the UK Government's response to the European consultation issued earlier in 2016, which eventually led to EU Preventive Restructuring Framework Directive 2019/1023. Member

[1] HM Revenue and Customs, "Tax Abuse and Insolvency: A Discussion Document - Summary of Responses", 7 November 2018 [online] (accessed 4 December 2019)
[2] See Gov.UK Tax Abuse and Insolvency – Consultation Outcome , 7 November 2018

states have until 17 July 2021 to implement this directive. In both consultations, the government said that it was seeking views on how to ensure that UK insolvency regime retains its "world-leading status", promotes business rescue and remains competitive post-Brexit.

On 26 August 2018, the government published its Response to the March 2018 consultation on "Insolvency and Corporate Governance" and the earlier 2016 review of the "Corporate Insolvency Framework". The Response outlines the major reforms the government will be taking forward. Key proposals include:

- directors responsible for the sale of an insolvent subsidiary of a corporate group to take proper account of the interests of the subsidiary's stakeholders;
- reversal of value extraction schemes;
- investigation into the actions of directors of dissolved companies; and
- strengthening corporate governance in pre-insolvency situations.

In respect of the broader aspects of insolvency law outlined in the 2016 consultation, the specific reforms include:

- The creation of a new flexible restructuring plan procedure that would include the ability to bind dissenting classes of creditors who vote against it (that is, cross-class cram-down provisions).
- The introduction of a new moratorium to help facilitate business rescue. This would enable financially distressed companies which are ultimately viable to benefit from protection against action by creditors (including secured creditors) allowing them to prepare to restructure or seek new investment.
- The prohibition of enforcement by suppliers of termination clauses (so-called "ipso facto" clauses) in contracts for the supply of goods and services on the grounds that a party has entered either: a formal insolvency procedure, the new moratorium or the new restructuring plan. This is to enable companies in financial distress to continue trading whilst they formulate a rescue plan.
- Action to improve the insolvency framework in cases of major failure.

The reforms are designed to reinvigorate the UK's rescue culture by changing and expanding the UK corporate restructuring toolkit, helping businesses to continue trading through the restructuring process. BEIS has described these reforms as being aimed at increasing creditor protection and to strike a fair balance between the rights of the company seeking rescue and the rights of creditors seeking payment of debts.

Collectively, the proposed reforms will involve either legislative reform or further consultation. The timing is unclear; the government has said it intends to bring forward legislation to implement the measures as soon as parliamentary time permits.

This is clearly an area where there is a great deal of focus and development. This Commons' briefing paper considers all three consultations in detail and summarises the key reforms to the corporate insolvency regime set out in the government's Response.

It should be noted that **corporate governance falls outside the scope of this insolvency paper**. However, the final section of this paper does provide an outline of proposed reforms to corporate governance. Further detailed information is provided in a separate Library briefing paper, "Corporate Governance Reform" (CBP8143).

1. Introduction

The UK insolvency regime already has a company rescue toolkit. There are several rescue procedures available, such as a company voluntary arrangement (CVA) and administration.

In brief, a CVA is a compromise or other arrangement with creditors under the Insolvency Act 1986, which is implemented under the supervision of an insolvency practitioner (known as a nominee before the proposals are implemented, and then becomes the supervisor). The arrangement will be binding on creditors if the relevant majorities vote in favour of the proposals at properly convened meetings of creditors and shareholders of the company. However, the arrangement does not affect the rights of secured or preferential creditors, unless they agree to the proposals. Importantly, small companies currently have an optional moratorium (i.e. stay on creditor action) before any CVA is put into place, although the government said in its 2016 insolvency consultation paper that it intends to remove this as it is little used.

Scheme of arrangement is a statutory legal process that allows a company to restructure its debts. The scheme must be approved by the court.

It is not an insolvency procedure under the Insolvency Act 1986; the scheme is referred to in the Companies Act 2006.

Administration is also a legal procedure under the Insolvency Act 1986.[3] A company may be put into administration by court order or by an out of court procedure available to the company itself, its directors or a qualifying floating charge holder.[4] At its heart, administration is a company rescue tool. A statutory moratorium[5] protects a company in financial difficulty from legal actions whilst a survival plan or an orderly wind down of the company's affairs is being achieved. During the process, the company is under the control of an administrator (an insolvency practitioner). By the end of the administration the business may survive, and the company may be rescued, but often the business and the company's assets are sold, and the administration ends in a liquidation.

Administration as a company rescue tool – an insolvency procedure

According to R3 (the Association of Business Recovery Professionals), it can be difficult to rescue a company. Once in financial distress, it can be difficult for a small company to placate its creditors and suppliers, whilst competitors are circling, in order to frame some sort of restructuring agreement. Some large companies and groups also struggle to achieve an out of court restructure or rescue agreement. Their high leverage leaves them more at risk if they suffer any reduction in operating cash flow as they must continue to pay high debt service costs.[6] Large

3 Detailed information about the administration procedure is available in a separate Library briefing paper, "Company administration" (CBP 4915)

4 A **floating charge** is taken over substantially the whole of the company's property as security for borrowings (debentures) or other indebtedness. Whilst solvent, charged assets can be bought and sold during the course of the company's business without reference to the charge holder. The floating charge is said to "**crystallise**" if there is a default. At that stage, the floating charge is converted to a fixed charge. A "**qualifying floating charge holder**" is any creditor (but usually a bank) holding a floating charge which explicitly allows the creditor to appoint an administrator.

5 A statutory **moratorium** applies in administration which protects the company against creditor action (including the commencement of legal proceedings) except with the consent of the administrator or court.

6 "Wrangling reform into the insolvency toolbox", Sarah Paterson & Mike Pink, R3 Recovery publication, summer 2019.

companies and groups are also subject to a highly liquid secondary markets for debt in which new investors trade into the situation and there are many different types of loan investor.[7]

Consequently, large companies in the UK have increasingly come to rely on **schemes of arrangement** in order to implement their restructuring proposals.[8] A scheme of arrangement can be used to bring about a solvent reorganisation of a company or group structure (including by merger or demerger) as well as to effect insolvent restructurings by a wide variety of debt reduction strategies (such as a "debt for equity swap"). The main advantage of this statutory procedure is its flexibility - it contains almost no restrictions on the nature of the arrangement that can be reached between the parties - but it also provides for court oversight and creditor protections.

According to R3 and other insolvency commentators, the scheme of arrangement procedure has proved both adaptable and effective in supporting the restructuring of large, highly leveraged companies. However, the procedure is also criticised for largely involving the investment banking sector and "restructuring boutiques", effectively leaving the insolvency practitioner "on the side lines".[9] Furthermore, the procedure lacks two important features associated with company rescue:

(i) a **moratorium** to keep company assets together while the restructuring is negotiated; and

(ii) the power to impose a restructuring plan on an entire class of dissenting creditors or shareholders, known as a **"cross-class cram-down"** power.

Currently, creditors and shareholders voting on a scheme of arrangement are divided into classes for the purposes of voting according to their rights going into the scheme and the rights which they will acquire under it. A majority in number and 75% of those voting by value is needed in each class for the scheme to be sanctioned by the court. If an entire class votes down the scheme there is no court power to approve it over the wishes of that class. In practice, a "workaround" has been developed whereby the scheme of arrangement is coupled with a pre-packaged administration sale.[10]

In contrast, both a moratorium (i.e. an automatic stay) and a cross-class cram-down power are features of **US Chapter 11 proceedings**. Cross-class cram-down is also a key part of the new EU Preventive Restructuring Framework Directive 2019/1023.[11]

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7 Ibid

8 A scheme of arrangement can be used to bring about a solvent reorganisation Ibid

9 Ibid

10 In situations where there are out-of-the-money shareholders, the company can first be put into administration, allowing the administrator to commence a "**pre-pack**" and subsequently implement the restructuring without the dissenting class blocking the proposed arrangements.

11 Under the Directive, enterprises in each member state should have access to a preventive restructuring framework which enables them to avoid insolvency and to continue operating. In the past, EU insolvency legislation has focused on regulating

Following three separate consultations to strengthen the UK's rescue culture and corporate insolvency framework (see **sections 2** to **4** of this paper), the government published on 26 August 2018 its "Response to the Insolvency and Corporate Governance Consultation. Crucially, it is proposing a new pre-insolvency moratorium and a new restructuring plan modelled on the current scheme of arrangement procedure but offering a cross-class cram-down power. In a further nod to US Chapter 11 proceedings, the government is also proposing a prohibition on ipso-factor clauses.[12] Detailed information on all these proposals is set-out at **section 5** of this paper.

cross-border insolvency proceedings and related issues (e.g. the jurisdiction of the courts, the recognition of the effects of proceedings in other member states, and conflicts of laws). This Directive is the first step in the process of harmonising the EU's diverse insolvency laws.

12 **Ipso facto clause** is a provision in an agreement which permits its termination due to the insolvency or financial condition of a party

2. First consultation: Review of the Corporate Insolvency Framework

2.1 Background

On 25 May 2016, Sajid Javid, then Secretary of State for BEIS announced the Government's ambition to "*make Britain the best place in the world to start and grow a business*". To this end, he was looking at ways to improve the insolvency regime to allow entrepreneurs to restructure in times of difficulty. According to the Government, reform is necessary for the following reasons:

- UK corporate insolvency law has changed little in 20 years.
- Insolvency practitioners are heavily regulated, and over the years, issues around personal liability has meant that some are reluctant to trade a business in administration for any length of time.
- Insolvent businesses are moved on quickly through an asset sale; often unsecured creditors receive next to nothing.

In May 2016, the Insolvency Service launched its consultation, "A Review of the Corporate Insolvency Framework: A consultation on options for reform". Commenting on this consultation, Sajid Javid said:

> […] entrepreneurs have to know that they can restructure when times are tough, without removing much-needed protection for creditors and employees. Getting the balance right will help more businesses survive, save more jobs and, in the long run, increase productivity.
>
> The UK's corporate insolvency regime is already highly regarded. But with the business world becoming ever-more fast-paced and complex, it is time ask ourselves whether – and how – the system can be improved.
>
> To remain at the forefront of insolvency best practice we also need to ask what a "good" regime looks like in 2016. An increasing international focus on company rescue has helped to shift the perceptions of what constitutes best practice; the UK needs to reflect this if our businesses, investors and creditors are to remain confident that the best outcomes can be achieved when things go wrong.[13]

2.2 Government proposals

Box 1: A review of the corporate insolvency framework

Proposals included in this consultation:

- Creating a new moratorium
- Developing a flexible restructuring plan
- Helping businesses to continue trading through the restructuring process
- Exploring options for rescue financing

[13] The Insolvency Service, "A Review of the Corporate Insolvency Framework – A consultation on options for reform", May 2016, [online] (accessed 22 November 2019)

The consultation sought views on reforms that might make a positive difference to the survival of viable companies in financial difficulty, their creditors, investors, lenders and the economy. As outlined in **Box 1**, the Government consulted on four main proposals, namely:

- **Creating a new moratorium.** To provide companies with an opportunity to consider the best approach for rescuing the business whilst free from enforcement and legal action by creditors. The proposed moratorium would last for 3 months, with the possibility of an extension if needed. During the moratorium creditors would have a general 'right' to request information from the insolvency practitioner.[14]
- **Developing a flexible restructuring plan**, which would bind secured as well as unsecured creditors and introduce a 'cram-down' mechanism[15].
- **Helping businesses to continue trading through the restructuring process**, including making it easier for companies to maintain supply contracts that are essential for the continuation of the business. The stated aim being to reduce the possibility of companies in financial difficulties (particularly micro, small and medium enterprises (MSMEs)) being held hostage by key suppliers, harming the prospects of a successful rescue solution.
- **Exploring options for rescue financing**. Currently, rescue financing is permitted as an expense in an administration procedure. The Government is seeking to understand the extent to which the law should be reformed to further develop the market for rescue finance.

It is proposed that these measures would be made available to all entities that currently have access to administrations and CVAs (Company Voluntary Arrangements). [16] According to the government, the reforms would best achieve its aims of rescuing distressed but viable businesses, thereby preserving both value and jobs.[17]

2.3 Response

The consultation closed on 6 July 2016 and the Government published a summary of the responses received on 28 September 2016. According to this summary, a range of views were expressed on the technical detail but there was broad support for the principles behind the

14 The Government was considering extending this provision to all insolvency procedures to improve transparency and provide and additional safeguard for creditors
15 Currently, dissenting creditors may, depending on the procedure, be able to block a restructuring proposal. Under a CVA (Company Voluntary Arrangement), secured creditors can voluntarily join in a restructuring plan, but in practice many never do. The company must then negotiate separate deals with secured creditors, and this may undermine achieving an optimal rescue solution and delay the process, increasing the costs of a rescue and putting the company at greater risk of failure.
16 Ibid
17 WPQ 114813, 27 November 2017

proposals. BEIS said that it would continue to liaise with stakeholders to refine its proposals.

With Carillion plc entering compulsory liquidation on 15 January 2018, questions were asked about the ability of the Insolvency regime to deal with large corporate failures. On 9 February 2018, Stephen McPartland MP, Chair of the Regulatory Reform Committee, called on the Government to bring forward proposals to reform the insolvency framework. He raised the issue with Cabinet Office Minister David Lidington during a meeting of the Liaison Committee to examine the cross-Government response to the collapse of Carillion. Specifically, he asked whether the Insolvency Service had all the resources it needed and whether opportunities had been missed to support the orderly winding-up of Carillion via administration rather than liquidation. Following this meeting, Mr McPartland said:

Liaison Committee: collapse of Carillion

> […] many of the basic insolvency procedures have remained largely unchanged since 2004 and there is a risk that this is making it harder for UK-based companies to avoid insolvency.
>
> The Government needs to respond to the consultation it held 18 months ago and come forward with some proposals to reform the insolvency framework to ensure the UK remains an attractive place for corporate restructuring.[18]

[18] Liaison Committee Oral Evidence: Cross-Government Response to Collapse of Carillion, HC 770, 7 February 2018 [online] (accessed 22 November 2019)

3. Second consultation: Insolvency and Corporate Governance

3.1 Background

On 20 March 2018, BEIS published a second consultation document, "Insolvency and Corporate Governance". In the wake of major company failures, views were sought on proposals to:

- reduce the risk of major company failures through shortcomings of governance or stewardship; and
- strengthen the responsibilities of directors of firms when they are in or approaching insolvency.

3.2 Government proposals for insolvency reforms

Box 2: Insolvency and corporate governance consultation

The main proposals focused on the following:

- Sale of businesses in distress
- Reversal of value extraction schemes
- Investigation the actions of directors of dissolved companies
- Protection for company supply chains in the event of insolvency
- Strengthening pre-insolvency corporate governance

As outlined in **Box 2** above, the consultation document sought views on four main proposals, each is considered in detail below.

1. Sale of businesses in distress

In the UK, many large businesses are made up of groups of companies under common control, usually through a parent company. According to the Government, an advantage of this structure is that it makes it possible to ring-fence higher risk business ventures from those that are more stable and profitable by placing them into separate companies:

> Providing a group company continues to receive sufficient financial support from its parent or other companies in its group, it can continue to trade even if it is making losses and would otherwise have to cease. This enables new start-ups within a group, or loss-making subsidiaries, to receive the time they need to grow or to be turned around. If these attempts are unsuccessful, the rest of the group remains protected from any losses made from a failed company in a group.
>
> The controlling directors and managers of a corporate group may conclude that a loss-making subsidiary should be disposed of. Even where a company is in financial difficulty, there may be some value to a third party in its business as a going concern, although it may need new investment or restructuring to return to profitability. One option for such a company is for it to be sold to new owners (by selling the company's shares). This may provide a

> cash return to the group, removes the need for it to continue funding the distressed company and transfers responsibility for the future operation of the company to its new owners.[19]

There may be value in a distressed subsidiary – even if the owner is unable or unwilling to continue to fund its trading – that makes it attractive to a new investor. The sale of a loss-making subsidiary may, in some cases, be in the best interests of all parties, including:

- stakeholders (such as creditors);
- employees; and
- the subsidiary's pension fund.

New ownership may return it to profitability and prevent its collapse - saving jobs, paying its suppliers and maintaining payments into any pension fund.

A parent company's reckless sale of a distressed subsidiary

However, there is no deterrent to reckless sales. Currently, directors of a holding or parent company cannot be held liable for the sale of an insolvent subsidiary, even if that sale is damaging to the subsidiaries' creditors and stakeholders. The legal position is outlined in detail in **Box 3** below.

Box 3: Current accountability of directors

- The management of UK companies is largely undertaken by its directors, appointed by their shareholders (the "owners") to run them on a day to day basis.
- Directors of UK companies must comply with the legal duties placed upon them; including key duties set out in the Companies Act 2006 and ensure that their companies comply with the law.
- Crucially, directors of an insolvent company must act in the best interests of its creditors.
- If an individual director falls short of the standards required they can be disqualified for up to fifteen years, and the law makes a variety of provisions for them to be made personally liable for losses they have caused.
- By contrast, no similar duties are imposed upon shareholders provided they do not take part in the day to day management of their company (and by doing so act as a director). This reflects the relative responsibilities of the director and shareholder roles, and what can reasonably be expected of a director who manages a business compared with a shareholder who simply holds a stake in its success.
- In many cases, a company's shares will be owned by another company (a 'holding company') and the decision to sell will be made by the holding company's directors.
- However, directors of a holding/parent company cannot be held liable for the sale of an insolvent subsidiary, even if is damaging to the subsidiaries' creditors and stakeholders. Existing company and insolvency law can address the conduct of the directors of the failed company (i.e. the subsidiary) and can challenge certain transactions which have unfairly harmed creditors (e.g. transactions at an undervalue or preference), but it does not readily allow for the conduct or actions of directors of another company (for example a parent company) to be addressed.
- There is currently no legal requirement for a seller to consider the future viability of a business after its sale. This means: (i) there is no formal requirement to review a purchaser's credentials and proposals; and (ii) no duty of care on the part of a seller towards the company's employees or future creditors.
- As a result, the seller (i.e. the controlling directors and managers of a corporate group in the case of a subsidiary) cannot be held accountable for the consequences of the decision to sell the

[19] "Insolvency and Corporate Governance", BEIS, 20 March 2018 [online] (accessed 19 November 2019)

> business, even if a company that was sold subsequently fails, even if the sale contributed to that failure. Similarly, if the purchaser is found to have had no viable way to return the business to profitability, the seller cannot be held accountable for the consequences of the decision to sell the business.

The Government considers that holding company directors should be held to account if they conduct a sale which harms the interests of the subsidiary's stakeholders (such as its employees or creditors), where that harm could have been reasonably foreseen at the time of the sale. In effect, directors would need to satisfy themselves that the sale would lead to a better outcome for creditors than putting the subsidiary into formal insolvency. BEIS explained the position as follows:

> A large subsidiary company within a group may have thousands of employees and smaller businesses may depend upon it for survival. The Government considers that when such a company is in financial difficulty, any decision to sell it outside of formal insolvency proceedings should take into account the interests of its stakeholders. For example, this would include the impact of the withdrawal of the group's financial support from the company being sold and the ability of the purchasing party to provide such support in the future.[20]

Penalties being considered for directors who cause loss or harm include disqualification and personal liability – this would be in line with the existing law. The consultation document makes it clear that the introduction of any new restrictions or penalties should be proportionate. Directors would only suffer penalties in exceptional situations where:

- the group subsidiary was in financial difficulty;
- the directors could not reasonably have believed that the sale was in the interests of creditors;
- the group subsidiary has subsequently entered administration or liquidation; and
- the harm that should have been foreseen has occurred, with creditors suffering losses.

It follows from this where a director reasonably believes that the sale is in the best interests of creditors; where creditors have not been adversely affected following the sale; or where the business does not fail within two years, no penalties would apply.

Two further points should be stressed:

- Beyond a certain point (the Government suggests 2 years from the date of the sale) it will not be appropriate to expect the selling company's directors to be able to predict the longer-term impact on the subsidiary's creditors.
- The proposal does not require there to be any causal link between the sale and the company's failure. The Government considers that it is enough that the director could not *reasonably* have

[20] Ibid

> believed that the sale was in the interests of creditors, and this has been borne out by a worsening position followed by formal insolvency.

There has been various commentary on the fact that the consultation gives no guidance on how intensively the directors of a holding or parent company will have to investigate the viability of a buyer's proposals and assess the impact of the sale on stakeholders. For example, would the directors be entitled to rely on statements made by the buyer? How far up the corporate group would responsibility lie?

Stakeholders' commentary on the proposal

2. Reversal of value extraction schemes

The Government wants all creditors to be treated fairly in an insolvency situation. The consultation sought views on how new powers might be introduced to allow the insolvency practitioner to apply to a court to reverse a transaction (or a series of transactions) considered to have unfairly removed value from a company in the approach to insolvency. Such powers would sit alongside the existing antecedent recovery powers.

Under existing insolvency legislation, once a company formally enters administration or liquidation, the appointed insolvency practitioner can apply to the court to reverse a transaction (or series of transactions) that are unfair to creditors (known as "antecedent recovery powers" (see **Box 4** below).

Box 4: Antecedent recovery powers

The existing antecedent recovery provisions recognise that value may be unfairly extracted from a company prior to insolvency. Office-holders have the right to apply to court to reverse such transactions to bring about a fairer distribution of a company's assets to all creditors.

When considering antecedent powers, two important points should be noted:

- Some antecedent powers apply differently depending on whether the transaction is entered into with people who are **connected** with the debtor company (e.g. a company director).
- Antecedent powers have a **lookback period**.

For certain antecedent recovery powers, where the parties are "**connected**" to the company a longer lookback period applies than where there is no connection. (This reflects the fact that a connected party will have a greater knowledge about the debtor company when entering into the transaction). The situation is best explained by way of an example:

- If a director was repaid a loan in the period before the company went into insolvency, this would be a connected transaction and the lookback period is usually **2 years**.
- Where there is **no connection** with the debtor company (e.g. a trade supplier with no common directors/owners with the debtor company), the lookback period is only **6 or 12 months** (depending on the type of antecedent recovery). This ensures that normal trading activity is not unnecessarily harmed.

In recent years, there has been concern that existing insolvency legislation does not adequately deal with a situation where a company in difficulty (though not yet in administration or liquidation) has been "rescued"' by investors who then extract value. Value extraction arrangements are often complicated and designed to avoid existing protections for creditors. Examples of extracting value arrangements might include:

- management fees;
- excessive interest on loans;
- charges over company property being granted;
- excessive director salaries or other payments; or
- the sale and leaseback of assets.

All these transactions have the potential to unfairly benefit certain parties, whilst putting creditors in a worse position than they would otherwise have been in should that company subsequently become insolvent.

Of course, business rescues will not always fail – many businesses will be turned around and succeed. However, where they do fail, the Government is concerned that some complex financial structures put in place by investors at the time of or after a "rescue" attempt, are unfair to the wider body of creditors:

> Supporting the Industrial Strategy's ambition to create a fair business environment shaped by competition and contestability, the Government wants all creditors to be treated fairly upon insolvency and wants to ensure that there are adequate tools for office-holders to reverse complex transactions that remove value prior to a company's insolvency in order to reach a fairer outcome for creditors.[21]

The Government considers that value extraction schemes are a "hedge" against a turnaround failing; a means of ensuring that the investor does not lose all or most of its investment. It explained the position as follows:

> Some recent insolvency cases have highlighted that value can now be extracted from ailing companies via complex investment schemes or transactions. These do not readily fall within the scope of the existing powers of recovery.
>
> The Government is concerned that the tools available to insolvency office-holders, while appropriate for more simple transactions, may not be adequate to counter all types of transactions which unfairly strip value from an ailing company in the modern world. This may particularly be the case where the company has been previously sold or new investment introduced in a way which unfairly immunises the investor to the extent that in a subsequent insolvency they suffer little or no loss, while others lose out.[22]

In seeking views on how certain transactions (or series of transactions) entered into before insolvency might be challenged, the Government proposed that the introduction of any new recovery tools should only cover "**connected party**" transactions with a lookback period of **2 years** (in line with existing antecedent recovery provisions). The test for challenging a value extraction scheme should be:

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21 Ibid
22 Ibid

> "That the scheme must have unfairly put the beneficiary in a better position than other creditors in a subsequent formal insolvency (liquidation/administration) than would otherwise have been the case."[23]

Some insolvency commentators have suggested that the Government's proposals may make it more difficult to put in place rescue funding. However, the Government said it was a question of adopting a proportionate approach:

> The Government believes that any new proposals to address unfair value extraction schemes must adequately balance the interests of all creditors in receiving a fair distribution with the interests of investors in receiving a fair return on their investment.
>
> […]
>
> The Government wants to ensure that all creditors are treated fairly in a formal insolvency. It believes that, in the vast majority of cases, this happens. However, in a small minority of cases, complex investment structures allow sophisticated parties to unfairly insulate themselves from risk to the detriment of other creditors. Existing legal protections are insufficient to allow insolvency office-holders to unpick these value extraction schemes.
>
> The proposed power will allow such schemes to be tackled by office-holders and so enable a fairer distribution of a company's assets when it fails. The Government also recognises that terms such as "unfairly" and "excessive" may be subjective terms. It is commercially reasonable that the party providing the rescue package will stand to benefit, otherwise there is no incentive to provide the finance. What Government is seeking to address is a transaction, or a series of transactions, that have been set up in such a way that value is being extracted from the company being rescued while at the same time: a) value is not being added to the company, and b) other creditors are being disadvantaged more than is commercially reasonable. Government is seeking views on what the balance should be between these competing interests.[24]

3. Investigating the actions of directors of dissolved companies

The consultation document also explored proposals to extend the Insolvency Service's existing investigative powers into the conduct of directors to cover directors of dissolved companies.

Currently, a limited company can stop trading and close in a variety of ways (see **Box 5** below). The method chosen usually depends on whether the company can afford to pay its debts.

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[23] Ibid
[24] Ibid

Box 5: When might a limited company cease trading and dissolve?

A limited company is a separate legal entity and as such it can be dissolved.
The method chosen to dissolve a company will depend, in large part, on whether it is solvent (i.e. it can pay its debts as and when they fall due).

A. **If the company is actively trading and is solvent, directors can either**:

- apply for voluntary dissolution (i.e. they make an application to get the company struck off the Register of Companies); or
- start a members' voluntary liquidation.

Striking off the company is usually the cheapest way to close it.

B. **If a company is no longer trading, but does not owe any money**, it can simply be left to become dormant. (However, whilst the company remains registered on the Register of Companies, annual accounts and confirmation statements must continue to be submitted.)

It is important to note that Companies House does have the power to compulsorily strike off a dormant company (this is known as "compulsory dissolution".

C. **If the company is insolvent**, the interests of its creditors legally take priority. There are a range of formal insolvency procedures by which a company can be closed (for example, administration, administrative receivership, compulsory liquidation). When a company is dissolved, it effectively no longer exists.

If a company is closed-down by a formal insolvency procedure, the Insolvency Service has the power to investigate the conduct of the directors (see **Box 6** below).

Box 6: Secretary of State's two investigatory powers

The Secretary of State currently has two investigative powers:

- the power to investigate live companies under the Companies Act 1985 and
- the power to investigate the conduct of directors of insolvent companies under the Company Director Disqualification Act 1986 (CDDA 1986).

In its appraisal of these powers, BEIS has provided the following statistics:

- On average, 1,200 directors are disqualified each year following investigation using these powers.
- The net benefit to the market (in terms of creditor damage prevented) for each director disqualified is estimated at over £100,000.
- Disqualification plays an important part in making the UK a safe business environment and maintaining confidence in the market and the limited liability framework.

However, instead of entering a formal insolvency procedure, a dormant company might simply be dissolved. Approximately 400,000 companies are dissolved annually. Owing to a loophole in the current legislative framework, the Insolvency Service cannot investigate the conduct of directors whose companies have been dissolved and removed from the Company Register unless:

- the company entered an insolvency procedure prior to dissolution; or
- has been restored to the Register

The obvious concern is that some company directors avoid being held accountable for misconduct by allowing, or actively causing, their companies to be dissolved instead of putting the company into a formal insolvency process.

According to BEIS, there is evidence of a low-level but recurring theme of directors using dissolution to avoid debts.

Although it is possible for the Secretary of State to act against a director of a dissolved company, it first requires an application to the court to restore the company to the Register. Owing to the time and costs involved, this is only an option in circumstances where the Secretary of State has strong evidence of misconduct.

To close this loophole, the consultation document explores proposals to extend the Insolvency Service's existing investigative powers to cover directors of dissolved companies, and to act against former directors who are found to have acted in breach of their legal obligations. Specifically, the Government sought views on whether the Secretary of State should have the power to:

- require any person to provide such information as may be reasonably requested to allow the Insolvency Service to investigate the conduct and actions of former directors of a dissolved company;
- seek an order disqualifying a former director from being a director of any other company;
- seek an order that the former director financially compensates creditor(s), where the director's actions caused identifiable losses; and
- seek a prosecution where there is evidence of criminal conduct.

Since there is no office-holder's report in the case of a dissolved company, it is envisaged by the Government that the trigger for investigation would be:

- a complaint received from a member of the public;
- a complaint received from a creditor;
- a referral from another government department; or
- a connection to an existing investigation into a 'live' or insolvent company.

The decision to investigate would be taken by the Secretary of State based on whether there is sufficient evidence of wrong-doing (or unfit conduct) and it is in the public interest to do so. Evidence of wrong doing might include:

- behaviour which is to the detriment of creditors when a company is insolvent;
- failure to comply with company law obligations; or
- failure to ensure that a company is properly run.

According to the Government, if this new power were introduced it would strengthen its ability to take rogue directors out of the marketplace:

> It would allow the Insolvency Service to target appropriate cases for investigation without imposing any additional burden on the majority of directors who wish to legitimately dissolve their companies and have not committed any misconduct.[25]

4. Protection for company supply chains

The Government sought views on whether more should be done to help protect payments to suppliers, particularly SMEs, in the event of the insolvency of the customer (usually a much larger company).

Once a large company becomes insolvent, it is unlikely that everyone in the supply chain will be paid. There will inevitably be losers in an insolvency situation. SMEs are particularly vulnerable because they have less leverage to extract payment from a large company. According to the Government's consultation document, the risks are particularly acute in sectors such as construction:

> "[…] where there are often delays in payment and certain contractual provisions can mean firms in the supply chain do not receive final contractual payments for up to a year after work has been completed."

The longer the payment terms (or the later the invoice is paid) the more is owed to suppliers when a customer becomes insolvent. This explains why the survival of SMEs is often threatened when a large company goes into insolvency. The consultation document considered various options, including the following:

- Increasing the use of specific ring-fenced mechanisms to prevent the abuse of contractual clauses (e.g. withholding money as a surety against defects). For example, mechanisms such as Project Bank Accounts (PBAs). A PBA is a ring-fenced bank account from which payments are made directly and simultaneously by a client to members of its supply chain down to second tier suppliers. According to the consultation document, PBAs have trust status, which secures the funds in them which can only be paid to the beneficiaries – the supply chain members named in the account. The obvious advantage of trust status is that in the case of insolvency of the main contractor, monies in the account due for payment to the supply chain are secure and can only be paid to supply chain members.
- Preventing the misuse of certain payment provisions, typically included in construction contracts (for example, the withholding of retention payments, or a proportion of the value of the contract used as surety against defects).
- Revising the amount of the ring-fenced funds in an insolvency known as the "Prescribed Part". There are circumstances in which a set proportion of funds is ring-fenced and paid over to unsecured creditors (which would include supply chain businesses)

[25] Ibid

ahead of the usual order of priority. This provision was introduced in 2003 and the level of funds ring-fenced is set out in the Insolvency Act 1986 (Prescribed Part) Order 2003 and is capped at a maximum of £600,000 - it has not been reviewed since then.

4. Strengthening pre-insolvency corporate governance

Finally, the Government sought views on whether action was needed to strengthen the corporate governance of companies. It focused on the following issues:

- Complex group structures
- Shareholder responsibilities
- Payment of dividends
- Directors' duties and the role of professional advisers

Corporate governance falls outside the scope of this insolvency paper, although **Section 6** does provide an outline of the reforms the government is intending to take forward. Detailed information is provided in a separate Library briefing paper, "Corporate Governance Reform" (CBP8143).

3.3 Response

The consultation ended on 11 June 2018, and BEIS published its "Response to the Insolvency and Corporate Governance Consultation" on 26 August 2018 (see **section 5** of this paper below).

4. Third consultation: Tackling Corporate Insolvency and Phoenixism

4.1 Background

In the Autumn Budget 2017 and Spring Statement 2018, the Government announced that it would explore ways to tackle those who deliberately abuse the insolvency regime in trying to avoid or evade their tax liabilities, including through the use of phoenixism. On 11 April 2018, HMRC published a discussion paper "Tax Abuse and Insolvency". The consultation ran until 20 June 2018.

In a nutshell, phoenixism is the practice of carrying on the same business or trade successively through a series of limited liability entities where each becomes insolvent and transfers its business, but not its debts, to a new entity (see **Box 7** below). There is also a separate Library briefing paper on "Phoenix trading and liability of directors" (CBP4083).

Box 7: What is phoenixism?

- Phoenixism is where the assets of an insolvent business are re-acquired (often at less than their full value) by its former directors (or other closely connected parties) who then set-up a new company involved in the same or similar business. This new company is referred to as a "phoenix company" or a "newco".
- Phoenix trading is often linked to pre-packaged administrations (referred to as 'pre-packs'). A pre-pack is an arrangement under which the sale of all or part of a company's business or assets is negotiated with a purchaser prior to the appointment of the administrator, and the sale contract executed on the appointment of the administrator or very shortly afterwards.

What are the main concerns with phoenix companies?

- Some creditors who are owed money by a failed company are often outraged to find that the directors of these companies may suffer little personal loss and are often able to start up a new business in the same field. To a certain extent this is an inevitable consequence of corporate 'limited liability'. For the purposes of the law, a company is a separate legal entity and if it trades with limited liability its directors and shareholders do not usually retain liability for the company's debts should it become insolvent.
- Legally, there is nothing in law to prevent a director of a failed company from starting a new business 'overnight' if he has acted properly in managing the first company both before and during its insolvency. However, if the director of an insolvent company has deliberately acted to the detriment of creditors, action may be taken against him under both insolvency and company legislation. In certain circumstances, directors may incur personal liability for their acts or omissions in managing the company.

4.2 Government proposals in detail

A key issue is the delay between when a tax liability arises and when it becomes enforceable, enabling a company to go insolvent in the meantime. Furthermore, the pursuit of legal action to clawback assets from a director or shareholder or impose personal liabilities is expensive, carries litigation risk and is subject to variables such as the provision of accurate information and the appetite of the insolvency practitioner to pursue the matter. In its consultation document HMRC invited comments on two potential approaches to this problem:

- transferring liability from corporates to directors and other officers in certain circumstances; and
- joint and several liability for those linked to the avoidance or evasion.

The consultation ran until 20 June 2018 and HMRC published a "Summary of Responses" on 7 November 2018.[26] In this response document, the government said it would legislate in 2019 to 2020 to allow HMRC to take directors and other persons involved in company tax avoidance, evasion or phoenixism jointly and severally liable for tax liabilities that arise from those activities where the company becomes insolvent.[27]

[26] HM Revenue and Customs, "Tax Abuse and Insolvency: A Discussion Document - Summary of Responses", 7 November 2018 [online] (accessed 4 December 2019)

[27] See Gov.UK Tax Abuse and Insolvency – Consultation Outcome , 7 November 2018

5. Government announces insolvency reforms

On 26 August 2018, BEIS published its "Response to the Insolvency and Corporate Governance Consultation, ["the Response"]. In this document, BEIS outlined the major reforms it would be taking forward to further strengthen the UK's corporate governance framework and improve the corporate insolvency framework. The overriding aim being to ensure that "the UK's insolvency regime retains its world-leading status".[28]

In the same document, BEIS also responded to the separate consultation published in May 2016 on broader aspects of insolvency law. It outlined the reforms it would be taking forward to increase creditor protections and achieve a fairer balance in insolvencies. Detailed information is provided below.

5.1 Action to further strengthen the UK's corporate governance framework

See Section 6 of this paper.

5.2 Action to improve the insolvency framework in cases of major failure

Sales of subsidiaries in distress

As soon as parliamentary time allows, BEIS intends to legislate to put in place measures so that a director of a holding company which sells a large subsidiary in financial distress[29] and who does not give due consideration to the interests of the stakeholders of the subsidiary, can be disqualified and made personally liable (via a compensation order) if the subsidiary enters into insolvent administration or insolvent liquidation **within 12 months**.

Importantly, the new measures should not disincentivise rescues or unnecessarily hold directors liable for the conduct of others over which they have no control. The current proposal is to limit the measures so that the legislation will:

- not expose directors to liability or sanction if they had a reasonable belief (at the time of the sale) that the sale would likely

[28] Department for Business, Energy and Industrial Strategy (BEIS), "Response to the Insolvency and Corporate Governance Consultation", 26 August 2018, [online] (accessed 19 November 2019)

[29] As regards the definition of "financial distress" for the proposes of these measures, the March 2018 consultation focused on a situation where at the time of the sale the subsidiary is either insolvent or insolvent but for guarantees provided by other companies or directors in its group. It is unclear whether this test is intended to apply or whether any subsidiary is in scope if it goes into insolvency within 12 months of the sale. If it does apply, it is unclear how insolvency must be tested.

deliver a no worse outcome for the subsidiary's stakeholders than placing the subsidiary into a formal insolvency; [30]

- not create a liquidator or administrator action for personal liability of a director, but will allow for the director to be disqualified;
- only apply where the subsidiary enters into administration or liquidation within 12 months of the completion of the sale; and only apply to sales of large subsidiary companies (i.e. those which do not qualify as small or medium-sized under the Companies Act 2006.

In effect, the Government has sought to strike a balance between encouraging holding company directors to consider the interests of the subsidiary's stakeholders and protecting the holding company directors from liability so as not to deter legitimate business rescue.

However, some commentators suggest that there are concerns for holding company directors and the risk of personal liability could mean that directors are incentivised to put more subsidiaries into insolvency and potentially for more companies to be sold via a pre-pack insolvency process. There are also potential conflicts of interest between the duties the director owes to the holding company and the subsidiary's stakeholders. Other commentators have suggested that in order to establish that they have acted "reasonably" directors of the holding company may have to conduct due diligence on the purchaser, including their creditworthiness. The expectation is that government guidance, once published, will clarify the burden these new measures will impose on directors.

Value extraction schemes - clawing back money for creditors

The government does not propose to introduce new standalone powers to challenge transactions which extract value from companies in the lead up to insolvency. Instead, it intends to legislate as soon as parliamentary time permits to enhance existing recovery powers of insolvency practitioners to deal with value extraction schemes designed to remove value from a company at the expense of its creditors when the company is in financial distress. BEIS is of the view that this is a better approach than introducing a new power.

The Government does propose to change the law so that where a company has provided a preference to a "connected" person there is a presumption that the company is insolvent at the time of the transaction. This aligns the position with that for transactions at an undervalue.

The Government will also consider changes to make it easier for an insolvency officeholder to challenge extortionate credit transactions, whilst recognising the risks being taken by credit providers, and will consider whether changes can be made to other existing provisions to

[30] The government will provide a non-exhaustive list through legislation and/or guidance of matters which the court may take into account in determining the "reasonableness" of a director's beliefs in relation to the impact of a sale (e.g. it may include whether professional advice was sought or whether the board of the holding company consulted with major stakeholders of the subsidiary prior to the sale).

make it easier to pursue antecedent transaction claims. Areas for potential change include:

- addressing uncertainty about whether the granting of security can constitute a transaction at an undervalue; and
- whether a shadow director can be subject to a remedy under section 212 of the Insolvency Act 1986 (remedy against delinquent directors) and dealing with the challenges of pursuing wrongful trading claims against directors.

Investigation of directors of dissolved companies.

The government has stated its intention to legislate to give the Insolvency Service the necessary powers to investigate the conduct of directors of dissolved companies where they are suspected of having acted in breach of their legal obligations. This will involve making amendments to the Company Director Disqualification Act 1986 in order to allow investigation of former directors of dissolved companies without having to restore dissolved companies to the register held at Companies House.

This measure is a response to calls for BEIS to act against the practice of "**phoenixing**" where, to avoid liabilities, a company is dissolved, and another company engaged in the same business is created soon afterwards.

Other insolvency reforms

Under section 176A of the Insolvency Act 1986 and the Insolvency Act 1986 (Prescribed Part) Order 2003, the prescribed part is the part of the proceeds from realising the assets covered by a floating charge[31] which must be set aside and made available to satisfy unsecured debts.

The prescribed part is calculated as a percentage of the value of the company's property which is subject to a floating charge namely, 50% of the first £10,000 of net floating charge realisations plus 20% of anything thereafter, subject to a maximum prescribed part of £600,000.

The Government has said it will increase the current £600,000 cap on the proportion of ring-fenced funds to be paid to unsecured creditors in insolvencies to £800,000. The increase matches inflation since the cap's introduction in 2003.

5.3 Action to increase creditor protections & achieve a fairer balance in insolvencies

In the same August 2018 response, BEIS also responded to the separate consultation published in May 2016 on broader aspects of insolvency law. Specific proposals include:

- The creation of a **new flexible restructuring plan procedure** that would include the ability to bind dissenting classes of

[31] See **footnote 2** for definition of a floating charge

creditors who vote against it (that is, **cross-class cram-down provisions**).

- The introduction of a **new moratorium**. Financially distressed companies which are ultimately viable would benefit from protection against action by creditors (including secured creditors) allowing them to make preparations to restructure or seek new investment.
- The prohibition of enforcement by suppliers of termination clauses (so-called **ipso facto clauses**) in supply contracts on the grounds that a party has entered a formal insolvency procedure, the new moratorium or the new restructuring plan. Thereby enabling distressed companies to continue trading.
- Action to **improve the insolvency framework** in cases of major failure.

BEIS has described the proposed reforms as being aimed at increasing creditor protection and to strike a fair balance between the rights of the company seeking rescue and the rights of creditors seeking payment of debts. Each proposed reform is considered in detail below.

New restructuring plan

The Government proposes the introduction of a new standalone restructuring procedure that may be proposed by solvent or insolvent companies (subject to certain exclusions). It would sit alongside existing schemes of arrangement and CVAs as a new corporate restructuring tool.[32]

Although modelled on schemes of arrangement,[33] a principal feature of the proposed new restructuring plan would be the use of a **cross-class cram down** provisions, which would allow a company to bind **all** creditors including junior classes and shareholders (based on US Chapter 11 proceedings[34]).

Key features of the proposed new restructuring plan procedure, including the eligibility criteria and the proposed legal process to the followed, are outlined in **Box 8** below.

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[32] For a definition of a CVA see page 5 of this paper

[33] For a definition of a Scheme of arrangement see pages 6 and 7 of this paper

[34] In **Chapter 11 proceedings**, cram down occurs when a plan or reorganisation proposed in relation to a debtor is implemented, even though an entire class of creditors votes against the plan. However, this is only permitted where the court deems the plan to be **fair and equitable** to the dissenting class (and any junior classes of creditors) and the claims of the dissenting class are to be paid in **absolute priority** to any more junior claims.

Box 8: Key features of the proposed new restructuring plan procedure

Eligibility:

- There would be no financial entry criteria.
- Certain companies would be excluded from eligibility for the new plan; that is, those excluded from the small company CVA moratorium under **Schedule A1** to the Insolvency Act 1986.
- A company acting through its insolvency officeholders as well as a company acting by its directors would be able to propose a restructuring plan. (Unlike a scheme of arrangement, only a company rather than its creditors may propose a restructuring plan).
- It is not clear what the **jurisdictional test** will be for a company wishing to propose a restructuring plan (e.g. whether it will be a COMI based test (like administration) or a "sufficient connection" test (as for schemes of arrangement).

Process:

- The process will closely resemble that for schemes of arrangement.
- The Response states that a restructuring plan proposal will be circulated to creditors and shareholders and filed at court.
- As in the case of a scheme of arrangement there will be a **first hearing** to examine the classes of creditors and shareholders proposed by the company, the formulation of which may be challenged by creditors and shareholders.
- The Government intends that the **jurisprudence** which has developed in relation to schemes be applied in relation to class formation for the new restructuring plan. If satisfied with class composition, the court will confirm a date for a vote to take place.
- The Government will prescribe certain **mandatory information** which will be required to be provided to creditors/shareholders which may take a form similar to the explanatory statement used in schemes.
- Importantly, the Government does not intend to prescribe the terms or duration of the restructuring plan so as to give a company maximum flexibility to address its financial difficulties. In a departure from the formal scheme process, it is expressly contemplated that creditors or shareholders may submit counterproposals which the court may allow to be put to other creditors and shareholders. However, there is no detail as to the timing and process for counterproposals to be submitted (e.g. it is unclear whether they need to be submitted and assessed before the first hearing or between the first hearing and the vote).
- The Response states that if no counterproposals are submitted or permitted by the court the creditors and shareholders will vote on the proposal. If the requisite voting majorities are met and the rules for imposing a cross-class cram down are complied with, there will be a **second hearing** at which the court will consider whether the relevant requirements have been met and will decide whether to confirm the restructuring plan.

Voting thresholds:

- Voting thresholds would differ slightly from schemes of arrangement: the plan would require the approval of **at least 75% in value** (measured by value of gross debt) of the creditors (and presumably shareholders) in each class (who vote) with the additional requirement that more than half of the total value of unconnected creditors must also vote in favour. [35]
- Even if a class does not vote in favour, a creditor or shareholder may be bound by the plan if the cross-class cram down rules are met.

[35] This removes the "majority in number" requirement applicable in a scheme of arrangement and aligns the voting thresholds to those in a CVA, although in a CVA the requirement is that more than half of the value of unconnected creditors do not vote against the proposal rather than vote in favour.

- As with a scheme of arrangement and CVA, the court's involvement would safeguard stakeholders' rights.
- The court would have absolute discretion as to whether to confirm a plan.
- Creditors and shareholders would be able to submit counter-proposals.
- Safeguards would provide that a dissenting class of creditors must be satisfied in full before a more junior class may receive any distribution or keep any interest under the plan, unless it is both necessary to achieve the aims of the restructuring, and just and equitable in the circumstances.[36]

Cross-class cram down

- Crucially, the plan might still be confirmed by the court even where one or more classes do not vote in favour, provided that at least one class of impaired creditors (i.e. who will not receive payment in full under the restructuring plan) votes in favour of the restructuring plan.
- The restructuring plan legislation will also provide that a dissenting class of creditors must be satisfied in full before a more junior class may receive any distribution or keep any interest under the restructuring plan. This is similar to the rule contained in Chapter 11 of the US Bankruptcy Code, known as the absolute priority rule.
- However, in response to criticism of the inflexibility of the absolute priority rule in Chapter 11, the Government intends that a court may confirm a plan even if it does not comply with the restructuring plan priority rule where non-compliance is necessary to: (i) achieve the aims of the restructuring; and (ii) is just and equitable in the circumstances. Nonetheless the test for overriding the priority rule is intended to create a high threshold.

Comparator:

- In determining whether a plan which effects a cram down of dissenting classes is fair, the test will be whether the plan gives a better outcome to creditors than the next best alternative. This may not necessarily be liquidation (e.g. administration may be a realistic option and deliver a higher value than liquidation).

  Ultimately, it will be for the court to determine what the next best alternative for creditors is.

In respect of this proposed new restructuring plan procedure, some commentators have highlighted cross-border recognition of the plan as being a major issue in practice. Other areas of uncertainty, include:

- The jurisdictional eligibility threshold; that is, to what extent the plan will be available to foreign companies.
- Whether the plan will necessarily involve all stakeholders.
- Whether the requirement for more than 50% of unconnected creditors to approve the plan will operate within each creditor class, or only overall.
- It is suggested that the inclusion of a cross-class cram down provision and the next best alternative comparator may lead to challenges and require more detailed valuation evidence than that submitted in schemes of arrangement where each affected class has a vote.

[36] This is a modified version of the absolute priority rule in US Chapter 11 proceedings. In assessing whether this rule has been satisfied, the curt will consider the next best alternative for creditors. Administration will often be the appropriate comparator, but liquidation may be the only realistic alternative.

It should also be noted that the government has decided not implement proposals to encourage **rescue finance** but has said it will keep the issue under review.

New moratorium

To help business rescue, it is proposed that a new moratorium will be introduced and made available to "pre-insolvent" companies that can meet their obligations as they fall due; that is, companies that will become insolvent if action is not taken but are not already insolvent. The aim being to encourage companies in financial difficulties to engage early with their creditors and consider options for rescue. However, some commentators have questioned how far in the future does the company have to look to for the purposes of determining that it is solvent at the time of entry into the moratorium.

It is proposed that the new moratorium will operate on **a standalone** basis**.** Directors will remain in control of the company during the moratorium (i.e. it is a **debtor in possession tool**); but a "**monitor**" (a licensed insolvency practitioner) will be appointed to supervise the moratorium and to protect creditors' interests.

As with the new restructuring plan outlined above, certain companies would be excluded from eligibility for the moratorium (see **Box 9** below). However, it is unclear from the government's Response whether the proposed moratorium would be available to non-UK registered companies.

Box 9: Proposed eligibility for a moratorium

- The company must not be a company excluded from the CVA moratorium applicable to small companies contained in Schedule A1 to the Insolvency Act (for example the capital markets arrangements exclusions will apply). (The Response notes that the Government intends to repeal the small companies CVA moratorium contained in Schedule A1 to the Insolvency Act 1986).
- A company cannot already be insolvent but should be in a state of "prospective" insolvency. It is not expressly stated in the Response how pre-insolvency is to be determined, but various stakeholders have presumed it will be on a cash flow basis.
- The company must not have entered into a moratorium, administration or a CVA in the previous 12 months.
- The company must not be subject to a petition for a winding up on public interest grounds; where there is a pending winding up petition on grounds other than public interest the court may approve the entry into a moratorium but the out of court filing method is not available.
- Once the moratorium is in place, it must be more likely than not that a compromise or arrangement with creditors can be agreed (in practice this may require the monitor to consult informally with creditors).

  The company needs to be able to meet its current obligations and those incurred during the moratorium as they fall due.

Key features of the proposed moratorium are set-out in **Box 10** below.

Box10: Key features of the proposed moratorium:

Process for obtaining a moratorium:

- The procedure for entry into the moratorium will resemble the current procedure for an out-of-court appointment of an administrator. The new moratorium will be initiated by filing papers at court; the monitor will file a consent to act and confirmation that he or she is satisfied that the eligibility criteria and qualifying conditions are met.
- The monitor must verify that the company has sufficient funds to meet its obligations as they fall due, and that rescue is more likely than not.
- All creditors must receive notice of the moratorium. The monitor must also register the company's entry into the moratorium at Companies House.

Scope and duration of the moratorium:

- The new moratorium would be modelled on the same parameters as the **administration moratorium**.
- The initial moratorium period would be **28 days**, which could be extended by a further 28 days subject to the monitor's confirmation that the qualifying conditions continue to be met. If further extensions are required they must be approved by more than 50% in value of unsecured creditors and more than 50% in value of secured creditors unless the company considers it impractical to obtain creditor votes in which case it can apply to the court for an extension.
- It is proposed that where a statutory procedure such as a scheme of arrangement or CVA has been proposed to creditors before the expiry of the moratorium, but the outcome has not yet been determined (e.g. because a vote is pending), the moratorium will stay in place until the creditors approve or reject the proposal.
- The moratorium would affect both **secured and unsecured creditors** but would not affect the enforceability of financial collateral arrangements (such as security over shares).
- Financial collateral arrangements will also be excluded from the scope of the moratorium.

Creditor protections:

- A requirement for any extensions **beyond 56 days** to be approved by creditors.
- A right to challenge the moratorium at any time. Creditors can challenge the moratorium either on the grounds that the qualifying conditions are not met (or the company is ineligible) or on the grounds of unfair prejudice to creditors at any time during the moratorium.
- A creditor may make a request to the company or the court to lift the moratorium and the same principles will be applied as apply in relation to an application to lift the administration moratorium. But the monitor would not be able to consent to the lifting of the moratorium stay.
- Creditor safeguards are also derived from the monitor's role.
- New sanctions to deter abuse of the moratorium by dishonest or reckless directors.

Supervisory role of the monitor during the moratorium:

- The monitor will assess the eligibility and qualifying conditions at the commencement of the moratorium and for the duration of the process.
- Importantly, the monitor will be obliged to terminate the moratorium if the qualifying conditions (e.g. the company being able to meet its current obligations) cease to be met. (The monitor will have immunity from claims arising from an erroneous termination of the moratorium provided he or she acted in good faith).
- The monitor will be responsible for sanctioning asset disposals outside the course of normal business, and the granting of any new security over company assets.
- It is proposed that a monitor should **not** be prohibited from providing additional services to a company subject to a moratorium (e.g. restructuring advice, or from being appointed as a CVA supervisor or advising in relation to a restructuring plan). However, a monitor cannot take an

appointment as an administrator or liquidator in the 12 months following the expiry of the moratorium.

Costs incurred during the moratorium:

- It is proposed that cost incurred during a moratorium would be given **super-priority status**. In effect, they would be treated in the same way as an expense in an administration and will have priority over any costs or claims in a subsequent administration or liquidation (including the expenses of these procedures).
- The highest priority will be given to the claims of suppliers who are prevented from relying on termination clauses (see below). Other costs rank behind these followed by the fees of the monitor.

Ipso facto clauses

It is proposed that new rules would prohibit the enforcement of so called "ipso facto clauses" (i.e. termination clauses) by suppliers in contracts for the supply of goods and services (or under a contractual licence e.g. of software or patents), where the clause allows a contract to be terminated on the basis that a party has entered:

- formal insolvency proceedings,
- the new moratorium procedure, or
- the new restructuring plan procedure.

Consequently, suppliers will have to continue to fulfil their commitments under their contract with the debtor company. However, suppliers would retain the right to terminate a contract on other grounds permitted by the contract including:

- for non-payment of liabilities incurred following entry into a moratorium, restructuring plan or insolvency procedure;
- by giving notice in accordance with the terms of the contract; and
- for reasons unconnected with the company's financial position or the fact it has entered into a moratorium, restructuring plan, or insolvency procedure.

These rules reflect the US approach to so-called "executory contracts" in Chapter 11 proceedings. Importantly, however, the UK proposals would only cover only supplier arrangements, not general commercial contracts.

The Response states that certain types of financial products and services would be exempt as **special cases**, although no further details are given. In addition, licences issued by public authorities (e.g. regulatory licences) would not be covered by the ipso facto provisions.

Importantly, it is proposed that where a supplier is significantly adversely affected by these measures, it could apply to the court to exercise a right to terminate on grounds of undue financial hardship. In considering such application the court must assess:

- whether or not the supplier would be more likely than not to enter an insolvency procedure as a result of being compelled to continue supply; and
- whether exempting the supplier from the obligation to supply would be reasonable in the circumstances having regard to the effect of non-supply on the debtor company and the prospects of rescue.

For suppliers, this **financial hardship protection** would be a safeguard of last resort. However, the threshold would be high; a supplier would only be able to seek an exemption from the court if continued supply threatens its own insolvency.

Financial hardship protection for suppliers should offer a safeguard of last resort.

In considering these ipso factor provisions (or supplier termination clauses), the following points should be noted:

- In principle the ipso facto provisions apply to all suppliers. This contrasts with the current regime which only provides for continuity of supply of **essential services** such as utilities and IT.
- The measures are a departure from the narrower proposals in the 2016 consultation.
- It is not apparent from the Response, what definition of "goods and services" will be used and the scope of exemptions from the provisions. (For example, would financial products and services be exempt?) The position in relation to asset leasing arrangements is also unclear.
- Depending on the scope of the termination provisions there may be a trend towards negotiating earlier termination triggers in contracts which could defeat the purpose of ensuring continuity of supply.

Looking at the proposals as a whole, various stakeholders (including the Insolvency Lawyers' Association and the City of London Law Society) broadly support the introduction of a wider range of tools into the UK's corporate rescue toolbox. However, some commentators have suggested that the tools are "likely to be too complex and disproportionately expensive for widespread use by SMEs, which are likely to continue to rely on other parts of the insolvency toolbox".[37]

It has also been suggested[38] that the new tools should not be freestanding and available to directors of financially distressed companies, but should instead be included into the current administration regime by the addition of a new schedule, applicable only where the administrator is pursuing the first purpose of company rescue:

[37] "Wrangling reform into the insolvency toolbox", Sarah Paterson & Mike Pink, R3 Recovery publication, summer 2019
[38] Ibid

This approach could balance the adequate protection of creditors by administrators and the courts with concerns that more powerful company rescue tools may be needed for large corporate restructurings in the next decade.[39]

[39] Ibid. p.15

6. Action to further strengthen the UK's corporate governance framework

As already mentioned, in the March 2018 consultation, "Insolvency and Corporate Governance", views were sought on proposals to reduce the risk of major company failures occurring through shortcomings of governance or stewardship. On 26 August 2018, BEIS published its Response in which it outlined the major reforms it would be taking forward (see Section 5 above).

Corporate governance falls outside the scope of this insolvency paper. Detailed information is provided in a separate Library briefing paper, "Corporate Governance Reform" (CBP8143). However, it may be useful to mention here that the government has stated its intention to strengthen the following:

- **Transparency requirements around complex group structures**

  Under existing company law, groups should have clear records on the entirety of their corporate structure, including the identity of all directors of subsidiary companies. It should also be clear to third parties which company within the group structure they are entering into contracts with, and which company within the group owns assets.

  In its consultation, the Government asked whether steps should be taken to improve the governance, accountability and internal controls within complex company group structures. This might include better records of the structure, directors and inter-company positions within a group

  In its Response, BEIS said it would consider various options to increase transparency, including working with industry to improve guidance or introducing a requirement for corporate groups of a significant size to disclose a diagram of their corporate structures, along with an explanation of how corporate governance is maintained through the group.

  Other steps have already been taken to make the relationship between parent companies and their large subsidiaries more transparent. For example, the Corporate Governance Code, overseen by the Financial Reporting Council (FRC), applies to premium listed companies. It seeks disclosure of corporate governance arrangements and material controls (including financial, operational and compliance costs).

  New reporting requirements were also introduced as part of the package of corporate governance reforms announced by the Government in August 2017. Larger companies (including large subsidiaries within groups of companies) are required to disclose their corporate governance arrangements.

- **Shareholder stewardship**

  In its Response, BEIS said it intends to work with the investment community, regulators and other interested parties to strengthen shareholder stewardship. Its aim is to identify means to incorporate stewardship within the mandates given to asset managers[40] by asset owners and establish safe channels through which institutional investors can escalate concerns about the management of a company by its directors.

  The consultation document also referenced the following developments:

  - The Financial Reporting Council's review of the Stewardship Code of 2010.[41]
  - The requirement since 2014 for listed companies to produce risk and viability statements under the FRC's Corporate Governance Code.
  - The Government's commitment to introduce a new statutory requirement on all large companies to report each year on how directors are fulfilling their duty under section 172 of the Companies Act 2006.
  - The Shareholder Rights Directive (2017/828/EU). By introducing minimum level requirements across the EU, this Directive aims "to strengthen engagement and increase transparency":

    > […] to achieve effective and sustainable stewardship amongst institutional investment, asset management and proxy advisers.

- **The UK's framework relating to dividend payments**

  Currently, under the Companies Act 2006, dividends can only be paid out of realised profits that are available for distribution. The directors of a company are responsible for making the assessment about what profits are technically available for distribution and how much should, in fact, be distributed having considered the requirements of company law. In its consultation, the government raised concerns that some large companies had paid out large dividends in the period immediately before their insolvency, in circumstances where net debt was high or there was a large pension fund deficit.

  BEIS stressed that it had no plans to interfere with decisions about dividend payments, these were matters for directors and shareholders. However, it sought views on whether the legal and

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40 E.g. **institutional shareholders** who manage large long-term investments on behalf of pension schemes and other asset owners. They might, due to their size and expertise, play an important role in steering investee companies.

41 Under this Code, investors are expected to base their stewardship approach on a consistent set of principles including: (i) regular and effective monitoring of company performance; and (ii) to set out publicly how they achieve this.

technical framework within which dividend decisions are made could be improved and made more transparent. For example, is the current definition of "distributable profits" fit for purpose? Is there sufficient transparency and accountability to stakeholders for decisions taken by companies on how to allocate capital? In its Response, BEIS said it would take steps to ensure that shareholders of listed companies have an annual say on dividends, if the practice of companies avoiding an annual shareholder vote on dividends by only declaring interim dividends is widespread and investor pressure and the new section 172 reporting requirements[42] do not deliver sufficient redress.

- **Directors' training and guidance**

  Directors' duties are set out in section 172 of the Companies Act 2006;they are expected to exercise independent judgment with reasonable care, skill and diligence. In effect, a director must act in good faith. This duty is owed by the director to the company and cannot be delegated (see **Box 6** below).

  Directors can seek professional advice to help them make important decisions for the company. However, the duties and responsibilities of directors to the company are very different from those of professional advisers. Whilst directors are subject to a statutory duty (section 172), professional advisers are only subject to whatever legislation, standards or supervision applies to their profession and contractual obligations to their client.

Box 6: Section 172, Companies Act 2006

(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to —

(a) the likely consequences of any decision in the long term,

(b) the interests of the company's employees,

(c) the need to foster the company's business relationships with suppliers, customers and others,

(d) the impact of the company's operations on the community and the environment,

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the company.

In its Response, BEIS said it would take steps to ensure that BEIS will bring forward proposals to strengthen access to training and guidance for directors (including raising awareness of their legal duties when making key decisions) and will consider whether some level of training should be mandatory for directors of large companies.

[42] Under the new Companies (Miscellaneous Reporting) Regulations 2018, Directors must now include a separate, clearly identifiable **section 172(1) statement** which describes how the directors have had regard to the matters set out in section 172(1) (a) to (f) of the Companies Act 2006 (see **Box 6** above) when performing their duty under section 172.

- **Improve boardroom effectiveness**

  BEIS has invited ICSA[43] to convene a group of investors and companies to identify further ways of improving the quality and effectiveness of board evaluations (including the development of a code of practice for external board evaluations).

It should be noted that these proposed measures follow the reforms that are currently in progress in relation to executive pay, strengthening the employee and wider stakeholder voice in the boardroom, and corporate governance in large privately held businesses.

43 The Chartered Governance Institute

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BRIEFING PAPER
Number CBP8291
5 December 2019